



**ASIC**

Australian Securities & Investments Commission

**REPORT 54**

# **Getting home insurance right**

## **A report on home building underinsurance**

September 2005

## **Acknowledgements**

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This report was prepared by our Consumer Protection and International Directorate:

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# Contents

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<b>Executive summary .....</b>	<b>5</b>
<b>Estimating rebuilding costs.....</b>	<b>6</b>
<b>Estimating the sum insured and mass disasters .....</b>	<b>8</b>
<b>Updating the sum insured.....</b>	<b>8</b>
<b>Policy design .....</b>	<b>9</b>
<b>Consumer choice and shopping for cheaper cover .....</b>	<b>10</b>
<b>The way forward .....</b>	<b>11</b>
<b>Further work by ASIC .....</b>	<b>11</b>
<b>Section 1: Exploring the problem.....</b>	<b>12</b>
<b>The implications of underinsurance.....</b>	<b>13</b>
<b>Our project .....</b>	<b>13</b>
<b>Facts and figures.....</b>	<b>14</b>
<b>What is underinsurance and how is it measured? .....</b>	<b>14</b>
<b>How prevalent is underinsurance?.....</b>	<b>15</b>
<b>Section 2: Estimating rebuilding costs .....</b>	<b>19</b>
<b>Why is it important? .....</b>	<b>20</b>
<b>Who estimates rebuilding costs?.....</b>	<b>20</b>
<b>Methods of estimating rebuilding costs.....</b>	<b>22</b>
<b>Estimating supplementary costs .....</b>	<b>26</b>
<b>Limitations on assistance from insurers .....</b>	<b>27</b>
<b>Section 3: Web-based calculators .....</b>	<b>30</b>
<b>Why is it important? .....</b>	<b>31</b>
<b>ASIC's review .....</b>	<b>31</b>
<b>How calculators estimate rebuilding costs .....</b>	<b>32</b>
<b>Range of estimates .....</b>	<b>33</b>
<b>Cost per square metre .....</b>	<b>34</b>
<b>Updating web-based calculators.....</b>	<b>35</b>
<b>Gaps in calculator prompts .....</b>	<b>36</b>
<b>Section 4: Updating the sum insured .....</b>	<b>38</b>
<b>Why is it important? .....</b>	<b>39</b>
<b>How does it work?.....</b>	<b>39</b>
<b>Increases in building costs .....</b>	<b>41</b>
<b>Changes to building codes or council requirements .....</b>	<b>43</b>
<b>Home improvements .....</b>	<b>44</b>
<b>Effect of GST .....</b>	<b>45</b>
<b>Gap between date of policy and date of claim .....</b>	<b>45</b>

<b>Section 5: Policy design</b> .....	<b>46</b>
<b>Why is it important?</b> .....	<b>47</b>
<b>Different ways of covering costs</b> .....	<b>47</b>
<b>Policy design and mass disasters</b> .....	<b>50</b>
<b>Policy design and supplementary costs</b> .....	<b>52</b>
<b>Section 6: Consumer choice</b> .....	<b>62</b>
<b>Why is it important?</b> .....	<b>63</b>
<b>Do consumers know they are underinsured?</b> .....	<b>63</b>
<b>Can consumers pay less for more cover?</b> .....	<b>64</b>
<b>Issues for consideration</b> .....	<b>67</b>
<b>Section 7: Other issues</b> .....	<b>68</b>
<b>Averaging clauses</b> .....	<b>68</b>
<b>Strata schemes and community title</b> .....	<b>68</b>
<b>Standard cover</b> .....	<b>69</b>
<b>Brokers</b> .....	<b>70</b>
<b>Claims handling practices</b> .....	<b>70</b>
<b>Appendix A: Project scope and methodology</b> .....	<b>71</b>
<b>Project methodology</b> .....	<b>71</b>
<b>Companies and brands surveyed</b> .....	<b>74</b>
<b>Appendix B: Review of web-based calculators</b> .....	<b>75</b>
<b>Description of homes</b> .....	<b>75</b>
<b>Appendix C: Experiences from the ACT bushfires...</b>	<b>78</b>
<b>Overview of ASIC's survey</b> .....	<b>78</b>
<b>Incidence and extent of underinsurance</b> .....	<b>80</b>
<b>Claims experience and satisfaction levels</b> .....	<b>82</b>
<b>Appendix D: Comparison of premiums and sum insured</b> .....	<b>85</b>

# Executive summary

*'The single greatest insurance lesson from the bushfires of 18 January 2003 is that in the event of a total loss, one is probably destined to be underinsured whatever one's prior good judgement and advice. Make a poor judgement or obtain bad advice and the outcome can be financial ruin, often at a time in life that precludes full recovery. There is little, if any, room for error.'*

A consumer responding to ASIC's ACT bushfire survey, 2004 (Case 35)

The level of underinsurance in Australia is high. Recent surveys in Australia suggest that between 27% and 81% of consumers were underinsured by 10% or more against current rebuilding costs.<sup>1</sup>

The financial impact for individual consumers can be severe, as shown by the aftermath of the 2003 Canberra bushfires. Many of those who lost their homes were unable to rebuild due to inadequate insurance cover, prompting ASIC to investigate the level and causes of underinsurance.

Some consumers reported that the scale of the disaster contributed to the extent to which they were underinsured. However, many of those affected were underinsured for reasons generally applicable to the Australian community.

This report identifies the following reasons for consumers being underinsured:

- Standard home building policies in Australia place the burden of estimating rebuilding costs on the consumer (unlike policies in some other countries). This is an intrinsically difficult task, requiring technical knowledge.
- Consumers place great reliance on their insurer for help in estimating rebuilding costs. However, only a small number of insurers provide consumers with access to reliable or comprehensive tools for estimating the cost of rebuilding their home.
- Consumers and insurers may not increase the sum insured over time to keep up with changes in building costs generally, or consumers may not increase their level of cover after renovating the home.
- Home building policies are complex and difficult for consumers to compare, so that they may not appreciate the extent to which they may be underinsured due to variations in the cover offered by different insurers.

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<sup>1</sup> Survey of 1000 consumers by Reed Business Information Systems in 2000, and survey of seven major home building insurers in 2002.

- Consumers may make a choice (whether adequately informed or otherwise) to accept a degree of underinsurance on their home.

This report presents findings and recommendations on underinsurance based on our research. The appendices to the report provide additional information.

## **Estimating rebuilding costs**

Consumers generally need specialist assistance to estimate rebuilding costs, ASIC's research indicates that it is not practical for them to obtain this help from a builder, architect or quantity surveyor (even though they are often referred to such professionals for advice). This means that consumers are either left to their own resources or must rely on the insurer.

Consumers are therefore likely to accept rebuilding estimates produced with tools provided by insurers as authoritative, given:

- the lack of alternative methods for obtaining estimates of the sum insured, and
- their perception of these estimates as having been approved or endorsed by the insurer (despite any disclaimers).

### **Methods for estimating the sum insured**

Apart from an onsite appraisal by a qualified expert, tools available to estimate rebuilding costs use two main methods:

- The *cost per square metre* method uses a simple calculation based on the size of the house and the material it is built from.
- The *elemental estimating* method involves assessing in detail different elements of the building (including individual features of the home) to price rebuilding costs 'from the ground up', using local wage and material rates and other construction data. A detailed series of questions enables these costings to be applied to the individual house.

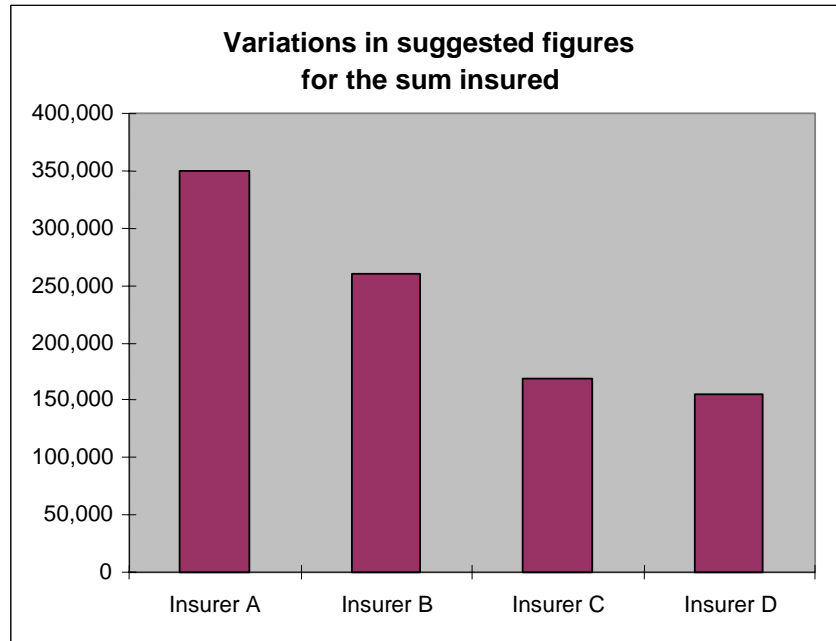
ASIC's research indicates that the elemental estimating method is likely to be more accurate than the cost per square metre method, as it takes into account features of the individual home and a greater range of factors influencing rebuilding costs.

### **Web-based calculators**

Many insurers now help consumers estimate rebuilding costs by providing them with access to web-based calculators. We reviewed the calculators offered by nine major insurers in the course of this report, and did a 'road test' to see what figures they produced for the sum insured for five different properties. Some calculators used the cost per square metre method, while others used elemental estimating.

Our review found that there were significant inconsistencies in the figures generated by these calculators. The largest gap between the lowest and highest estimates was 169%. In other words the highest estimate was more than two and a half times the lowest estimate for the same house in the same location.

The following chart illustrates the range of estimates that insurers provided, through their calculators, for a Federation period house in Melbourne. It sets out the figures suggested by four different calculators.



The estimates range from \$349,265 by Insurer A (using the elemental estimating method) to \$155,040 by Insurer D (using the cost per square metre method), a difference of \$194,225 or 125%. The difference between the highest and lowest estimates is likely to be greater for Federation homes due to distinctive features not identified through the cost per square metre method (such as steeper roofs, ornate cornices or leadlight windows).

These features are not detected in the questions asked about the consumer's home, and are therefore not taken into account in the calculation of rebuilding costs. Consumers using cost per square metre method calculators where the cost of rebuilding is increased by such 'invisible' factors are at particular risk of being underinsured.

While the degree of variation is likely to be greater in cases involving features invisible to the cost per square metre method, there were significant differences in the estimates for each house tested. The smallest variation between the highest and lowest estimates was sizeable, at 42% (on figures of \$209,000 and \$298,000 for an ACT home). This suggests that the risk of

consumers being underinsured is widespread. However, in the absence of alternative information they are likely to accept the figures generated by calculators as convincing.

We therefore consider that where insurers offer tools to consumers for estimating rebuilding costs, those tools should use the most reliable methods available.

## **Estimating the sum insured and mass disasters**

Where a number of homes are destroyed at the same time, as in the case of mass disasters, there is a risk that there will be a jump in building costs. Reports suggest that building costs increased by 75% after Cyclone Tracy in Darwin in 1974.<sup>2</sup>

Virtually all consumers will be underinsured where there are increases in rebuilding costs of this scale after a mass disaster. A consumer who has correctly estimated the rebuilding costs if their home was destroyed in a 'one off' event will be underinsured where there are widespread losses.

This position is both problematic for consumers and economically inefficient, in that the only way a consumer can avoid being underinsured against this type of increase in costs at the time of claim is to be overinsured when taking out the policy. An alternative approach is for insurers to make *extended replacement* policies more widely available. Under these types of policies, insurers increase the payment in the event of a mass disaster to cover higher rebuilding costs (typically an additional 20% to 50% of the sum insured)

We are aware of only one insurer that offers this type of cover in Australia, and its policy is only available in respect of strata title properties. However, this type of policy is common in the United States.

## **Updating the sum insured**

Insurers generally encourage consumers to review their level of cover each year on renewal of the policy. Even if the consumer accurately assessed the initial rebuilding costs, there is a risk that they will become underinsured where:

- The sum insured is increased annually, either by the consumer or the insurer, but the amount of the increase is insufficient to cover rebuilding costs, so that a gap develops between the level of cover and the amount required to rebuild the property.
- It can take only a short number of years for a significant gap to arise. ASIC has identified three measures used by insurers to increase the sum insured under their policies: the consumer price index (CPI), the

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<sup>2</sup> See [www.chu.com.au/index](http://www.chu.com.au/index).



house building index (HBI) and a specialist building cost index, known as CHIP. Between March 2000 and March 2005, the HBI increased by 12%, the CPI by 17%, and CHIP by 33%. If these increases are applied to an initial sum insured of \$200,000 in March 2000, then, after five years, the figure for the sum insured using the CPI would be \$31,000 lower than if the sum insured had been increased by CHIP.

- The consumer does not increase the sum insured following improvements to their home. A 2003 survey by the Royal Automobile Club of Victoria (RACV) found that 24% of consumers did not increase the level of cover after renovations costing between \$20,000 and \$40,000.
- The consumer renovates their home but only plans to increase the sum insured on renewal of the policy, and the property is a total loss prior to renewal. The 2003 RACV survey found that 60% of consumers only increased the level of cover after the renovations were complete.

## Policy design

The risk of the consumer being underinsured varies according to the type of policy selected. Insurers cover rebuilding costs in different ways. These differences are not easily identified or understood by consumers, but can make a significant difference to the amount they will receive in the event of a claim.

This is particularly true in relation to supplementary costs, such as the cost of alternative accommodation and architects' fees. Where the house is completely destroyed, variations in cover can make a significant difference to the amount the consumer will be paid. Situations can arise in which the consumer will be underinsured due to restrictions in the policy, even where they have correctly estimated rebuilding costs and have received the maximum amount payable under the policy.

We encourage insurers to explore whether it is commercially viable to:

- make *total replacement* policies more widely available, as under these policies the insurer agrees to pay all rebuilding costs, and not simply those costs up to a specified maximum figure. Under these policies the onus of estimating rebuilding costs shifts to the insurer. At least one insurer in Australia offers this type of policy, although they are more common in New Zealand and the United States.
- offer *extended replacement* policies, which provide cover to meet potentially higher rebuilding costs in the event of a mass disaster, and
- review limits on payments for *supplementary costs* (such as architects' fees or alternative accommodation) to ensure that any caps

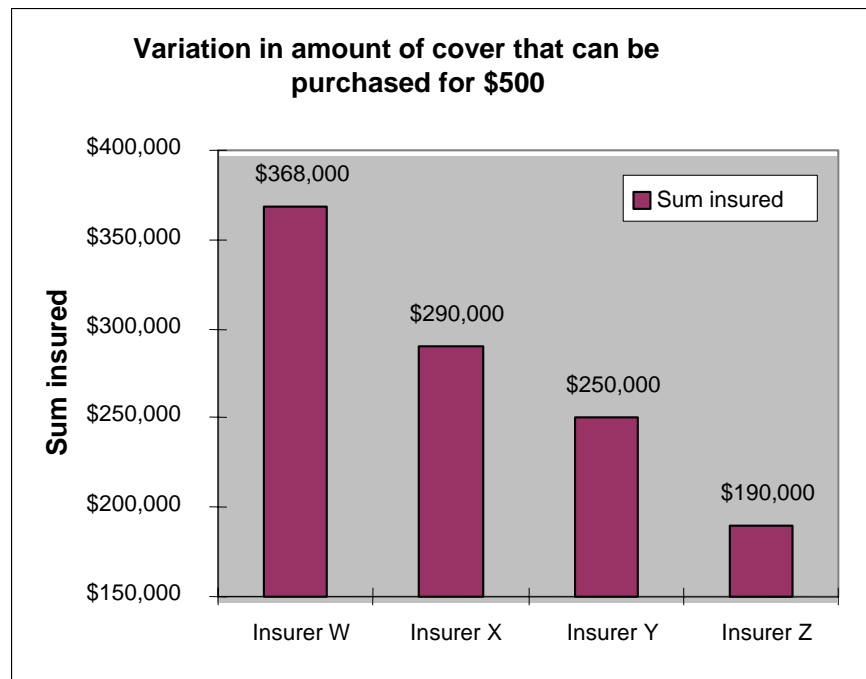
on cover are generally based on the likely level of costs the consumer will incur, or that consumers are made aware that the policy may not meet all the costs they are likely to incur in rebuilding.

## Consumer choice and shopping for cheaper cover

In at least some cases, consumers make a conscious decision to underinsure, or take no action to increase the sum insured, when they know or suspect they are underinsured. However, it is difficult to determine the extent to which underinsurance may be a deliberate choice rather than the result of barriers such as price or obtaining accurate information about rebuilding costs.

Websites provide an efficient means for consumers to compare prices between different insurers. Their increased use could reduce the level of underinsurance, to the extent this is due to price. ASIC also reviewed the cost of cover online, as part of its survey of websites. This review found significant variation in the cost of cover between insurers.

The following chart sets out the differences in the sum insured that can be purchased for the same premiums from four insurers, to provide cover for a brick veneer house in Engadine, NSW.



This chart suggests that consumers may be able to obtain a significantly higher level of cover by finding an insurer who provides cheaper cover. By shopping around those consumers who currently have the most expensive policies:

- may be able to get the same level of cover but at a price that is cheaper by up to 40%, or
- for the same premium, may be able to increase their level of cover by up to 94%.

Consumers still need to consider differences in the cover offered by insurers, but in general they will be in a better position if they can increase their sum insured by \$60,000 or more for the same premium (as in the case of the Engadine house).

## **The way forward**

This report recommends action in the following broad areas:

- work by the insurers and the Insurance Council of Australia to identify and provide consumers with access to the most reliable tools for calculating rebuilding costs, and to explore whether it is commercially viable to offer broader cover under their policies,
- better communication between insurers and insureds, particularly on renewal, to improve consumer understanding of the need to be adequately insured, and to encourage them to assess whether their level of cover is adequate,
- work with third parties who are likely to have contact with consumers at a time when they need to either take out or increase insurance cover, to provide information about assessing whether their level of cover is adequate, and
- continued work by ASIC in promoting appropriate community education messages about underinsurance and non insurance.

More detailed recommendations addressing these broad issues are at the beginning of each section (except Sections 1 and 7).

## **Further work by ASIC**

ASIC will be continuing to work on this issue by:

- working with insurers in relation to their calculators,
- monitoring changes in practices by insurers, and
- conducting a further review of the calculators provided by insurers in 12 months time.

# Section 1: Exploring the problem

## Findings

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- There were at least 5.8 million home building insurance policies in force as at June 2004.
- A 2000 survey of 1000 randomly selected homeowners by a company specialising in estimating rebuilding costs found that:
  - 87% of homes were insured for less than their replacement value, and that the average level of underinsurance was 34%,
  - 81% of homes were underinsured by 10% or more, and
  - 59% of homes were underinsured by 30% or more.
- A 2002 survey by the Insurance Council of Australia of seven companies making up 80% of the home building insurance market found that:
  - approximately 27.5% of homes were underinsured by 10% or more, and,
  - 7.5% of homes were underinsured by 30% or more.
- The Insurance Disaster Response Organisation reported that the homes destroyed in the ACT bushfires were underinsured by 40% of the replacement cost, on average.
- ASIC's survey of ACT homeowners found that consumers were underinsured by 27% on average (where they had rebuilt similar homes enabling a comparison with cover before and after the fire to be made).
- Mass disasters can cause massive increases in the cost of rebuilding. For example, rebuilding costs reportedly increased by 75% following Cyclone Tracy in Darwin in 1974, and by 35% in Newcastle after the 1989 earthquake.
- The rate of underinsurance will be higher where rebuilding costs increase by these levels, as even a prudent consumer cannot predict a need to increase the amount of cover to meet jumps in price of this size.

## The implications of underinsurance

In January 2003, bushfires caused death, injury and destruction of property in the ACT. In all, 488 homes in and around Canberra were destroyed.<sup>3</sup> After responding to the immediate impact of the fires, homeowners turned to their insurance company for the financial resources necessary to rebuild their homes.

There were only six homeowners who were not insured at all,<sup>4</sup> a lower rate of home building non insurance than for Australia as a whole.<sup>5</sup> However, many insured homeowners found that their building insurance policy did not meet the full cost of rebuilding their home and associated expenses—that is, they were *underinsured*.<sup>6</sup>

The complete destruction of a home is relatively unusual, and total losses make up only a tiny proportion of claims made against home building insurance policies. Nevertheless, there appears to be a very high rate of underinsurance of homes in Australia. The trauma of losing a home will often be compounded when the consumer discovers that their insurance will not be sufficient to allow them to rebuild.

## Our project

After receiving reports of a significant level of underinsurance following the bushfires, we decided to investigate the causes of underinsurance, and to identify measures that could be taken to reduce the incidence of underinsurance in the future. This report summarises the findings and recommendations of that project.

Research for the project included:

- a survey of consumers who lost their homes in the ACT bushfires,
- a review of the policies offered by major insurers,
- a survey of those insurers' practices, and
- a comparison of the 'web-based calculators' offered by insurers to help consumers determine the appropriate amount they should insure their homes for (the sum insured).

For full details of the project scope and methodology, see Appendix A.

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<sup>3</sup> ACT Bushfire Recovery Taskforce *The Report of the Bushfire Recovery Taskforce—Australian Capital Territory October 2003* (Taskforce report), p. 3.

<sup>4</sup> Taskforce report, Chapter 10, p. 99.

<sup>5</sup> Estimates of the proportion of uninsured homes in Australia range from 2% to more than 15%, as discussed later in this section.

<sup>6</sup> Taskforce report, p. 99. See also the results of ASIC's ACT bushfire survey at Appendix C.

## Facts and figures

Home building insurance policies are insurance contracts under which the insurer agrees to pay claims for the costs of repairing or replacing the insured building in the case of damage or loss caused by various events.

Australians held at least 5.8 million home building policies as at the end of June 2004.<sup>7</sup> In 2002 the average sum insured was \$201,650 and the average annual premium was \$384, according to the Insurance Council of Australia.<sup>8</sup> In addition to these individual home building policies we estimate that in 2005 there were about 90,000–100,000 strata policies covering 900,000–1 million apartments.<sup>9</sup>

## What is underinsurance and how is it measured?

At first sight, it would seem that a consumer is underinsured if the maximum amount payable under an insurance contract is less than the full costs incurred in rebuilding the insured home. However, any measurement of the level of underinsurance will be affected by the following factors:

- First, the ‘full cost of rebuilding’ can only be definitively determined when the property is a total loss and the costs of rebuilding are known. Otherwise the level of underinsurance is being tested against a hypothetical figure, the accuracy of which cannot itself be definitively determined.
- Second, the estimate against which the sum insured is tested or compared will necessarily be based on factors that are foreseeable at the time of the estimate. If building costs are increased by an amount that could not be predicted (e.g. due to a mass disaster), the consumer is unlikely to be covered for such a spike in costs. For example, rebuilding costs increased by 75% following Cyclone Tracy in Darwin in 1974 and by 35% in Newcastle after the 1989 earthquake.<sup>10</sup> This type of underinsurance is ‘inadvertent’ underinsurance (as it is not apparent at the time the policy is taken out that the consumer is underinsured).

<sup>7</sup> Insurance Enquiries and Complaints, *Annual Review 2004*, p. 20, Table 10: Code of Practice Statistics (2003–2004) <http://www.iecltd.com.au/review/AR2003.pdf>. This table reports on the numbers of policies issued by members of IEC. Some insurers only list the number of building policies issued to owner occupiers, while others list both these policies and policies issued to landlords/investors. Accordingly to the extent that insurers have not listed policies issued to landlords, this figure is an underestimate of the number of home building policies on issue.

<sup>8</sup> Insurance Council of Australia, *Report on Non-Insurance/Under-Insurance in the Home and Small Business Portfolio*, 2002, p. 19. These figures are based on responses by insurers representing about 80% of the home building insurance market.

<sup>9</sup> There were 923,139 apartments recorded in the 2001 census (Australian Bureau of Statistics, *Basic Community Profile*, cat. 2001.0), the vast majority of which would be part of strata schemes. Land and Property Information NSW estimates that in 2005 there are 600,000 strata units in 61,000 schemes in NSW alone, an average of approximately 10 units per scheme.

<sup>10</sup> See [www.chu.com.au/index](http://www.chu.com.au/index).

## How prevalent is underinsurance?

Underinsurance of homes has been recognised as a problem for a considerable period of time. Underinsurance was initially recognised in Australia in the 1970s, when the effects of a relatively higher rate of inflation were seen as a factor leading to underinsurance.

### Australian research

In 2000, the Construction Data division of Reed Business Information Systems (Reed) surveyed 1000 randomly selected homeowners. Respondents were mainly middle managers and small business owners. Reed compared the actual sum insured for their home with their own estimates of the replacement value (using a refined estimating tool).

Reed has advised ASIC that its survey found that:

- the average sum insured was \$191,905,
- 87% of homes were underinsured by any amount, and 13% were overinsured,
- the average level of underinsurance was 34%,
- 81% of insureds were underinsured by 10% or more, and
- 59% of insureds were underinsured by 30% or more.

In 2002, the Insurance Council of Australia conducted a survey of seven companies sharing 80% of the home building insurance market. The survey suggested that:

- 27.5% of homes were underinsured by 10% or more, and
- 7.5% of home buildings were underinsured by 30% or more.<sup>11</sup>

### ACT bushfires

The Insurance Disaster Response Organisation reported that structures destroyed in the ACT bushfires were underinsured, on average, by 40% of the replacement cost.<sup>12</sup> The Insurance Council of Australia gave evidence to the Commonwealth Parliament that the *rate* of underinsurance in the ACT bushfires was about 40% for property and 30% for home contents.<sup>13</sup>

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<sup>11</sup> Insurance Council of Australia, *Report on Non-Insurance/Under-Insurance*, p. 20; see also Insurance Council of Australia, *Households Urged to Check Their Insurance Cover*, Media Release, 17 February 2004, available at [www.ica.com.au](http://www.ica.com.au).

<sup>12</sup> Submission to the House Committee Into Recent Bushfires, Insurance Council of Australia, May 2003, p. 6.

<sup>13</sup> A. Mason, Executive Director, Insurance Council of Australia, Evidence to House of Representatives Select Committee on Recent Australian Bushfires, *Hansard*, 22 August 2003, p. 13.

ASIC's ACT bushfire survey provides only limited data on the extent of underinsurance. It is only possible to obtain precise data on the level of underinsurance where the homeowners rebuilt a house of a similar quality. Only 59 of the 133 people surveyed had rebuilt or committed to rebuilding, and in only 19 cases, was the house of a similar quality.

These consumers were on average 27% underinsured, although some consumers were underinsured by up to 50%. This level of underinsurance is high compared to the averages in the research undertaken by Reed and the Insurance Council of Australia.

We have already noted that the rate of non insurance for affected homes was far lower than most other estimates of the rate of non insurance for households in Australia generally. It is also possible therefore that ACT consumers would generally have higher levels of cover, and, if this was the case, that the rate and level of underinsurance following the ACT bushfires may have been higher due to increases in building costs.<sup>14</sup>

For more information on underinsurance in our survey sample, see Appendix C.

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### Case studies

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One consumer owned a single story brick veneer home with five bedrooms. They obtained a quote of \$2000 per square metre to rebuild:

'this [quote] was to build our home as it was. We loved our home and simply wanted the same design. We wanted [insurer] to rebuild our home exactly as it was. They advised they didn't have to do this as it was too expensive as housing was at a premium.'

In another case, the original house was 260 square metres. The consumer built a smaller house of 200 square metres but was still underinsured by \$35,660. (Case 35)

Here are some more accounts by consumers of their experiences:

'We were told to allow at least \$1500 to \$2000 per square metre. We would not have had enough insurance money to cover that. We gave up ideas of rebuilding pretty quickly.' (Case 40)

'[we had] architect plans drawn up, [it was] not a level block so needed a suspended slab, [we] spoke to builder, insurance [company] was quoting approx \$1000 per square metre whereas in reality it was closer to \$1500.' (Case 60)

'I have rebuilt but not to the same quality. I estimate this to be \$2000m<sup>2</sup> in the current market. [my estimate is based on] four builders quotes, [and my] familiarity with the cost of materials and labour.' (Case 58)

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<sup>14</sup> Whether or not this was so has not been investigated as part of this report, although the issue is considered briefly in Section 2.



## US research

A 2003 survey in the US reported 64% of home insurance policy holders are underinsured, on average by 27%.<sup>15</sup> Any amount of underinsurance was counted in this survey.

## Non insurance

A consumer who is underinsured after a catastrophic loss is in a better position than one who has no insurance at all. Although not the focus of this report, ASIC is also concerned about the number of homeowners who have no building insurance.

Estimates of the proportion of uninsured homes range from 2% to more than 15%:

- the Insurance Council of Australia has estimated that the rate of *owner occupiers* who are 'uninsured' decreased from 6.17 % at the end of June 1994 to 4.49% at the end of June 1999,<sup>16</sup>
- two major insurers independently estimate around 15% of households do not have home building insurance,<sup>17</sup>
- ASIC has estimated that rates of non insurance vary from 2% to 13% based on comparing ABS data on the number of dwellings with estimates of the number of insurance policies on offer.

It is not known what proportion of non insurance is the result of a deliberate decision to take a risk as opposed to an uninformed decision or other barriers to obtaining appropriate insurance.

## Home contents insurance

When a home is destroyed, affected consumers generally lose both their home and its contents. A consumer who has underinsured both the house and their possessions will be left with a greater financial burden, limiting their choices in the event of a total loss.

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## Case study

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'We soon realised that we were underinsured for the building (could have replaced with a much smaller home) but were seriously under-insured for the contents. We eventually sold our land and bought in another suburb.' (Case 47)

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<sup>15</sup> L Weston, *Why two out of three homes are underinsured*, <http://moneycentral.msn.com/content/Insurance/Insureyourhome/P35340.asp>

<sup>16</sup> Insurance Council of Australia, *Report on Non-Insurance / Under-Insurance*. The ICA report does not include any information about rates of insurance held by landlords.

<sup>17</sup> M de Kleuver, 'Insurance: Lessons learnt from the January bushfires', [http://www.bushfirerecovery.act.gov.au/banking\\_insurance/index.htm#insuranceinfo](http://www.bushfirerecovery.act.gov.au/banking_insurance/index.htm#insuranceinfo) reports one major insurer as estimating that 'one in six' (about 17%) of Australian homes have *neither* a building nor contents policy. AAMI advises that its research indicates 15% of households do not have home building insurance. Advice from AAMI March 2005.

However, the issues raised by underinsurance for building and contents insurance are significantly different. It is more difficult for consumers to determine the cost of rebuilding costs, as the factors involved are more complex and varied, and require greater specialist knowledge. The financial consequences of underinsurance for rebuilding costs can also be more dramatic.

For these reasons, our project focused on building insurance. We are aware that non insurance and underinsurance for contents insurance are also important issues.

## Section 2: Estimating rebuilding costs

### Findings

- Under the most common type of home building insurance policy in Australia (known as a sum insured policy), the consumer bears the onus of assessing the sum insured and the financial consequences of an incorrect assessment (in that they will be underinsured in the event of a total loss).
- Estimating the precise cost of rebuilding a destroyed home is an intrinsically complex task requiring specialist knowledge and expertise.
- It is not practical for consumers to obtain estimates of rebuilding costs through building professionals (such as architects, builders or quantity surveyors).
- Consumers will rely on assistance provided by insurers in estimating the sum insured, given the lack of alternative sources of help.
- Insurers provide consumers with access to tools (including web-based calculators) for estimating rebuilding costs. Two main methods are used: the *cost per square metre* calculation and *elemental estimating*. These methods can produce significantly different results for the same house.
- The cost per square metre method has a number of limitations in that it does not address variations between homes generally, and it does not take into account factors which may increase the cost (particularly the age of the home, site difficulties and high quality finishes).
- The elemental estimating method is capable of taking these factors into account. As it requires more information and uses more data to generate an estimate, it is likely to be more accurate.
- Under some policies, the consumer must estimate the sum necessary to cover supplementary costs (such as architects' fees or the cost of demolishing the house). Consumers lack access to tools or information about these costs, apart from some web-based calculators.

### Recommendations

- The ICA and insurers should assess the relative accuracy of the various methods of estimating rebuilding costs. Insurers should be encouraged to use the most reliable method of estimating rebuilding costs and promote it to consumers.
- Insurers should review the tools they provide to assist consumers in estimating rebuilding costs to ensure that they provide reasonably accurate estimates.
- Insurers should not refer consumers to architects or builders to obtain estimates of rebuilding costs, unless they are satisfied they will be able to assist the consumer.
- Insurers should ensure that calculation tools are updated regularly, to reduce the risk of consumers being underinsured through relying on rebuilding costs that are out of date.
- Insurers should specifically disclose to consumers, as early as possible and prior to the consumer nominating a figure for the sum insured, whether the sum insured covers:
  - only material and labour costs, or
  - both material and labour costs and supplementary costs.
- Where the sum insured includes supplementary costs (such as architects' fees), the insurer should help the consumer estimate the amount needed to cover these costs by:
  - indicating the types of costs covered by the insurer, and
  - improving access to information about the amounts needed to cover these costs.
- Where the insurer offers a tool which cannot provide a reliable response for certain groups of homeowners (such as where the house is on a severe slope) the insurer should use filtering questions to exclude those groups, in preference to providing a response where there is a risk the consumer will be underinsured.

## Why is it important?

To avoid being underinsured, a consumer must correctly estimate the sum insured when taking out their policy. There are two distinct steps in this process:

- estimating the cost of materials and the builder in replacing the destroyed home, and the labour charges by a builder (*materials and labour costs*), and
- estimating the *supplementary costs* likely to arise in the event that the property is a total loss, such as architects' fees, removing debris from the property or making it safe.

## Who estimates rebuilding costs?

The most common home building insurance policy in Australia (known as a *sum insured* policy) places the risk of an incorrect estimate on the consumer in that:

- if the estimate is too high, the consumer will pay a premium calculated on the higher sum but can gain no benefit (as the insurer will not pay any more than the actual loss suffered by the consumer), and
- if the amount is too low, then in the event of a total loss, the consumer will not be able to rebuild their home without using other financial resources.

Under *total replacement* policies, the insurer accepts responsibility for estimating rebuilding costs. These policies are rare in Australia, but are more common overseas, where insurers will meet the total costs of rebuilding the home, and will have charged the consumer a premium based on their calculation of rebuilding costs. This issue is examined in detail in Section 5.

## What the law says

Historically, the approach of insurance law is that the proposed insured (the consumer) is in the best position to know the true value of a risk being proposed.<sup>18</sup> This presumption may be correct for other insured items. However, it has limited application to home building insurance policies for typical consumers.

While consumers may know more about their home than the insurer, they generally have limited experience of rebuilding costs. A survey of 1015 Victorian consumers in 2003 by the Royal Automobile Club of Victoria (RACV) found that only 54% of respondents said they knew how to accurately calculate the value of their house for insurance purposes.<sup>19</sup>

<sup>18</sup> *Carter v Boehm* (1766) 3 Burr 1905, 1909.

<sup>19</sup> The results of the survey are set out on RACV's website at [racv.com.au](http://racv.com.au). ASIC acknowledges that additional information has been provided to it by RACV.

Accurately estimating rebuilding costs is an intrinsically difficult task, requiring expertise and specialised knowledge. Insurers impliedly acknowledge this fact when they make available to consumers various forms of assistance to help consumers estimate the sum insured (such as guides in leaflets or web-based calculators), and when those guides advise consumers to seek specialist assistance from an architect, builder or other valuation expert.

There are some economic inefficiencies in the current arrangements in that the party with the least expertise (the consumer) must place a value on rebuilding costs. This can operate to the disadvantage of both parties. The consumer may be underinsured, and experience shows that insurers can on occasions come under significant public and political pressure to meet all rebuilding costs, even though the premium charged was based on a lower figure.

The ICA considers that if most consumers had adequate cover, insurers would benefit through a larger premium pool and more accurate underwriting of the risk, which could result in lower premium levels.<sup>20</sup>

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### Case study

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'Insurance guidelines for estimating value of building were (and still are) inadequate except for basic project homes on flat blocks with good orientation. It is unreasonable to expect lay people to track movements in costs.' (Case 68)

### ACT bushfires

Respondents to ASIC's ACT bushfire survey were asked how the sum insured under their home building policy was *initially* calculated.

The ability of consumers to accurately recall the method used as well as the types of methods that were likely to apply may be affected by the passage of time, given that the period in which consumers first took out policies ranged from several weeks to 32 years before January 2003.

**Table 2.1: How was the sum insured calculated?**

Method	No of consumers
Carried over from previous policy	15
Estimated by consumer	69
Suggested by someone else (insurer/broker/agent)	45
Not specified	4
<b>Total</b>	<b>133</b>

Source: ASIC's ACT bushfire survey, 2004

<sup>20</sup> Insurance Council of Australia, *Report on Non-Insurance/Under-Insurance*, p. 21.

ASIC's survey found that:

- 33% of consumers relied on the insurer or a third party to estimate rebuilding costs,
- while 69 consumers (or 51%) estimated the sum insured, 31 of these reported using information from an insurer to help them, and
- only seven consumers obtained an independent valuation.

The extent of reliance on insurers is not surprising, given the complexity of the task and lack of access to other sources of assistance. Only two consumers reported using a web-based calculator, which is consistent with generally low levels of purchasing policies online, and the relatively recent introduction of such calculators.

**Table 2.2: Method used by consumer to estimate sum insured**

Method	No of consumers
Insurance leaflet/guide	22
Using advice given over the phone by insurer/ broker/ bank/ financier	11
Insurance web-based calculator	2
Independent valuation	7
Own inquiries	4
Own estimation	35
<b>Total</b>	<b>81</b>

Source: ASIC's ACT bushfire survey, 2004. The total is greater than 69 as some consumers used more than one method.

Even where the consumer insures their home for an amount based on an accurate estimate of rebuilding costs, they will not be covered where building costs increase significantly following a mass disaster. This issue is considered in detail in Section 5.

## Methods of estimating rebuilding costs

It is difficult for both consumers and insurers to determine rebuilding costs and, therefore, the correct sum insured. This task requires a detailed knowledge of conditions in the building market both now and in the future. This means that consumers generally need assistance in calculating rebuilding costs. A number of methods of obtaining estimates are available.

### Site specific costing

The most accurate estimate of reconstruction costs is likely to be provided by a building professional. That person will have access to

building cost information and be able to adjust it in light of the particular features of the consumer's home.

However, the ICA has recognised that the cost of an individual valuation for consumers has been prohibitive since 1996.<sup>21</sup> ASIC's inquiries confirm that this is still the current position:

- The Housing Industry Association (HIA) provides referrals for consumers seeking to locate a builder within their area.<sup>22</sup> We contacted a number of builders listed on the HIA website. All builders refused to provide an estimate of reconstruction, as they considered it to be, as one said, 'a pointless, hypothetical exercise'.
- The Royal Australian Institute of Architects (RAIA) advised ASIC that the vast majority of architects would not provide estimates of reconstruction costs, and that such a service was more likely to be within the purview of a quantity surveyor. Similarly, the building advisory service of the RAIA—Archicentre—does not offer reconstruction cost estimates (even though it provides a range of advice to consumers on home building).
- Quantity surveyors, in contrast, are willing to provide reconstruction cost estimates to ordinary consumers. The cost of such a service, however, is likely to be prohibitively expensive for most consumers. A quantity surveyor from a major firm based in Sydney estimated the cost of an estimate for the next year only for a typical home would be \$900–\$1000. The average annual premium for home insurance as at December 2000 was \$384 for cover of about \$200,000.
- Independent property valuation firms are able to value homes; however, they are rarely if ever asked to do so for the purpose of estimating rebuilding costs. We contacted one major firm who suggested that the cost of a valuation for this purpose would be disproportionately expensive.

Insurance companies are able to achieve economies of scale in relation to individual reviews of the insured property. However, ASIC is only aware of one insurer that undertakes a site-specific assessment of rebuilding costs.

### **Average building costs per square metre**

A common method of estimating rebuilding costs is the cost per square metre method. Typically, such estimates involve:

- calculating the area of the home in square metres,
- multiplying the area by a building cost per square metre, with the building cost determined according to a limited number of variables

<sup>21</sup> Insurance Council of Australia, *Report on Non-Insurance/Under-Insurance*, p. 25.

<sup>22</sup> Housing Industry Association referral line: 1300 650 690 and website: [www.homesite.com.au](http://www.homesite.com.au).

(such as the property's location, type of construction and standard of finish), and

- allowing the consumer to include specific amounts for additional items (such as swimming pools or fences, or high quality fittings), or additional features (such as additional costs due to the nature of the property).

Estimates derived from the cost per square metre method are usually based on broad assumptions about the nature of the house being evaluated, and do not readily cater for the individual nature of each home. The cost of rebuilding produced by this method may be too low, simply because the method reflects average costs, and therefore does not address variations between individual houses.

A number of other specific factors that may increase or affect rebuilding costs include:

- where the house is of above average quality (due to either the complexity of the design or a higher quality of materials being used),
- individual features of the property (such as the gradient of the site or difficulties for builders of obtaining access),
- any special features of the home—this can cover a range of features such as whether the house is built on a concrete slab or has a wooden floor, and whether the house has split levels or balconies,
- the period of construction, and
- regional or local variations in rebuilding costs.

### **Elemental or component estimating**

Elemental or component estimating involves considering in detail the component elements of buildings to price buildings 'from the ground up', using local wage and material rates, building codes and other costs of construction data. It is therefore likely to be more accurate than the cost per square metre method.

#### *United States*

Elemental estimating has been used in the United States for a number of years now. One supplier of such information, Marshall and Swift/Boekh (MSB), has specific data for 2600 locations across the country.<sup>23</sup> MSB compares the information it has collected with actual reconstruction costs derived from its insurer clients' claims experience and adjusts as appropriate. It has become easier in the last few years for consumers to access this information through websites.

<sup>23</sup> Marshall & Swift/Boekh, *Good News: Underinsurance Problem Lessening, Says MS/B* [http://www.msbinfo.com/newsroom/2\\_newsroom.asp?story=63&news\\_year=2003](http://www.msbinfo.com/newsroom/2_newsroom.asp?story=63&news_year=2003). MS/B claim that 95% of the property insurance industry in the US use their data, and that rates of building underinsurance are falling as a result (personal communication Matt Hoffman).



Some commentators in the United States recommend consumers purchase policies from insurers that use total component estimating, as it is likely to provide a more accurate estimate of the cost of rebuilding.<sup>24</sup>

### *Australia*

In Australia, Reed Business Information Systems (Reed) collects similarly detailed building cost information. Information is collected on a quarterly basis from 105 regions, comparing building costs from over 20,000 sources. Reed uses this information to undertake elemental estimating of the cost of building a house. Three insurers incorporate Reed's elemental estimating system in their web-based calculator, while a number of other insurers make use of its data for other purposes. Reed suggests that its calculator is accurate to within 7.5% in 90% of cases.

### **Initial construction costs**

Where a consumer is aware of the initial construction cost of a relatively new home (e.g. one they built), this cost can be used as a starting point for estimating the rebuilding costs. This method will be limited to a relatively small and discrete sector of consumers.

Some sources urge caution as rebuilding may be more expensive than building in the first place. This is more likely to be the case where construction methods have changed or where the initial builder gained economies of scale through building a number of similar homes at the same time.

Initial construction costs may also be a source of information for estimating replacement costs for features such as swimming pools, paving, garden sheds and fences.

### **Purchase price less land value**

Consumers may be tempted to estimate the value of the building by subtracting the unimproved capital value of the land from the purchase price or current market price for the property. This method is not likely to produce an accurate rebuilding cost and is discouraged by consumer organisations and the insurance industry.<sup>25</sup>

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### **Case study**

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'My brother and I had recently purchased our house for \$305,000 (April 02)... The land value was \$120,000. I insured (underinsured) the house at \$200,000. The fault for this fell on my brother and I, so we've had to work very hard to rebuild our house.' (Case 119)

<sup>24</sup> <http://www.kiplinger.com/basics/archives/2003/03/underinsured.html>. The website includes the following statement: 'To make sure you get the correct amount of coverage, look for an insurance company that uses a method called total component estimating.'

<sup>25</sup> Insurance Council of Australia, *Households Urged to Check Their Insurance Cover*.

## Estimating supplementary costs

Where the house is a total loss, consumers incur two types of costs: the cost of rebuilding the home and supplementary costs (such as making the property safe, removal of debris and architects' fees). Insurers adopt two distinct approaches to covering supplementary costs, depending on whether they are included in the sum insured (*global sum insured* policies), or payable on top of the sum insured (*sum insured plus benefits* policies).

The different policy designs affect the need for the consumer to estimate supplementary costs. For global sum insured policies, the consumer needs to estimate the amount necessary to cover supplementary costs and include it in the sum insured. This breaks down into two tasks:

- working out which costs must be included in the sum insured,
- placing a value on each cost.

For sum insured plus benefits policies, the insurer calculates the amount necessary to meet the supplementary costs, usually by imposing a cap on the amount payable in the policy. The consumer's task is therefore to assess the adequacy of these caps.<sup>26</sup>

Some insurers use a combination of these approaches in that a cost will be paid up to a maximum specified in the policy, but this payment can be topped up by any surplus from the sum insured.

Irrespective of the type of policy, the consumer will find it difficult to determine whether they are adequately covered for supplementary costs, as this task varies according to the insurer and type of policy, is potentially confusing and involves knowledge and judgement well outside most consumers' experience. Consumers cannot simply transfer the sum insured set under one policy to a new policy with a different insurer. These factors all increase the risk of underinsurance.

There is also a lack of access to tools or information for consumers about these costs. The exception to this is web-based calculators for global sum insured policies, where the figure for the sum insured includes amounts for supplementary costs, according to the design of the calculator. However, the calculators are generally not transparent about the way they do this, in that they do not always separately identify for the consumer the amount of the sum insured being used to meet the costs of materials and labour, and the amount used to meet supplementary costs.

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<sup>26</sup> The range and adequacy of the limits for supplementary costs is considered in Section 5.

## Limitations on assistance from insurers

### Effect of time constraints

In making decisions about how to help consumers, insurers are faced with a commercial dilemma. If the process of obtaining a figure for the sum insured is too lengthy or protracted, the insurer risks losing customers. The insurer will also incur additional call centre staffing costs.

We are aware that some insurers resolve this issue by having their call centre staff offer the consumer the choice of establishing the sum insured by a simplified questionnaire or a more detailed survey.<sup>27</sup> The consumer is required to answer fewer questions as a trade-off between having the most accurate estimate of sum insured and the perceived need to keep telephone calls reasonably short. However, insurers vary as to whether the consumer is advised of which method is more reliable.

Where an insurer offers consumers a basic and a comprehensive model for estimating the sum insured, we believe the consumer should be advised about the relative accuracy of the methods used, and allowed to choose the model they wish to use on an informed basis.

### Costs covered by the sum insured

When a consumer uses a web-based calculator or arranges a policy over the phone, they may not be aware of what amounts are included in the sum insured, and what amounts are paid as benefits additional to the sum insured. They may therefore not appreciate whether costs apart from material and labour costs need to be included in the sum insured.

Our review of insurers' websites suggests that this information is not always clearly presented to consumers. The review found that:

- One insurer has wording on its website that is ambiguous about whether supplementary costs are included in the sum insured or payable in addition to this sum.
- One insurer gives the consumer the opportunity to increase the sum insured to cover supplementary costs but only identifies for the consumer two types of supplementary costs (and not all those for which the consumer needs to include in the sum insured).

We consider that it is preferable that, before the consumer nominates a figure for the sum insured, the insurer informs them about the range of costs that need to be paid from the sum insured in the event of a claim. Current methods of presenting information about supplementary costs can confuse consumers and contribute to them being underinsured.

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<sup>27</sup> The difference in time can be between 3–5 minutes for the short questionnaire, and 10–15 minutes for the longer version.

## Referral to third parties

There are two issues for websites and brochures based on the cost per square metre method.

First, these websites and brochures generally include disclaimers stating that consumers should not rely on the estimates produced by the leaflet or calculator, and advising them to consult an architect, builder or other valuation expert to get an accurate assessment of the building replacement value. As discussed earlier in this section, referrals to these professionals are frequently not of practical use, and likely to result in consumers becoming discouraged from seeking out other sources of information.

Secondly, some of these calculators indicate that the consumer needs to increase the sum insured (above the sum generated by the calculator) to cover increased costs from factors such as a severe slope, without, however, assisting consumers to estimate the amount of any such increases. However, given the lack of access to information about the effect on rebuilding costs, consumers are unlikely to be able to make accurate allowances for these types of factors.

These types of general statements therefore do not help the consumer to accurately estimate the sum insured. The level of underinsurance in these circumstances is likely to be reduced only if insurers provide consumers with access to more comprehensive tools.

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## Case study

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'The key issue from my perspective is that the recommended insurance for the house was inadequate ... The replacement cost was about 30–40% higher than recommended. ... I checked out the brochures of a couple of insurers [insurer A] and [insurer B] and the costs per m<sup>2</sup> are still around \$900/m<sup>2</sup>—in reality, the cost is \$1300–1500, and in some cases up to \$2000. So describing a structure as solid brick/brick veneer is scarcely adequate. It's [the] floor coverings, windows, roof type, project house, architect designed house that greatly affects the cost. In round figures, the fire represents a loss of about \$200K beyond the insured value.' (Case 122)

Despite the disclaimers and the advice to obtain an independent quote, the calculators are presented as accessible and convenient methods for deriving an appropriate sum insured. In a number of cases, the consumer can move directly from determining a sum insured using the calculator to obtaining an online quote for insurance using the figure for the sum insured proposed by the calculation.

This process militates against the consumer seeking assistance from other sources. ASIC considers it would be preferable if insurers used filtering questions to exclude consumers from using their calculator where particular

features (such as a severe slope or other site aspects) would prevent their calculator from providing a reliable response, rather than using disclaimers or general warnings. One effect of this would be that consumers would use sources of information from third parties that are more comprehensive (including calculators offered by other insurers). Insurers therefore have a commercial incentive not to raise these limitations, notwithstanding the consequent risk of underinsurance for consumers.

### **Estimating the size of the house**

Both web-based calculators and call centre staff provide a figure based on the consumer's estimate of the size of their home. There is a risk that some consumers will be underinsured where they are unable to provide accurate information about the size of their home.

Some web-based calculators enable the consumer to enter the size of the house either in square metres or according to the number of bedrooms (with the calculator making assumptions about the size of the house from the number of bedrooms).

This approach may help consumers, although there is a potential for a greater divergence in the estimate (where the actual size of the bedrooms is larger or smaller than the figures used by the calculator). It is clearly preferable if consumers have an accurate figure for the size of their home.

## Section 3: Web-based calculators

### Findings

- ASIC used the web-based calculators of ten major insurers to obtain estimates of rebuilding costs for five houses. This review found that significant inconsistencies in the figures generated by the calculators.
- ASIC's review found that across the houses tested:
  - the highest degree of variation was a difference of 169% between the lowest and highest estimates of rebuilding costs generated by the calculators, and
  - the smallest variation between the lowest and highest estimates of rebuilding costs for the same house was 42%.
- Calculators using the *elemental estimating* produced either the highest figure or the second highest figure for the sum insured for each house.
- The *cost per square metre* method does not take into account some factors which increase the cost of rebuilding (such as site difficulties or a high level of quality to internal finishes).
- ASIC's review of calculators using the *cost per square metre* method found that:
  - there were significant variations between insurers in the figures used as the cost per square metre, and
  - as at April 2005, two insurers used a figure in the ACT for rebuilding costs that was below \$1090 per square metre (the minimum figure for rebuilding costs identified as at February 2003).
- Consumers using calculators that apply the *cost per square metre* method are at a greater risk of being underinsured.
- Some calculators do not allow the consumer to nominate an amount to cover all types of outdoor features (such as pergolas or garden sheds) covered by their policies.

### Recommendations

- Given the inconsistent results currently produced by calculators and the potential for consumers to be underinsured, insurers should provide consumers with access to calculators that are as reliable and comprehensive as possible.
- Where insurers give consumers access to a web-based calculator they should:
  - make clear what costs are covered by the figure generated (i.e. whether it covers the cost of materials and labour as well as supplementary costs),
  - make clear the different amounts apportioned to the cost of materials and labour, and to supplementary costs,
  - identify for the consumer any specific limitations with the calculator, rather than relying on general warnings or disclaimers,
  - ensure that the calculator is updated regularly, and
  - include information on the website advising when the calculator was last updated.
- Insurers should review their web-based calculators to ensure that prompts to consumers to include amounts to cover particular features (such as pergolas or swimming pools) are designed to capture all such features covered by the insurer under their policies.

## Why is it important?

*‘... as at April 2002 it is possible for a domestic building replacement cost estimate to be obtained from at least one company website without cost ... If such a facility as that described becomes generally available to the market, insurers and brokers would be in a position to require potential clients to use the system and insure accordingly.’*

Insurance Council of Australia, *Report on Non-Insurance/Under-Insurance in the Home and Small Business Portfolio*, October 2002, p. 25

The more widespread availability of calculators that provide reliable estimates of rebuilding costs would have a significant impact on the capacity of consumers to have adequate levels of cover. Conversely, consumers are at continuing risk of being underinsured where they use calculators that produce figures that are consistently low by comparison with those provided by other insurers, or that cannot take into account features which have a significant impact on rebuilding costs (such as where the house is built on a severe slope).

## ASIC’s review

Nearly all major home building insurers in Australia now give consumers access to a ‘home rebuilding calculator’ on their websites.<sup>28</sup> Our survey of 15 insurers indicated that policies sold over the internet comprise a very small percentage of total sales, with 5.4% being the highest proportion of sales cited by any company. It is likely that the calculators are used by a higher percentage of consumers in the course of making inquiries about cover.

We reviewed the calculators offered by ten insurers, by using them to generate an estimate for the sum insured. The review was conducted in April 2005. The results are listed in Tables 3.1 and 3.2.<sup>29</sup> We used the calculators to produce figures for five distinct homes of varying specifications. The five homes we used were:

- a small fibro home in Canberra,
- a brick veneer home in Canberra,
- a brick veneer home in a southern Sydney suburb,
- a Federation home in inner-city Melbourne, and
- a fibro home in Townsville.

<sup>28</sup> We identified calculators on the websites of the following nine major insurers: AAMI, Allianz, APIA, Australian Unity, CommInsure, GIO, NRMA, Suncorp and Westpac. A calculator for a tenth insurer, CGU, was identified on the website of a third party selling CGU policies. However, ASIC understands that this calculator has not been endorsed by CGU, although it was based on information provided by CGU.

<sup>29</sup> The results for nine calculators are listed in Table 3.1 as: first, there are two separate instances of insurers using identical calculators (reducing the number of results by two), and, second, one insurer changed their web-based calculator around the time of the survey, moving from a cost per square metre method to an elemental estimating method. The results using both the old calculator—Insurer A (old)—and the new calculator—Insurer A (new)—are included in the table.

For the detailed specifications of each house, see Appendix B.

Each web-based calculator produces a figure for the sum insured. Some insurers provide that supplementary costs will be paid from the sum insured (*global sum insured* policies). Other insurers define the sum insured as only covering the costs of materials and the builder, so that supplementary costs are paid in addition to the sum insured (*sum insured plus benefits* policies).

Those calculators that include supplementary costs in the sum insured should generally produce a higher figure than those calculators where the sum insured only covers materials and labour costs.

## How calculators estimate rebuilding costs

In ASIC's review two insurers use the elemental estimating method: Insurer 1 and Insurer A (for its new calculator). These calculators seek information in approximately 30 categories including the size of individual rooms, ceiling heights and the period of construction. The other seven results are based on the cost per square metre method. Their calculators generally ask between four and ten questions (as a minimum, the overall size of the home, the state in which property is located, and type of construction).

The insurers are divided into two groups, according to whether the insurer offered global sum insured policies (five results) or sum insured plus benefits policies (four results). This division results in comparisons between insurers where there are similar assumptions of the costs covered by the sum insured. The estimates of rebuilding costs by insurers offering global sum insured policies are set out in Table 3.1, and for insurers offering sum insured plus benefits policies in Table 3.2.

**Table 3.1: Results generated by calculators where sum insured covers rebuilding costs and supplementary costs**

	Fibro, ACT	Brick veneer, ACT	Brick veneer, Engadine	Federation, Elwood	Fibro, Townsville
Insurer 1	162,445	287,424	292,717	349,265	198,000
Insurer 2	126,800	298,904	347,440	259,800	171,000
Insurer 3	110,600	287,982	283,816	155,040	154,980
Insurer 4	89,150	209,448	206,383	169,237	131,100
Insurer 5	80,000	222,000	220,000	255,000	120,000
<i>Highest</i>	<i>162,445</i>	<i>298,904</i>	<i>347,440</i>	<i>349,265</i>	<i>198,000</i>
<i>Lowest</i>	<i>80,000</i>	<i>209,448</i>	<i>206,383</i>	<i>155,040</i>	<i>120,000</i>
<i>Difference (\$)</i>	<i>82,445</i>	<i>89,456</i>	<i>141,057</i>	<i>194,225</i>	<i>78,000</i>
<i>Difference (%)</i>	<i>103.1%</i>	<i>42.7%</i>	<i>68.3%</i>	<i>125.3%</i>	<i>65.0%</i>



**Table 3.2: Results generated by calculators where sum insured only covers rebuilding costs**

	Fibro, ACT	Brick veneer, ACT	Brick veneer, Engadine	Federation, Elwood	Fibro, Townsville
Insurer A (new)	162,500	287,500	291,500	349,500	198,000
Insurer A (old)	121,600	257,742	260,700	196,950	156,000
Insurer B	98,800	230,880	206,140	129,750	127,800
Insurer C	85,500	197,580	192,060	141,300	117,450
<i>Highest</i>	<i>162,500</i>	<i>287,500</i>	<i>291,500</i>	<i>349,500</i>	<i>198,000</i>
<i>Lowest</i>	<i>85,500</i>	<i>197,580</i>	<i>192,060</i>	<i>129,750</i>	<i>117,450</i>
<i>Difference (\$)</i>	<i>77,000</i>	<i>89,920</i>	<i>99,440</i>	<i>219,750</i>	<i>80,550</i>
<i>Difference (%)</i>	<i>90.1%</i>	<i>45.5%</i>	<i>51.8%</i>	<i>169.4%</i>	<i>68.6%</i>

Source: ASIC's review of web-based calculators, March–April 2005.

## Range of estimates

The following conclusions can be drawn from these results:

- The smallest variation between the lowest and highest estimates of rebuilding costs for the same house was 42% (for the insurers in Table 3.1) and 45% (for the insurers in Table 3.1).
- The greatest variation between the lowest and highest estimates of rebuilding costs for the same house was 125% (for the insurers in Table 3.1) and 169% (for the insurers in Table 3.1).
- The elemental estimating calculator (Insurer 1) suggested a sum insured that was the highest for three of the five homes tested, and the second highest for the two remaining homes (for the insurers in Table 3.1).
- The elemental estimating calculator (Insurer A's new calculator) suggested a sum insured that was the highest for each of the five homes tested (for the insurers in Table 3.2). A calculator using the cost per square metre method produced figures that were between 45% and 169% lower than the figures produced by the elemental estimating calculator.

Variations of this magnitude are of concern. Depending on the actual costs of rebuilding, individual consumers may be either overinsured or underinsured by a significant margin. However, ASIC's research suggests that the elemental estimating method is more accurate, and those consumers who rely on a calculator using the cost per square metre method are at a greater risk of being underinsured.

Feedback to ASIC from the insurers using the elemental estimating method suggests that it has a superior level of accuracy, particularly where rebuilding costs are increased by the period of construction, the slope of the land, or a superior quality to the interior or fittings. One insurer advised that it had tested its calculator's estimate of rebuilding

costs against the costs actually incurred following total loss claims. It reported that the calculator had generated results that were reliable.

Secondly, the advantages of the elemental estimating method can be examined by changing the features of the home to enable an assessment of the way the calculators take into account factors such as a severe slope or the period of construction.

We conducted a further ‘road test’ of the elemental estimating calculator used by Insurer 1 as follows:

- The fibro house in Ainslie was tested changing the slope of the site from flat to severe (but leaving all other features identical). This resulted in an increase in the sum insured to \$190,877, or nearly an additional \$30,000.
- The house in Elwood was tested by changing the period of construction from Federation to contemporary. This resulted in a decrease in the sum insured to \$298,732, or nearly \$50,000. Federation homes have a number of features that can increase rebuilding costs (such as extended ceiling heights, ornate cornices, steeper roofs and leadlight windows).

The cost per square metre calculators do not take these features into account in generating a figure for the sum insured. It is axiomatic that consumers with house features that increase rebuilding costs are at risk of being underinsured by a greater extent where they use a calculator of this type.

Our view is that, both in theory and practice, the elemental estimating method is likely to be more accurate, and that increased use of this method will reduce the level of underinsurance.

To the extent that the assumptions and methods underlying web-based calculators are used by the insurer through brochures or by call centre staff, there is a considerable margin for error in the advice provided by insurers to consumers about the appropriate sum insured.

We note that the cost to insurers of obtaining more detailed data on building costs is likely to be greater than existing expenses. However, it would not appear to be prohibitive, given that three insurers currently provide consumers with access to calculators using this information. Note: ASIC is unaware of when each insurer last updated the figures used by its calculator to generate a response. If an insurer had updated its calculator just before ASIC's review then its calculator would be using more recent figures and generate a higher estimate than a calculator using older figures. However, this should not make a significant difference to the results, given that building costs increase by a maximum of 7.9% nationally.

## **Cost per square metre**

There are significant variations between the figures generated by the web-based calculators that use the cost per square metre approach. For

those insurers in Table 3.2 (who offer sum insured plus benefits policies) the sum insured only includes the costs of material and builders.

It is possible therefore to establish the 'dollar per square metre' figure used by the calculator, by dividing the sum insured by the size of the house. For example, using the fibro house in Ainslie, if the sum insured is \$80,000, and the size is 100 square metres, then the cost per square metre used by the calculator is \$800.<sup>30</sup>

The results for the three insurers using this approach are set out in Table 3.3.

**Table 3.3 Cost per square metre figures used by different insurers**

	Fibro, ACT	Brick veneer, ACT	Brick veneer, Engadine	Federation, Elwood	Fibro, Townsville
Size (metres <sup>2</sup> )	100m <sup>2</sup>	222m <sup>2</sup>	220m <sup>2</sup>	150m <sup>2</sup>	150m <sup>2</sup>
Insurer A (Old)	1,256	1233	1221	1513	1040
Insurer B	1,028	1112	973	1065	852
Insurer C	895	962	909	1142	783
% difference between highest and lowest figures	40.3%	28.2%	34.3%	42.1%	32.8%

Insurers are using significantly different figures for the cost per square metre in calculating rebuilding costs. These variations may be due to:

- different sources of information on building costs, or
- differences in the regularity with which the insurer updates building figures.

For the two ACT properties, three of the figures are below \$1090 per square metre. The Bushfire Recover Taskforce found that, shortly after the bushfires, building costs were a minimum of \$1090 per square metre.<sup>31</sup> The continued use of such low figures in April 2005 creates a significant risk that consumers using these calculators will be underinsured.

## Updating web-based calculators

The accuracy of the estimate produced by a web-based calculator will also depend on the frequency with which the information used to generate the sum insured is updated.

ASIC's survey of insurers found that there were considerable variations as to how regularly they updated the information used in their calculators. One insurer updated their calculator every six months, the

<sup>30</sup> This exercise cannot be undertaken for the figures for the global sum insured group as the sum insured includes an unknown allowance for supplementary costs.

<sup>31</sup> This issue is discussed in detail in Section 5.

majority updated it annually, and in one instance the calculator was updated after an 18-month interval.

The financial consequences for consumers of a lengthy interval in the period between which calculators are updated can be significant. We note that, since our review in April 2005, one insurer has apparently updated the information used by its calculator to generate responses, resulting in substantial increases in the results. For example, for the ACT properties, the update resulted in increases in the figures for the fibro house of 47.6%, and for the brick veneer house of 30.6%.

Increases of this magnitude do not reflect sudden or recent increases in the cost of materials and labour, and therefore suggest that the calculator was not updated regularly or that the previous figures used were too low. There is a risk that a consumer who used the calculator just before it was updated would be underinsured by a significant amount.

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### Case study

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'The main problem in my mind is that the insurance companies have a very outdated and low price per square metre that they calculate the house value to. We now know that there is no way our house could be rebuilt for what they state in per square metre calculation.' (Case 40)

Where the calculator is updated every 12 months, there can be a 23-month gap between the rebuilding costs at the date the policy is taken out and the date of claim. For example, if a calculator is updated in January 2003 and the policy is taken out in November 2003 then the sum insured will be calculated using building costs from 11 months earlier. If the insured property is a total loss in November 2004, then 23 months will have elapsed (and on average figures building costs may have increased from 6% to 8%, or from \$12,000 to \$16,000, on rebuilding costs of \$20,000).

## Gaps in calculator prompts

Virtually all home building policies provide cover for outdoor features of the property, ranging from swimming pools, pergolas and granny flats to clothes lines and blinds attached to the side of the house. There are few limitations in cover for these types of features, except where they are not attached to the property or where they are used for a commercial purpose.

These features need to be specifically identified in any estimate of rebuilding costs (irrespective of the method used). Web-based calculators address this by including a series of specific questions or prompts, asking the consumer to include specific amounts for these costs. The sum insured is then increased by the amounts suggested by the consumer for these features.

However, ASIC's review of websites found gaps in the way insurers informed consumers about the types of features that need to be covered:

- very few insurers provided consumers with a general description of the types of features that need to be included (so that, in the absence of such a description, the consumer may assume that only the listed items are covered), and
- a number of insurers presents the list of options as definitive or exhaustive (so that the consumer does not have the choice of including costs for features apart from those offered by the calculator). In fact the policies offered by these insurer indicate that a broader range of features will be covered.

These practices may lead to the consumer excluding certain items in their estimate of the sum insured, even though those items are covered under their policy. If the figure for the sum insured nominated by the consumer is too low as a result, then the consumer will be underinsured.

## Section 4: Updating the sum insured

### Findings

- Generally, insurers increase the sum insured each year on renewal of the policy. Insurers base these increases in the sum insured on a number of different measures relevant to building costs, including:
  - the consumer price index,
  - a house building index monitored by the Australian Bureau of Statistics, which tracks changes in the price of building materials but not labour, and only in capital cities, and
  - the Cordell Housing Index Price (CHIP), which tracks changes in both material and labour costs by region, and is therefore likely to be a more accurate measure.
- If the amount of the annual increase does not keep pace with rebuilding costs, the consumer can become underinsured within a short period of time.
- Between March 2000 and March 2005, the house building index increased by 12%, the consumer price index by 17%, and CHIP by 33%. If these increases are applied to an initial sum insured of \$200,000, then there is a difference of \$42,000 in five years if the sum insured is increased by the house building index or by CHIP.
- When renewing the policy the consumer also needs to take into account potential increases in costs from changes to building codes. Difficulties for consumers in estimating these costs include lack of ready access to this information, and changes to building requirements after the policy is taken out.
- Consumers need to increase their level of cover when renovating their home. A 2003 survey found that 24% of consumers did not increase the level of cover after completing renovations costing between \$20,000 and \$40,000.
- Insurers may underutilise the opportunity created by renewal to include information that can prompt consumers to assess whether their level of cover is adequate.

### Recommendations

- Insurers should review their practices for proposing increases in the sum insured to ensure these increases accurately reflect changes in building costs.
- If one particular method of tracking changes in building costs is shown to be more accurate, insurers should be encouraged to use that method and/or promote it to consumers.
- The ICA and insurers should explore ways to minimise the risk of consumers becoming underinsured due to changes in building codes.
- Insurers should also consider using renewal notices to:
  - illustrate the costs of increasing cover by an additional amount (such as \$20,000 or \$50,000),
  - indicate the amount by which the sum insured has been increased (at least since the previous year, if not for a greater period of time),
  - indicate the basis or formula used by the insurer for calculating the amount of any increase in the sum insured,
  - include questions or information directed at the individual consumer, indicating specific ways in which they might want to consider reviewing the sum insured (e.g. to take into account home improvements), and
  - include information as appropriate about whether the consumer can obtain greater cover for an equivalent premium by selecting a higher excess.

## Why is it important?

*'I treated each insurance renewal as a bill to be paid, rather than as an opportunity to review my insurance needs.'*

A consumer—responding to ASIC's ACT bushfire survey, 2004 (Case 113)

After a consumer has taken out home building cover, they need to regularly update the sum insured under their policy to avoid becoming underinsured over time.

The sum insured can be increased either:

- as the result of a conscious decision by the consumer, or
- by the insurer (usually by a default figure on renewal).

Any increase in the sum insured needs to take into account the following factors:

- any improvements to the property,
- increases over time in material and labour costs,
- increases in material and labour costs specifically due to changes in local council or building code requirements, and
- increases in supplementary costs.

If any increases from these changes are not factored into the sum insured, a gap may develop over time between the sum insured and the rebuilding costs, leaving the consumer underinsured, even though they initially had an appropriate level of cover.

## How does it work?

### Consumers' experiences

Of the 133 people affected by the ACT bushfires who responded to the ASIC survey, 83% reported that the sum insured had been increased during the time they had held the policy. All but one of these reported annual increases. Respondents advised that two thirds of these increases were based on changes in the consumer price index and one third on other factors.

Of the remaining respondents, 9% reported that the sum insured had not been increased and 8% were unsure. Only two of the 12 consumers who reported no increase had held their policy for more than three years, while four had held their policies for more than two years.

Most respondents reported that they received a renewal notice that specified the sum insured. Typically, this is the previous sum insured increased by an amount determined by the insurer. However, typically

the renewal notice did not include the old sum insured. This may have led respondents to the survey to under report the extent to which insurers propose an increase in the sum insured.

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### Case study

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'The sum insured for the building was increased over the 18 years we lived in the house from a combination of annual increases suggested by [insurer] in each renewal notice, adjusted on occasion by my own research. It would probably have proved adequate to rebuild the house as it was.

However, there were two factors that helped us decide not to rebuild [in this way]:

- the increased cost of labour and materials (both on supply and demand), and
- ... [wanting] to take advantage of advances in building technology, especially in improved energy efficiency.' (Case 16)

Australian research indicates that a significant percentage of consumers do not have a good understanding of their level of cover. The 2003 RACV survey<sup>32</sup> found that:

- 16% of consumers had only a rough idea of how much their home was insured for, and
- 17% had no idea of how much their home was insured for.

These figures suggest that up to 33% of consumers may depend on the insurer to increase the level of cover on renewal.

### Insurers' practices

Our survey of 12 insurers asked them to provide information about their practices for revising the sum insured on renewal. Insurers use a range of different methods. Most insurers increase the sum insured according to the consumer price index, the building price index or information provided by specialist building data companies. Four insurers indicated that they increased the sum insured by a fixed amount (between 3% and 6%). One insurer reported that the increase was based on discussions with professionals.

All the insurers surveyed indicated that they increase the sum insured on their customer renewal notices. We reviewed the standard renewal notices sent to consumers. This review indicated that:

- eleven insurers did not provide information to the consumer about their previous level of cover (which would enable them to assess the amount of any increase, and form an initial or intuitive view as to whether it is appropriate),

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<sup>32</sup> See footnote 16.



- most insurers did not inform consumers about the method by which the suggested increase was determined, and
- only three insurers suggested in their renewal notices that consumers may wish to review the level of cover (although it is possible information of this type may have been included in any covering letter sent with the renewal letter, as a copy of any such letter was not always provided in response to the survey).

It would appear that insurers underutilise the opportunity created by renewal to alert consumers on matters to consider in increasing the sum insured. This may contribute to the extent to which consumers see insurance renewal letters as ‘bills to be paid’. ASIC also acknowledges that consumer inertia and lack of awareness create significant obstacles to utilising this opportunity effectively.

Insurers could use renewal notices to provide additional information including:

- advice on how to estimate an appropriate level of cover,
- information about the website calculator (where appropriate),
- examples of the cost of particular levels of cover (e.g. the cost of having an additional \$20,000 or \$50,000 of cover), and
- making renewal notices more specific to the consumer by including information about their circumstances or location (e.g. the average sum insured in their area).

### **United States experience**

Insurers in the United States use mail or telephone surveys to ask the homeowner a series of targeted questions as a way of checking that a property is likely to be correctly insured. Insurers can use a seven minute telephone survey to review sum insured values across all or some of their business; the mail survey is supplied to consumers at renewal time to assist both them and the insurer to derive an appropriate figure for the sum insured.

## **Increases in building costs**

Insurers use the following measures to assess changes in the sum insured on renewal:

- The Consumer Price Index (CPI), which measures changes in the prices of a ‘basket’ of consumer items, but not specifically building costs.

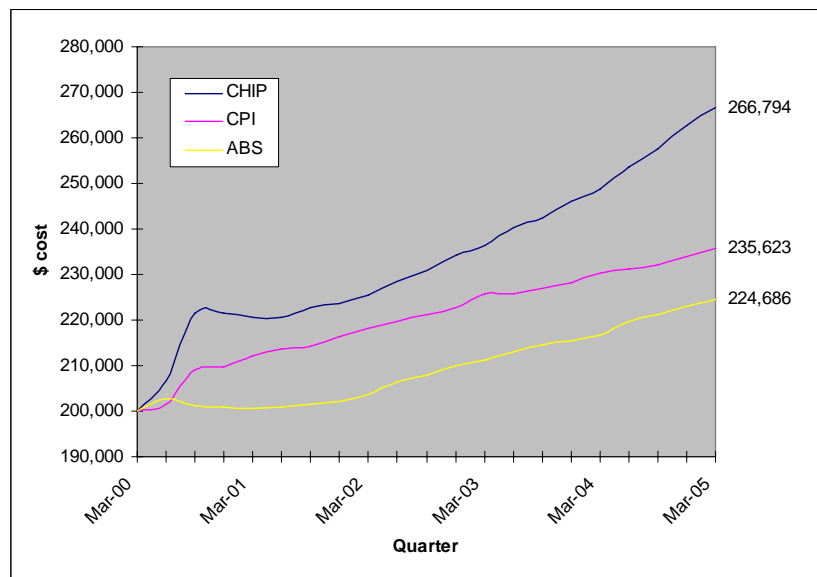
- The Building Price Index (BPI), which measures changes in prices of selected materials used in the construction of houses for each state capital.<sup>33</sup>
- The Cordell Housing Index Price (CHIP).

The BPI has two limitations: first, it does not monitor changes in labour costs (which typically constitute 45% of the costs of rebuilding), and, second, it is only available for capital cities.

ASIC considers that CHIP is likely to produce a more accurate assessment, as, first, it tracks changes in the costs of both materials and labour, and, second, it provides a breakdown by city and region.

The following chart shows the changes in a sum insured of \$200,000 over the five-year period to date, if the sum insured was increased annually by the CPI, the BPI and by CHIP.<sup>34</sup>

**Chart 4.1 National changes in the CPI, the house building index and CHIP from March 2000 to March 2005**



There is therefore a greater risk of the consumer being underinsured where the annual increase on renewal is based on the CPI or the BPI. The compounding effect of variations in the level of increase mean that the potential gap can increase at an ever widening rate, increasing the risk of underinsurance for consumers who have been policyholders for 10 or 15 years.

<sup>33</sup> The Australian Bureau of Statistics monitors the BPI.

<sup>34</sup> Between March 2000 and March 2005, BPI increased by 12%, CPI by 17%, and CHIP by 33%.

## Changes to building codes or council requirements

Apart from changes in price, the cost of materials and labour may also increase due to changes in building requirements. Recent examples of changes to building requirements that can increase replacement costs include: cyclone coding, upgrading of fibro houses, energy efficiency ratings and increased fence heights.

ASIC's review of insurers found that only eight out of 16 policies provided cover for increases due to stricter building standards. However, in seven of these eight policies, the consumer had to include an additional amount in the sum insured to meet these extra costs. Our review found that insurers did not have any straightforward method of quantify these costs internally, indicating the complexity of the task.

The website of Suncorp/GIO specifically reminds consumers to consider this issue in a 'tip sheet' entitled 'Tips to Ensure the Right Level of Cover':

'When repairing or replacing damaged parts of your home, we will pay the extra cost of making these parts comply with any changes to building laws or regulations that came into effect after your home was originally built or altered. When arranging or renewing your insurance, it's a good idea to check with your local council to review the relevant building laws and make sure your sum insured covers such costs which may arise if you need to rebuild or replace.'<sup>35</sup>

Drawing attention to this issue is desirable. However, a number of practical limitations inhibit the capacity of consumers to adequately assess the need for cover for increases from changes to building requirements:

- Consumers will need to make their own inquiries with building authorities about changes in building requirements. However, in most cases, these bodies will be unable to advise on the financial impact of these changes.
- Consumers generally have no easy way of ascertaining the financial impact of any such changes on rebuilding costs for their home.
- Consumers will need to take into account changes to building codes both since the house was built and in the future. Some changes to building requirements can be foreshadowed when the policy is taken out, but others will be unknown and impossible to predict.

Some ACT consumers became aware of this problem after their home was destroyed.

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<sup>35</sup> [www.suncorp.com.au](http://www.suncorp.com.au).

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## Case studies

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'We were never invited to update insurance to cover: minimum energy ratings, ... smoke detectors and safety switches ...' (Case 68)

'[We] couldn't build the same home due to change in building regulations. All the enquiries we made were going to be substantially more than the payout from the insurance company.' (Case 99)

The difficulties with assessing the financial impact of changes to building codes are considerable. This is an issue requiring further research as to possible alternative approaches.

## Home improvements

Even if the consumer has accurately assessed the initial rebuilding costs, there is a risk that they will become underinsured where:

- they renovate or improve the property and fail to increase the sum insured, or
- they renovate their home but only plan to increase the sum insured on renewal of the policy, and the property is a total loss prior to renewal.

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## Case study

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'In July 2002 we had completely remodelled our kitchen and family room. The cost was about \$25–30,000. We were waiting to update our amount insured until the next renewal. We were therefore underinsured [at the time of the fires in January 2003].' (Case 110)

The 2003 RACV survey found that consumers were more likely to adjust the level of cover as the value of the renovations increased, and more likely to increase cover after the renovations were complete.

The survey found that:

- where the renovations cost more than \$60,000, 33% of respondents adjusted their insurance while renovating and 67% after renovating,
- but where the renovations cost between \$20,000 and \$60,000, 16% of respondents adjusted their insurance while renovating, 60% after renovating, and 24% did not adjust their insurance at all.

Insurers do not routinely have contact with insureds between renewal notices. When renovating, consumers interact with a range of third parties, such as local councils or other statutory bodies, builders, architects, and other building professionals. In most states, homeowners must obtain a certificate of occupation (or equivalent) once their renovations are complete.

It may be possible therefore to use these opportunities to provide timely reminders to consumers to increase their building insurance (e.g. when building plans are lodged with planning authorities or in conjunction with the provision of the certificate of occupation). We will be exploring these options as part of our ongoing work following publication of this report.

### **Effect of GST**

The introduction of the Goods and Services Tax (GST) resulted in a 10% increase in rebuilding costs. Insurers varied as to whether they increased the sum insured by an additional 10% on renewal, or left this to the consumer to arrange. Some Canberra consumers advised that they were unaware that the sum insured had not been increased to take into account, and they received ex gratia payments to meet the resulting shortfall. It would be desirable if those insurers who did not increase the sum insured to take into account the effects of GST raised this issue with consumers on renewal.

### **Gap between date of policy and date of claim**

There is necessarily a gap between the date the policy is taken out and the date of any claim (up to a maximum period of nearly 12 months where the policy is renewed annually). This means that rebuilding costs are likely to have increased between the date the policy was taken out and the date of any claim.

We note that some insurers have addressed this issue through their policies by providing that, in the event of a claim, the sum insured will be increased by a percentage according to the number of months since the policy was taken out. It would be desirable if all insurers adopted methods to address this issue.

## Section 5: Policy design

### Findings

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- Insurers cover rebuilding costs in different ways. These variations are not easily identified or understood by consumers but can make a significant difference to the amount they will receive in the event of a claim.
- Under the most common type of home building insurance policy in Australia, known as a *sum insured* policy, the consumer will be adequately covered if they have correctly estimated rebuilding costs (except in the case of a mass disaster).
- The risk of underinsurance could be reduced by greater availability of *total replacement* policies. With these policies, the insurer agrees to pay the rebuilding costs as at the date of claim, rather than these costs up to a specified maximum.
- Only one company in Australia offers total replacement policies. The policy is only available in areas where the nature of the housing stock enables this insurer to make accurate estimates of the rebuilding costs.
- This insurer charges a price for its total replacement policy which is not significantly higher than the cost of its sum insured policy, and, in some cases, may be even cheaper.
- Even prudent consumers will be underinsured where there is a large and sudden increase in the cost of rebuilding their home, as can occur after a mass disaster. The risk of underinsurance would be reduced if *extended replacement* policies were more widely available. Under these policies the insurer agrees to pay the sum insured plus an additional 20–50%. These policies are rare in Australia, but more common in NZ and the USA.
- Under an *indemnity* policy, the consumer will automatically be underinsured as the insurer will only pay the depreciated value of the building materials (i.e. taking into account wear and tear), rather than the replacement cost.
- Apart from the cost of materials and labour, consumers also need cover against *supplementary costs* incurred when rebuilding (such as architects' fees or demolition costs).
- Consumers will be underinsured even where they have correctly estimated rebuilding costs where insurers exclude some supplementary costs from cover under the policy or impose caps which do not reflect the likely or maximum costs consumers may incur.
- Examples of the ways in which policies may not meet supplementary costs include:
  - *Demolition costs*: The Insurance Council of Australia has suggested that demolition costs can be 10% of the sum insured. Three of the 16 policies reviewed by ASIC use a formula which will generally result in a payment of less than 10% for demolition costs.
  - *Landscaping expenses*: Nine of the 16 policies reviewed by ASIC did not cover this cost at all, while the other seven policies imposed strict monetary limits on the amount payable. The maximum payment under the policies reviewed by ASIC for landscaping expenses was \$5,000.

### Recommendations

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- The ICA should work with insurers to consider whether it is viable for insurers to:
  - make total replacement cost policies more widely available, and
  - offer extended replacement policies.
- Where insurers offer indemnity policies they should highlight to the consumer that they are at risk of being underinsured.
- It is desirable that the insurer highlight limitations in cover for supplementary costs which mean that the consumer may not be covered for costs they are reasonably likely to incur.

## Why is it important?

There are significant variations in the cover offered by different insurers, with some insurers providing more comprehensive coverage of the costs commonly incurred where the house is totally destroyed. These differences mean that the type of policy selected can affect the extent to which the consumer is underinsured. It is, however, a complex task for consumers to understand what costs they may have to pay, or how to analyse policies to establish which costs are covered and to what extent.

Differences in cover between insurers can have a significant financial impact on individual consumers. However, underinsurance due to restrictions in cover affects only a relatively small number of all policyholders, as only very few consumers experience total losses. This limits the extent to which experience means consumers become aware of this issue at the point of sale, or make purchasing decisions based on these differences.

For these reasons, this section of the report analyses in detail the differences between policies, and identifies ways consumers may become underinsured due to limitations in cover.

## Different ways of covering costs

There is significant variation in the way Australian home building insurance policies cover material and builder costs, and even greater variation between the common types of Australian policies and the policies available overseas, in countries such as the United States and New Zealand.

The following table sets out different types of home building insurance policies and describes the way they meet liability for material and builder costs.

**Table 5.1: Types of cover**

<b>Sum insured policy</b>	<p>This is the most common type of policy in Australia. It caps the insurer's liability for rebuilding in the event of a total loss at an amount specified by the consumer, called the 'sum insured'.</p> <p>The consumer is responsible for determining the sum insured, so if this figure is too low the consumer will be underinsured. These are sometimes called 'sum insured replacement' policies.</p>
<b>Total replacement policy</b>	<p>The amount the insurer agrees to pay is not fixed or capped. Instead the insurer agrees to pay the full cost of rebuilding the home to the same size and at equivalent quality using up-to-date materials and building methods, and regardless of changes in building costs.</p> <p>The onus is on the insurer to ensure that its building cost valuation is accurate and that the valuation and premiums are regularly reviewed to reflect changes in construction costs and other factors that may affect the amount of any payout. Only one company in Australia offers a policy of this</p>

	type. These policies are more common in New Zealand (where they are called 'total replacement' policies) and the United States (where they are called 'guaranteed replacement' policies). <sup>36</sup>
<b>Extended replacement policy</b>	This type of policy obliges the insurer to pay the sum insured plus an additional amount up to a certain percentage (typically in the range 20–50%) above the sum insured specified in the policy. We understand that these policies are the current standard policy in the United States. <sup>37</sup>
<b>Indemnity policy</b>	An indemnity policy only pays the depreciated value of the building at the time of the loss. These policies were common in Australia into the 1970s and perhaps beyond. By definition, they will not provide enough money to rebuild the house as new. They may be an appropriate choice for a consumer with an old or poor condition property and who would not want to rebuild in the event of destruction of the property. At least two insurers currently offer indemnity policies in Australia.
<b>Combination sum insured/indemnity policy</b>	The amount paid by the insurer varies as the insurer will only pay the indemnity value (i.e. a lower amount reduced to take into account wear and tear and depreciation) if: <ul style="list-style-type: none"> <li>• the consumer takes a cash settlement, or</li> <li>• the consumer elects to rebuild the property on a different site.</li> </ul> Otherwise the insurer will pay the rebuilding costs up to the sum insured. There is potential for the consumer to become confused due to the different methods of calculating the amount payable in the event of a claim. The risk of confusion increases where the policy is described as providing cover on a 'new for old' basis, and where the policy does not clearly indicate the situations where the claim is paid according to the indemnity value.

Each policy differs as to whether the consumer will be underinsured in the event of a total loss. The policies can be ranked according to the extent of the risk as follows:

- Under a *total replacement* policy, the consumer will not be underinsured as the insurer has agreed to pay the rebuilding costs as at the date of claim.
- Under an *extended replacement* policy, the consumer, if they have accurately estimated rebuilding costs, will be adequately insured where the house is a total loss, even where rebuilding costs increase significantly and unexpectedly (such as following a mass disaster).

<sup>36</sup> See, for example, Insurance Information Institute 2002, 'Before the Next Hurricane – Review Your Insurance Policy to See What Coverages and Deductibles You Have', <http://iiiidev.iii.org/media/updates/press.634800/>

<sup>37</sup> See, for example, Kiplinger.com, *Is Your Home Underinsured?*, last updated 25 March 2003, [www.kiplinger.com/basics/archives/23003/03/underinsured](http://www.kiplinger.com/basics/archives/23003/03/underinsured); Weston 2004 *Why two out of three homes are underinsured* <http://moneycentral.msn.com/content/Insurance/Insureyourhome/P35340.asp> referring to research by Marshall Swift / Boeckh summarised in *Insurers Improving Undervaluation Problem*, 24 July 2003 at [http://www.msbinfo.com/newsroom/2\\_newsroom.asp?story=62&news\\_year=2003](http://www.msbinfo.com/newsroom/2_newsroom.asp?story=62&news_year=2003), viewed 14 December 2004.



- Under a *sum insured* policy the consumer, even where the rebuilding costs are accurately assessed, will not be adequately insured where there is a sudden and unforeseeable surge in building prices.
- Under an *indemnity* policy the insured is paid the depreciated value of the building materials (i.e. taking into account wear and tear), rather than the replacement cost. The consumer will therefore automatically be underinsured where they take out this type of policy if they decide to rebuild (rather than sell the property). If the consumer sells they will receive a smaller lump sum than they would receive under a *sum insured* policy. In this situation, while they may not be underinsured for rebuilding costs, they may not have enough money to buy an equivalent home.<sup>38</sup>

As far as we are aware, only one Australian insurer currently offers a total replacement policy. Promotional material by this insurer states: ‘This policy will simply replace your house or damaged parts to the same size and equivalent quality and design as it was before. This will be done regardless of cost and without any dollar sum insured limitation’.

Total replacement policies are readily available in New Zealand. The NZ Insurance Council website<sup>39</sup> says that most insurance companies offer ‘total replacement’ or ‘no sum insured’ home building policies. The insurer will rebuild the house and pay all the fees involved in the process. The website says that this type of insurance is usually limited to houses that are owner-occupied, under a certain age and in good condition.

Total replacement policies are also offered by some companies in the United States. These policies were common in the United States until the Oakland fires destroyed 3000 homes in 1991 and Hurricane Andrew caused \$21 billion damage in 1992.<sup>40</sup>

United States insurers had placed values that were too low on many of the homes destroyed in the Oakland fires and by Hurricane Andrew, in part because, reportedly, ‘insurance companies that had sold guaranteed replacement policies hadn’t done a great job of tracking building cost trends and hadn’t factored into the equation the run-up in costs that would occur if extensive damage was concentrated in a relatively small area’.<sup>41</sup>

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<sup>38</sup> The survey of 1015 Victorian consumers by RACV in 2003 found that 12% of respondents had an indemnity policy.

<sup>39</sup> <http://www.icnz.org.nz>.

<sup>40</sup> Kiplinger.com (2003, *Homeowners Insurance: Is your home underinsured?*, <http://kip2.kiplinger.com/basics/archives/2003/03/underinsured.html>).

<sup>41</sup> Kiplinger.com, *Is Your Home Underinsured?*, last updated 25 March 2003, [www.kiplinger.com/basics/archives/23003/03/underinsured.html](http://www.kiplinger.com/basics/archives/23003/03/underinsured.html). Note that not all policies obliged the insurer to meet the cost of rebuilding to the standards in the building code current at the time of claim (which had been substantially upgraded since many of the original homes were built).

The insurer offering the total replacement policy in Australia has advised ASIC that:

- The policy is only available in places where the housing stock is relatively recent and uniform in nature, making the assessment of rebuilding costs more straightforward. The policy is currently available in Perth and country regions in south west Western Australia, Adelaide and rural South Australia, Melbourne and rural Victoria.
- It calculates the cost of rebuilding the insured property at an individual level, either by reviewing a copy of the house plans or, if they are not available, conducting a site visit to inspect and measure the home.
- It has undertaken price modelling, which indicates that the cost of a total replacement policy is similar to that of a sum insured policy (which it also offers). In fact, in some instances, it may be cheaper for the consumer to take out a total replacement policy rather than a sum insured policy.

We acknowledge that it is unlikely that total replacement policies could be introduced in Australia without insurers being able to obtain accurate information about rebuilding costs.

It is also likely that these types of policies may only be available for certain types or categories of homes where the rebuilding costs can be more readily and accurately estimated. Nevertheless, we consider that if the level of underinsurance is to be reduced, insurers should be encouraged to explore whether it is possible to make this type of policy more widely available.

## **Policy design and mass disasters**

### **Effect of mass disasters on rebuilding costs**

Even a prudent consumer will be underinsured where:

- there is a sudden and unforeseeable jump in rebuilding costs, and
- the insurance policy does not provide cover against such an extraordinary increase.

The extent to which building costs can increase following a mass disaster is illustrated by reports suggesting that prices increased by 75% following Cyclone Tracy in Darwin in 1974 and by 35% in Newcastle after the 1989 earthquake.

This type of underinsurance can be characterised as ‘inadvertent’ underinsurance. A consumer can only avoid being underinsured in these

circumstances by overinsuring their property when calculating the sum insured.

### **ACT bushfires**

There are diverging views about whether or not building costs in the ACT significantly increased after the bushfires of January 2003. This issue was not independently investigated by ASIC as part of this report.

The Bushfire Recovery Taskforce established a Building Costs Monitoring Committee to investigate and report on a range of issues influencing buildings costs in the ACT. The Taskforce report contains the following information on pricing:

- Building prices increased from approximately \$800 per square metre in November 2002 to \$1200 per square metre in January 2003 (but that prices declined briefly after January 2003).
- Building costs increased 3% between January and May 2003.
- As at the date of publication of the report, October 2003, building prices ranged from \$1090 to \$1500 per square metre, according to the quality of the home.<sup>42</sup>

However, the report acknowledges that the conduct of the Committee, the ICA and insurers (in monitoring costs, liaising with building industry bodies, and promoting action to relieve labour shortages) are likely to have helped minimise bushfire related price increases.<sup>43</sup>

There is anecdotal evidence from respondents to ASIC's survey, indicating that, irrespective of the average level of increase, some consumers experienced substantial increases in price.

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### **Case studies**

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'The assessor was asked the Wednesday after the fires what their assessment was based on. She said \$1000 per sq metre. As the home was underinsured by this measure there was no problem paying our claim. Immediately after the fire, queries were made of builders right through to Oct 2003 regarding costs. Minimum throughout was \$1300 per m<sup>2</sup>.' (Case 72)

'When deciding on rebuilding we were quite confident that our total sum insured on the building was adequate. After the fires every time we went to a builder the price per square metre increased until we decided that unless we wanted a mortgage (which we didn't have on the original house) we couldn't afford to rebuild.' (Case 99)

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<sup>42</sup> Taskforce report, pp. 90–92. See also Appendix D.

<sup>43</sup> *ibid.*

### Overseas experiences

It has been suggested that building costs increased 30–50% in the Oakland area of California after fire destroyed 3000 homes in 1991 and that similar experiences followed Hurricane Andrew in Miami-Dade County, Florida in 1992. Some US states have passed anti-gouging laws in response.<sup>44</sup> We are not aware whether such laws have in fact been effective in reducing post-disaster price increases.

There is a significant risk that virtually all consumers will be underinsured to some extent following widespread losses of homes in a mass disaster.

The number of homes totally destroyed by disaster remains a very small percentage of overall claims. It is unlikely therefore that such additional cover would affect cost significantly, given that the bulk of the premium is used to meet claims where the house is not a total loss.

In broad terms there are three possible responses:

- consumers could be encouraged to overinsure by a certain percentage to cater for the possibility of their home being destroyed in a mass disaster,
- government or industry-wide intervention in the form of a levy,<sup>45</sup> or
- changes to policy design, so that insurers offer greater cover through extended replacement policies.

We are aware that at least one insurer in Australia currently offers extended replacement policies. However, this policy is only available for strata title buildings and not residences generally. This insurer offers ‘Catastrophe’ cover as either an optional addition to their standard strata body policies or as a stand-alone policy available to supplement insurance taken out with another insurer.

Under this policy the insurer agrees to pay an amount to meet any escalation in rebuilding costs up to the sum insured (as selected by the consumer). The insurer suggests that consumers may need to increase their existing cover by a minimum of 30% to meet additional costs.

### Policy design and supplementary costs

In addition to the cost of replacing the main building, insurance policies may also cover a range of costs associated with rebuilding. These costs include:

- fixed landscaping,
- damage to fixed coverings,

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<sup>44</sup> Section i501.160 of Title XXXIII of 2004 Statutes: Regulation of Trade, Commerce, Investments and Solicitations.

<sup>45</sup> For one example, see the proposal for a \$40 levy on all homeowners proposed by Rice Walker, referred to in Susan Hely, ‘Insurance Wake-up Call’, *Personal Investor*, 1 March 2003, p. 54.

- demolition, removal of debris and site clearing,
- the fees of architects, surveyors and other professional advisers,
- making the damaged premises safe,
- extra costs required to satisfy any new or changed requirements of local councils or other government authorities,
- temporary accommodation,
- legal liability relating to occupying the property, and
- cost of discharging any mortgage.

### **Consumers' experiences**

Our survey of people affected by the ACT bushfires sought information on their experience of insurance cover for several types of loss. We asked respondents whether their insurance payout included an amount for each item and whether this payment was sufficient to cover the associated expenses.

Not all consumers could identify the amount paid for each particular supplementary cost, as they received a lump sum payment. However, some consumers were significantly underinsured because their policies did not provide sufficient cover to meet their losses.

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### **Case study**

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'Because of our age, we had almost repaid our mortgage. If we had been younger, we would have had serious problems rebuilding. As it is, we have an additional \$60,000 mortgage. This mainly relates to fencing, paving, pergola, retaining walls, driveways, plants, soil, etc. Most of the landscaping is being done by ourselves due to cost.' (Case 41)

### **Variations in policy design**

ASIC reviewed 16 policies from 12 insurers. These policies vary as to:

- the range of supplementary costs covered,
- the maximum amount payable for some of these costs (typically, any such cap is specified either as a cash amount, e.g. 'to a maximum of \$5000', or as a proportion of the sum insured, e.g. 'to a maximum of 10% of the sum insured'), and
- whether supplementary costs are payable from the sum insured or paid as amounts additional to the sum insured.

The types of supplementary costs covered, and the limits on the amount of any payment, are set out in Table 5.2.

**Table 5.2: Home insurance policies—additional benefits payable**

Loss covered	Included in sum insured	Additional to sum insured	Range of limits where additional cover provided	Not covered
Demolition and removal of debris	9	7	A (1), B (1), C (1), D (4)	0
Making safe	4	2	D (1), E (1)	10
Architect/surveyor fees	9	7	A (1), B (1), C (1), F (4)	0
Extra costs to satisfy council/government authority requirements	7	1	A (1)	8
Temporary accommodation	0	16	A (1), G (12), H (1), I (1), J (1)	0
Garden/landscaping	1 <sup>^^</sup>	6	\$500 (1), \$1000 (1), \$1250 (1), \$2000 (2), \$5000 (1)	9
Legal liability	0	16	\$10m (8), \$20m (2), Amount specified (6)	0
Mortgage discharge	0	12	\$500 (2), \$1000 (2), \$5000 (1), A (1), no limit (6)	4

Source: ASIC Review of Home Building Insurance Policies March 2004

#### Notes

A—Demolition/remove debris + architects etc fees + meeting statutory authority requirements + rental accommodation to maximum of 10% of sum insured + any part of sum insured not used

B—Demolition/remove debris + architects etc fees to 10% of sum insured

C—Demolition/remove debris + architects etc fees + new title documents + mortgage discharge fees + meeting statutory authority requirements to maximum of \$3000 + any part of sum insured not used

D—Demolition/remove debris to 10% of sum insured

E—Reasonable costs of removal, no limit

F—Architects etc fees to 10% of sum insured

G—Temporary accommodation in similar premises for maximum of 12 months and to maximum of 10% of sum insured

H—Temporary accommodation in similar premises to maximum of 10% of sum insured

I—Temporary accommodation in similar premises for maximum of 12 months

J—Temporary accommodation in similar premises to maximum of 20% of sum insured

<sup>^^</sup>—Includes paths, garden beds, paving etc, but excludes lawns, trees, shrubs and hedges

#### Responsibility for estimating supplementary costs

As can be seen from Table 5.2, there are two broad approaches to covering supplementary costs:

- The sum insured covers both material and builder costs, and supplementary costs (i.e. *global sum insured* policies). Under these policies, the consumer nominates a figure for the sum insured that is sufficient to cover both material and builder costs and supplementary costs.

- The sum insured only covers material and builder costs and supplementary costs are payable on top of this amount (i.e. *sum insured plus benefits* policies). The insurer determines the amount that will be paid for supplementary costs, by excluding cover for particular costs, or specifying caps or limits on payments.

### **Implications for consumers—global sum insured**

Under a global sum insured policy, there is a risk of underinsurance where the consumer either does not include an amount in the sum insured to cover supplementary costs, or underestimates that amount. The amount of additional cover required is likely to be more than 20% of the base sum insured, given that both demolition costs and architects' fees can cost up to 10% of the sum insured each.

The risk of this type of underinsurance occurring increases where the policy wording or layout is confusing. We note that the wording of at least one policy current at the time of the ACT bushfires was ambiguous in relation to architects' fees. The insured complained to the Insurance Ombudsman Service, which found that the policy was contradictory in the way it described how the insurer would pay architects' fees. It decided that this ambiguity should be construed against the insurer, and determined that it should pay the cost of an architect.<sup>46</sup>

### **Implications for consumers—sum insured plus benefits**

Under sum insured plus benefits policies, the insurer only agrees to pay supplementary costs up to the limits stated in the policy. Clearly insurers are able to impose limits on cover as they see fit. However, consumers may expect that limits reflect the likely level of costs to be incurred. The consumer will be underinsured where they incur supplementary costs for an amount greater than the cap or limit specified by the insurer.

ASIC's review of insurers found that:

- very few insurers kept data about the amount paid for particular supplementary costs in the event of a claim, and
- only a small number of insurers based limits on supplementary costs on the likely maximum cost.

It would appear that some insurers do not test the adequacy of the limits in their policy, either through testing these caps against the amount incurred by the consumer in the event of a claim, or through more general research.

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<sup>46</sup> Determination 103–17256. The policy contained the following statements: '*We do not cover these costs [including architects fees] if ... the buildings sum insured is already used up by the payment made to you*', and '*The most we pay is the building sum insured shown on your Certificate of Insurance as well as any costs [including architects fees] detailed on pages 42 to 44*'.

For some types of costs the amount payable is typically calculated as a percentage of the sum insured (e.g. to a maximum of 10% of the sum insured). Where supplementary costs are capped in this way the consumer may be underinsured if:

- the consumer has underestimated the sum insured,
- the supplementary costs do not fluctuate significantly according to the size or value of the house, and
- the rebuilding costs are relatively low (as may be the case in some rural areas).

### **Supplementary costs not covered by insurers**

A significant number of the 16 policies reviewed by ASIC did not provide cover against three types of supplementary costs:

- making the property safe (10 policies),
- the cost of re-establishing the garden/landscaping (9 policies), and
- extra building costs incurred to satisfy enhanced council or local government building requirements (8 policies).

The review also found that three policies excluded all three of these supplementary costs.<sup>47</sup>

### **Temporary accommodation**

Insurers agreed to meet the cost of temporary accommodation under all policies we reviewed. The cost of temporary accommodation is invariably a benefit payable in addition to the sum insured. The amount payable is often capped as a percentage of the sum insured. If the consumer nominates a figure for the sum insured that is too low, this may have a flow on effect and leave them underinsured for the cost of temporary accommodation.

In our survey of people affected by the ACT bushfires, 86 insured consumers (77% of those answering the question) reported that the amount paid for temporary accommodation was sufficient, and 26 (23%), reported that it was not.

Of the consumers who reported receiving an ex gratia payment from their insurance company, 19 advised that it was paid to meet temporary accommodation expenses (e.g. the insurer agreed to continue to pay beyond the typical policy limit of 12 months).

The most common formula used by insurers in capping accommodation costs is that the insurer will meet the cost of temporary accommodation

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<sup>47</sup> In one case the insurer covered one of the excluded costs under a different policy, offering a more expensive but more comprehensive level of cover.



in similar premises for a maximum of 12 months and to a maximum of 10% of the sum insured (used in 12 of the policies reviewed by ASIC).

If consumers are not to be underinsured where this formula is used, then:

- the consumer should be able to rebuild within 12 months, and
- the cost of alternative accommodation for a maximum of a year should be approximately 10% of the sum insured.

With the first proposition, we note that the Insurance Council of Australia advises consumers that they may need alternative accommodation for up to 18 months, depending on the level of property destruction or damage.<sup>48</sup> ASIC's review of policies shows that 13 of the 16 policies paid accommodation costs for a maximum period of 12 months only, and that one policy provided a lower level of cover.<sup>49</sup>

There is therefore a risk that policy limits on temporary accommodation will contribute to underinsurance where:

- the formula used to cap costs does not accurately reflect the amount the consumer is likely to incur,
- the sum insured is relatively low, or
- there are regional variations (e.g. in locations with unusually high rental costs relative to building costs).

Mass disasters also have the potential to affect accommodation costs in two ways:

- Those displaced by the catastrophe need alternative housing at short notice, creating immediate pressure on rental prices.
- There may be a shortage of builders compared to demand, so that it takes longer than usual for the consumer to rebuild.<sup>50</sup>

We are aware of one insurer that offers increased accommodation cover in the case of a mass disaster. Under its 'Catastrophe' policy, the insurer agrees to top up the consumer's cover under their existing building policy by covering accommodation costs until the property is rebuilt.<sup>51</sup>

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<sup>48</sup> Insurance Council of Australia, *Households Urged to Check Their Insurance Cover*.

<sup>49</sup> The formula used in the policy was that the insurer would pay a maximum of 10% of sum insured plus any part of sum insured not used to meet the following costs: demolition costs and removal of debris, architects' fees, meeting statutory authority requirements and rental accommodation.

<sup>50</sup> As at September 2005, only 238 out of the 407 homes destroyed in the Canberra bushfires of January 2003 had been rebuilt (*Canberra Times*, 5 September 2005, p. 3).

<sup>51</sup> The policy is only available for strata title properties.

## Professionals' fees

Payments by insurers to meet architects' fees was one area where homeowners reported a significant level of underinsurance. Of the respondents to ASIC's ACT bushfire survey, 44 reported that the payments made under the policy were not sufficient to cover professionals' fees, and ten advised that it was sufficient. The remaining respondents were unable to answer this question (only 59 respondents had rebuilt their house at the time of the survey).

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## Case studies

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'Architects' fees amount to \$20,000. Fencing and landscaping of a base plot will cost a considerable amount.' (Case 48)

One ACT survey respondent reported that their insurer was reluctant to pay for architects' fees:

After months of dispute, I took [insurer] to the Insurance Industry Tribunal—with a successful outcome. Note that my policy made specific provision for architect's fees. [Insurer]'s position was that nothing was payable because there were (30+ year old) plans in existence. (Case 86)

We have obtained a copy of the 'Small projects fee guide', issued by the Royal Australian Institute of Architects.<sup>52</sup> The figures are issued by the Institute for general guidance only, and include estimates of architects' fees as a percentage of total construction costs. The guide indicates that:

- for simple projects architects' fees will exceed 10% of the construction costs where those costs are less than \$100,000, rising to approximately 14% for construction costs of \$50,000, and
- for complex or individually designed homes, the architects' fees will be higher and they will therefore constitute a higher percentage of the overall costs. For example, for a complex home costing \$100,000, architects will usually charge more than \$10,000 (or 10%). For these homes, architects' fees exceed 10% of the construction costs until the overall cost of the home reaches approximately \$400,000.

All policies we reviewed included cover for the cost of professionals' fees (architects, engineers and surveyors). For nine policies, the cost is included in the sum insured and for seven policies, it is an additional benefit (in four cases, limited to 10% of the sum insured).

Nine of the policies in Table 5.2 include the cost of professionals' fees in the sum insured. For seven policies, the cost is an additional benefit, with the amount payable subject to a cap in the policy:

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<sup>52</sup> Published in July 2001.

- in four cases, the maximum amount payable for architects' fees was 10% of the sum insured, and
- in three cases, the policy used a formula which would result in a lower figure (by capping the amount payable for the total of both architects' fees and other supplementary costs at 10% of the sum insured or \$3000).

There is a risk that policy design will contribute to underinsurance for architects' costs where:

- the consumer incurs fees higher than 10% of the sum insured (as may be the case where the sum insured is relatively low or the insured property was of a complex design), and
- the level of underinsurance in these circumstances will be higher under one of the three policies where the insurer pays less than 10% of the sum insured.

However, in some cases it will not be necessary for the consumer to obtain an architect's design in order to rebuild, where previous plans are still available (and not outdated), or where the consumer rebuilds a project home using a standard design. This will vary according to the requirements of individual councils.

### **Legal liability cover**

The report of the ACT Bushfire Recovery Taskforce noted that for many homeowners, legal liability cover ceased from the moment that their claim was paid. In this case consumers were underinsured, not because of a monetary limit or cap in the policy, but because of limits on the period of time for which this cover was offered.

This was also a matter frequently raised by respondents to our survey.

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### **Case study**

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'I was not at all impressed with the way [insurer] dealt with the claim. ...I was particularly upset with their need to rush thru after the assessment on Jan 22. I tried to stop the payment on Jan 24 after I found out that 7-day payment of claim, public liability insurance on the block would cease... I had to arrange for a group of friends to push over all walls standing to reduce risk ... public liability insurance was later resumed but not until after a lot of time and stress had eventuated...' (Case 72)

The ACT Government had to intervene and resolve the situation by arranging for a suitable legal liability policy to be made available for purchase by affected consumers. According to survey respondents, some insurers also extended legal liability cover on an ex gratia basis, beyond that required by their policies. However, such arrangements are unlikely to be

available to consumers when their home is destroyed in a one-off event (leaving them uninsured at a time when their damaged property is likely to offer particular dangers to third parties).

It is understood that a number of insurers have revised the terms on which legal liability cover is provided following the ACT bushfires, and that this has reduced the extent to which this may be a problem in the future.

### **Demolition and removal of debris**

All policies we reviewed included cover for the cost of demolition and removal of debris. For nine policies, the cost was included in the sum insured and for seven policies, it was an additional benefit (in four cases, limited to 10% of the sum insured).

After the 2003 bushfires, the ACT Government introduced a system to 'case-manage' demolition and removal of debris. A number of consumers reported benefiting from a grant of \$5000 made by the ACT Government towards demolition costs. This action reduced typical demolition costs.

In all, 38 respondents to ASIC's ACT bushfire survey reported that the payments made under the policy were sufficient to cover demolition and removal of debris, while 33 reported that the insurance payout was not sufficient. However, given the subsidy from the ACT Government, the survey results are inconclusive on the adequacy of cover.

The Insurance Council of Australia has suggested that demolition costs, where it is necessary to remove fire debris from the property, can be 10% of the sum insured.<sup>53</sup> ASIC's review of policies shows that four of the seven policies capped the maximum payment at this figure. However, three policies used a formula that would result in the insurer paying less than 10% of the sum insured for demolition costs.<sup>54</sup>

There is a greater risk of underinsurance for demolition costs where the consumer takes out a policy that provides cover that is more limited in this way.

### **Landscaping**

Landscaping is a problematic area, in that the need for this type of cover can vary enormously between consumers, from relatively small amounts to thousands of dollars. If insurers automatically included substantial cover for landscaping this would result in some consumers bearing the cost of cover for which they may have no need.

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<sup>53</sup> Insurance Council of Australia, *Households Urged to Check Their Insurance Cover*.

<sup>54</sup> These policies provided that the insurer would meet both demolition costs and other supplementary costs from a maximum of 10% of the sum insured.

Cover for landscaping was offered by only seven of the 16 policies reviewed. For five of the seven policies, cover is limited to an amount in a range from \$500 to \$2000. For one policy, the cover limit is \$5000 and for another, the cover is included in the sum insured but only applies to items such as paths, garden beds and paving (and does not apply to lawns, trees, shrubs or hedges).

Of the 62 respondents to our ACT bushfire survey who reported incurring landscaping expenses, only two stated that their insurance policy was sufficient to cover these expenses. Some consumers paid out substantially more for landscaping than the amount covered in the policy. In 13 cases, respondents reported that the cost of landscaping ranged from \$10,000 to \$40,000.<sup>55</sup> One consumer reported that the insurer met the cost of a landscape architect but not the landscaping work. One consumer reported that they required \$8000 for driveways alone.

It is evident that typical policy limits for landscaping are at times grossly insufficient to meet landscaping costs—at least after a bushfire, which not only destroys the house but also devastates the surrounding garden.

The large variation between individual needs in this area makes it a complex issue for insurers. However, insurers use the model of providing additional cover on an optional basis where selected by the consumer used by insurers for other aspects of cover (such as damage from fusion of motors). This model could be adapted.

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<sup>55</sup> This omits one very large figure, which would appear to be an error.

## Section 6: Consumer choice

### Findings

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- Consumers may be deliberately underinsured in different ways:
  - Some consumers knowingly choose a level of insurance that is lower than required to rebuild their house.
  - Other consumers, suspecting that they are underinsured, do not act to increase their level of insurance.
  - The consumer may believe that their level of underinsurance is only marginal and within their risk tolerance, when in fact the gap between their level of cover and rebuilding costs is greater than they realise.
- Ways to help consumers insure for the correct amount include:
  - improved tools to estimate the correct sum insured, and a better understanding of which tools are likely to produce the most accurate figure,
  - additional information about the cost of increasing the level of cover,
  - a greater ability to compare insurance policies, and
  - community education about the risks of loss in the case of underinsurance, particularly about ways of obtaining comparative pricing information.
- By comparing prices consumers may be able to increase the sum insured without having to pay a higher premium. Some consumers who have a policy with more expensive insurers may be able to obtain additional cover of up to 94% for a similar premium (or an additional \$170,000 cover on a property currently insured for \$190,000).
- To the extent cost is a factor in decisions to underinsure for consumers, the level of underinsurance may be able to be reduced by more information on prices.
- Websites are a relatively efficient way for consumers to compare premiums by obtaining e-quotes.

### Recommendations

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- Insurers could help consumers to assess the level of cover offered by policies and to compare the benefits under policies by providing them with:
  - a clear statement of the costs covered by the sum insured, and
  - other information to prompt or help them assess whether their level of cover is adequate (such as information about the previous amount insured, the method used to calculate the proposed new sum insured and the cost of a higher level of cover, and variations in premium according to the level of excess selected).
- ASIC should continue to deliver appropriate community education messages about non insurance and underinsurance.

## Why is it important?

It is sometimes suggested that one of the main causes of underinsurance is that consumers choose to nominate a low sum insured to reduce their premium.<sup>56</sup> There is no doubt that some consumers make this choice.

However, even among this group, difficulties in estimating rebuilding costs mean that consumers are unlikely to be aware of the actual degree to which they are underinsured. In other words, the level of underinsurance may be greater than as perceived by the consumer, and may be beyond their risk tolerance.

Despite some degree of consumer volition the level of underinsurance can be reduced if consumers have increased access to relevant information about:

- rebuilding costs (including access to reliable tools for estimating those costs), and
- the cost of alternative cover.

## Do consumers know they are underinsured?

The complexities in accurately calculating rebuilding costs make it problematic to survey or estimate the extent of deliberate underinsurance.

One major insurer advised us that its research indicates 26% of consumers *believe* that they are underinsured for their home building cover. However, it added that some consumers may have overestimated the cost of rebuilding where they confused increases in property prices with increases in building costs.<sup>57</sup>

Conversely, in our survey of people affected by the ACT bushfires, only three people (2%) said they knew they were underinsured before the fires, with 80% saying they believed they were adequately insured and 16% advising they had not considered whether or not they were underinsured. Clearly, a significant percentage of the consumers who thought they had adequate cover were underinsured.

Some consumers had made significant efforts and even changed insurers in order to obtain cover for the right amount.

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<sup>56</sup> As suggested by Weston, former NRMA Group General Manager, at *Factors Contributing to Under-insurance*. See also the results of the Quantum Research survey for the Insurance Council of Australia discussed at *Factors Contributing to Under-insurance*.

<sup>57</sup> It is not known whether these consumers may have not increased their level of cover because they assumed that their premiums would increase at a similar proportion to the perceived increase in property value.

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## Case study

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'I was convinced that [insurer A]'s estimates and cost per square metre were too low. The other costs borne by policyholders are not highlighted in most insurers marketing material. [Insurer A] in particular I thought was poor. This was one of our reasons for switching to [insurer B]. We were insured with Insurer A for \$250,000 based on their estimates. When we moved to Insurer B we factored in our own calculations with allowances, site clearance, survey, fences, gardens etc. We insured with Insurer B for \$370,000. Thank god! PS: Even \$375,000 was not enough.' (Case 76)

## Can consumers pay less for more cover?

As noted in Section 1, Reed Building Information (Reed) conducted a survey in 2000 into the levels of underinsurance, which found significant levels of underinsurance. Reed calculated that an additional \$90,000 in cover would cost, on average, an additional premium of \$74.<sup>58</sup>

Reed then resurveyed 20% of those earlier respondents. Of these, 94% said they would be prepared to pay an additional \$75 in premium for additional cover of \$90,000.<sup>59</sup> This suggests that consumers may be willing to pay for a higher level of cover if they are able to access more information about relative costs.

### Higher excess

Many home building insurance policies enable the consumer to reduce the premium by agreeing to pay a higher excess in the event of a claim.

The RACV survey of 1015 Victorian consumers in 2003 found that 30% of respondents had only a rough idea or no idea of how much their excess was.<sup>60</sup> This group at least is unlikely therefore to use the size of their excess to increase their level of cover (where they are concerned both about being underinsured and the cost of the premium).

### Comparing premiums

Some (but not all) of the web-based calculators reviewed by ASIC will also generate a premium for the suggested sum insured, provided the consumer answers additional questions concerning matters such as their claims history.

We used the web-based calculators of a number of insurers to obtain quotes for premiums for the same five properties used in Section 2. We used the same premium to compare variations in the sum insured offered by different insurers. This was done by varying the size of the home until

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<sup>58</sup> Based on premiums quotes by six major home building insurers.

<sup>59</sup> Information provided by Reed Business Systems.

<sup>60</sup> 12% had only a rough idea and 18% had no idea of the amount of their excess.



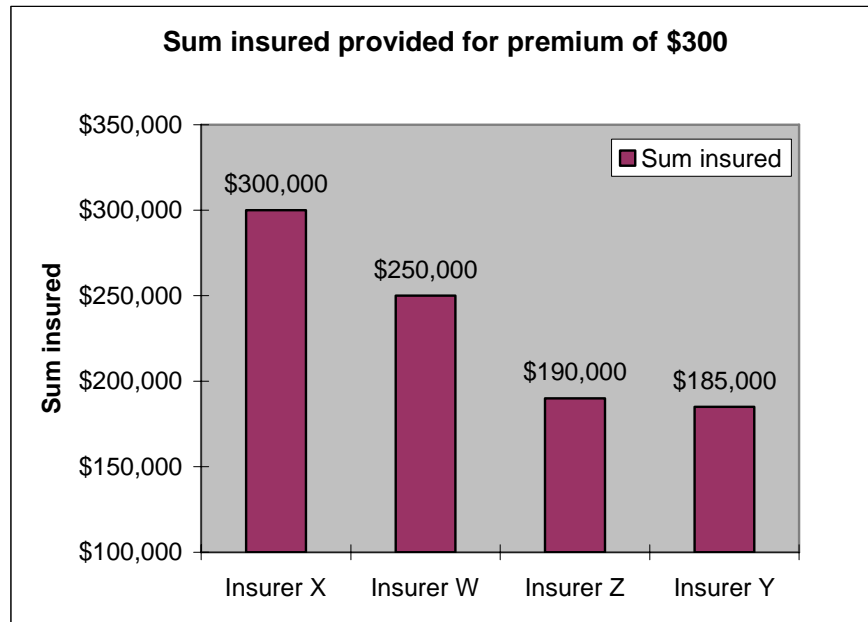
the calculators for each insurer generated a similar premium. The survey therefore only produces an indication of the range in price. Two of the five houses in Section 2 were used for this exercise.

We limited the comparison to those insurers offering global sum insured policies and whose calculators used the cost per square metre method, as this group would produce a comparison using similar features, and where the difference in the size of the home had least potential to distort the cost. In all cases, an excess of \$100 was selected.

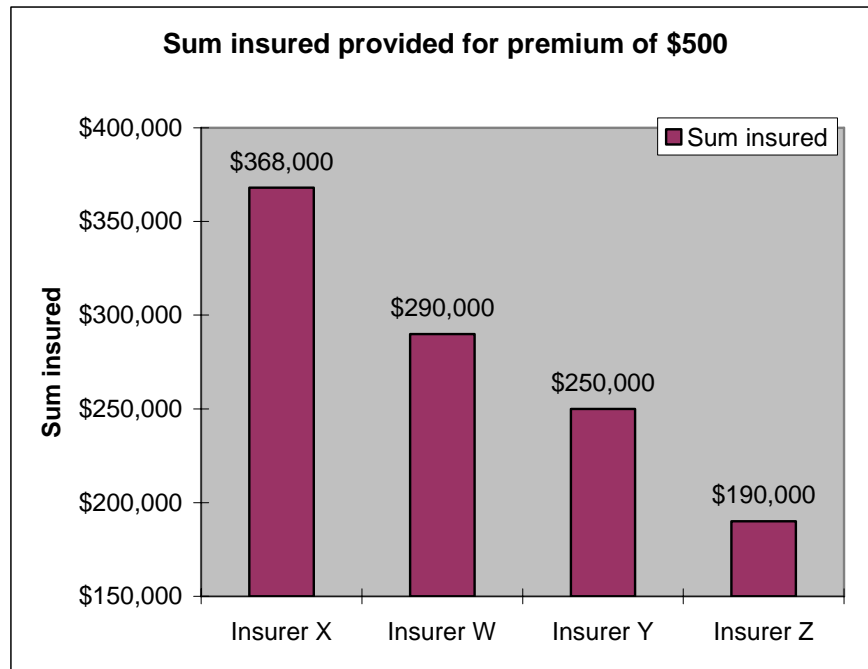
A similar exercise was also undertaken to produce premiums enabling a comparison of the range of prices charged for insurers for an equivalent insured for the same house. This was done by varying the size of the home until the calculators for each insurer generated a similar estimate of the sum insured, and then using this figure to obtain a quote for a premium.

The results of this survey using the same sum insured are set out in the following charts.

**Chart 6.1 Comparisons of sum insured and premiums between four calculators using cost per square metre method (for brick veneer house in Ainslie ACT)**



**Chart 6.2 Comparisons of sum insured and premiums between four calculators using cost per square metre method (for brick veneer house in Engadine, NSW)**



This survey suggests that those consumers who have expensive policies may, without an increase in cost, be able to obtain significantly higher levels of cover, 62% in the case of the Ainslie property, and 94% in the case of the Engadine property.

ASIC also obtained e-quotes to establish the difference in price charged by insurers for the same sum insured. The results are set out Charts D.1 and D.2 in Appendix D. For the Ainslie house premiums ranged from \$273 to \$378 (a variation of 38%) and for the Engadine house from \$425 to \$596 (a variation of 40%).

Charts D.3 to D.6 in Appendix D set out the different premiums charged by insurers for the sum insured generated by their calculator (as set out in Table 3.1). This review also shows significant variations in premium. In only one instance did the insurer proposing the highest sum insured charge the highest premium, and in two cases the insurer proposing the lowest sum insured charged the lowest premium. This analysis also indicates that consumers can obtain greater cover for a cheaper or equivalent premium.

These reviews do not take into account any differences in the cover offered under the policies, or the extent to which the difference in price may be due to a lower level of cover for supplementary costs. These assessments would need to be made by individual consumers, who can utilise the ASIC website for general guidance: [www.fido.asic.gov.au](http://www.fido.asic.gov.au). However, irrespective of these differences consumers will generally be better off with a significantly higher level of cover.

## Issues for consideration

Consumers need to consider the following issues when comparing policies and selecting cover:

- They need to be able to recognise and use the most accurate tools to obtain an estimate of the rebuilding costs.
- They need to understand the difference between a *global sum insured* policy and a *sum insured plus benefits* policy. A review of a number of insurance policies showed that this distinction was not always clearly presented in the policy. The consumer would need to read the policy in detail to determine which type of policy they held.
- They need to decide whether to select their own level of cover for supplementary costs by increasing the sum insured under a global sum insured policy. Only one insurer offering a global sum insured policy had a clear statement in highlighted format stating which costs should be taken into account to estimate the sum insured.
- If they take out a sum insured plus benefits policy, they face two issues: first, it will not be easy for the consumer to determine which costs are simply not covered (as by its very nature this task requires the consumer to identify an absence); and, second, it will be difficult for the consumer to assess whether the caps on supplementary costs are realistic.
- They need to understand how to compare the cover offered against the premium. It is easier to compare the cost of global sum insured policies. Websites provide a relatively efficient means of consumers comparing premiums charged by different insurers.

## Section 7: Other issues

### Averaging clauses

Averaging clauses allow insurers to reduce the amount paid to a consumer who is significantly underinsured. In theory, these clauses are a mechanism to encourage consumers to be fully insured, although in practice this depends on consumers having a detailed knowledge of their policy.

It appears that many people believe, incorrectly, that averaging clauses are common in home building policies currently on the market. We are aware of only two insurers that include an averaging clause in their home building policy. We are not aware of any evidence suggesting that increased use or awareness of averaging clauses is likely to alter consumer behaviour.

### Strata schemes and community title

Particular statutory requirements apply where the insured property is an apartment that is part of a strata title scheme. These requirements may reduce the risk of underinsurance for these types of properties.

All Australian States and Territories require owner corporations to take out adequate home building insurance. Except in the unusual event of non compliance with these requirements, there is no 'non insurance' issue for strata apartments.

In most jurisdictions the legislation requires that the sum insured be sufficient to cover rebuilding to an 'as new' condition, and that the policy must also provide cover for other costs (such as demolition costs and professionals' fees).<sup>61</sup>

In New South Wales, for example, the building insurance policy must cover the cost of rebuilding the building as new (together with demolition costs and professionals' fees) or specify a sum insured no less than the amount necessary to do so.<sup>62</sup> The risk of underinsurance is reduced as the owner corporation must have an insurance valuation carried out at least once every five years. The fee charged by a quantity surveyor or valuer for a replacement estimate for a typical block of six two-bedroom units can range from \$500 to \$2000.

There is no legislative requirement that policies include coverage for temporary accommodation or loss of rental income, although standard policies do make provisions for these benefits.

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<sup>61</sup> See G Bugden, *Insuring Strata and Community Title Buildings*.

<sup>62</sup> *Strata Schemes Management Act 1986*, s82 and Regulations 1997, reg 12.

Notwithstanding these express requirements, the adequacy of the level of strata insurance cover can be affected by many of the same causes of underinsurance as home building insurance. It would also appear that a particular issue in this area is valuers failing to include a sufficient allowance for quality finishes.<sup>63</sup>

## Standard cover

The *Insurance Contracts Act 1984* (Insurance Contracts Act) and Regulations create a ‘standard cover’ regime for certain types of insurance including home building insurance.<sup>64</sup> Section 35 of the Insurance Contracts Act requires an insurer to clearly inform an insured person (before the contract is entered into) of any terms of the insurance contract that differ from the standard terms.

The Insurance Contracts Regulations prescribe standard cover for home building insurance. Standard cover stipulates the prescribed events that home building insurance should cover (including fire, earthquake, storm damage, loss as a result of burglary and public liability), and the allowable exceptions (e.g. damage arising out of war).

Under regulation 12, the minimum amounts payable for the prescribed events are:

- the cost to indemnify the insured for the damage to the building,
- in addition, ‘the reasonable cost of:
  - identifying and locating the cause of destruction or damage concerned if it is necessary to do so to effect a repair,
  - demolition and removal of debris, and
  - emergency accommodation’, and
- the cost to indemnify the insured for a public liability claim up to \$2,000,000.

The standard cover provisions were considered in the review of the Insurance Contracts Act completed for Treasury in June 2004.<sup>65</sup> Recommendation 5.2 of the Review Panel was that: ‘The standard cover regulations should be updated and modernised following a suitable process of consultation with stakeholders including the insurance industry and consumer representatives’.

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<sup>63</sup> See G Bugden, *Insuring Strata and Community Title Buildings*, CHU Underwriting website: <http://www.chu.com.au/>.

<sup>64</sup> Insurance Contracts Act, Part V, Division 1 and Insurance Contract Regulations.

<sup>65</sup> See <http://icareview.treasury.gov.au/content/finalreport.asp> (page 46 of the Final Report).

The review of standard cover for home building policies could consider whether the range of supplementary costs needs to be updated, given that it does not include all the costs identified in Section 5 of this report.

## Brokers

A broker is under a duty at common law to arrange a satisfactory level of cover.<sup>66</sup> Where the consumer engages a broker to arrange cover for them, responsibility for assessing the appropriate sum insured may pass to the broker. Brokers are more likely to have an expert knowledge of the industry and the tools available to estimate rebuilding costs.

One respondent to our survey indicated that their broker had failed to increase the level of cover for their home over time.

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### Case study

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'We didn't get a renewal with any increase (we didn't get a renewal at all)'. The already inadequate sum insured was not increased at all over three renewals (Case 74).

However, this report has not reviewed how brokers assess building costs or whether consumers who use brokers are more likely to be adequately insured.

## Claims handling practices

ASIC has also received information about the way insurers handled claims. There were differences in approach between different insurers. We consider that best practice by insurers in the event of mass claims following a disaster would include:

- providing consumers with copies of the policy before settling claims,
- not delaying in paying claims by requiring insureds to execute a deed of release as a matter of practice,<sup>67</sup> and
- providing dedicated staff to assist consumers until their claim is resolved.<sup>68</sup>

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<sup>66</sup> See, for example, *Fanhaven Pty Ltd v Bain Dawes Northern Pty Ltd* (1982) 2 NSWLR 62.

<sup>67</sup> See Determination 103–17370 of the Insurance Ombudsman Service.

<sup>68</sup> Claims handling was considered in detail by the ACT Bushfire Recovery Taskforce: see its report at pp. 87–91.

# Appendix A: Project scope and methodology

## Project methodology

Key sources of information for the project were:

- the experiences of 133 homeowners affected by the ACT bushfires who responded to a survey prepared by ASIC (see below),
- a review in 2004 of the policy coverage of common insurers in our sample of homeowners affected by the ACT bushfires,
- a survey in February 2005 of the 12 major insurance groups in the home building market, and
- a review from February–April 2005 of ‘web-based calculators’ designed to help consumers determine the appropriate sum insured for their policy.

These results were supported by desk research, consultations with individual insurers, the Insurance Council of Australia and providers of building cost information, and research provided to ASIC by the Insurance Council of Australia.

We also examined data on consumer complaints about home building insurance made to Insurance Enquiries and Complaints (now the Insurance Ombudsman Service) and the Insurance Brokers Disputes scheme.

### Initial investigations

ASIC staff reviewed a range of home building policies, media reports and information provided on the websites of the Insurance Council of Australia and individual insurers.

We consulted the ACT Government’s Bushfire Support Unit, and sources in the building and insurance industries. We also sought information on existing practices for determining valuations, and the factors that affect building prices in particular circumstances.

ASIC staff interviewed a small number of people who lost their homes in the ACT bushfires to further develop our understanding of the likely range of consumer experiences.

We then held discussions with the Insurance Council of Australia and with a number of insurance companies about the project.

## **Survey of homeowners affected by ACT bushfires**

ASIC conducted a survey of homeowners affected by the ACT bushfires in 2003. We received 133 surveys, a response rate of about 33%.

A number of respondents were very pleased to be asked for information about their experiences and provided detailed comments.

Information from the survey is included at relevant points in the body of this report. For more details about the survey methodology and a summary of other information gained from the survey, see Appendix C.

The survey is quite detailed, so a copy of the survey form is only available with the electronic version of this report on our website at [www.asic.gov.au](http://www.asic.gov.au).

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## **Case study**

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Thank you for the opportunity to contribute. Even though we are as content with our situation as one could hope for after such a life-changing event, all of us acknowledge that the many lessons of 18 Jan 2003 must be learnt quickly to help others. It will happen again, somewhere. Societal expectation of asset protection and assistance with rehabilitation through adequate and uncomplicated Insurance is integral to those lessons. (Case 35)

## **Review of web-based calculators**

A number of insurers attempt to help consumers determine the appropriate value to insure their home, or the appropriate value on annual policy renewal, by means of a web-based calculator.

The approach to valuation varies significantly between calculators. The websites generally contain a disclaimer to the effect that the suggested rebuilding cost arrived at by use of the calculator is only a guide or an indication, and/or consumers should consult a builder or architect for a more precise estimate of rebuilding costs.

As part of the project, we reviewed a number of calculators: see Table A.1. We have included information from the review at relevant points in the body of this report.

Appendix B sets out the information we provided about the characteristics of the home and the consumer to obtain estimates of rebuilding costs and premiums from the calculators.



## **Consultation with the insurance industry and survey of insurers**

We met with the Insurance Council of Australia and with a number of insurers and observed one insurer's call centre in operation.

To gain a consistent understanding of the range of practices, we surveyed the major general insurers that offer home building insurance. We developed the insurance survey form after preliminary analysis of the survey of homeowners affected by the ACT bushfires and in consultation with the Insurance Council of Australia.

Information from our analysis of the returned surveys is included as relevant throughout the report. For details of the companies and brands covered by the survey, see Table A.1 below.

## **Insurance Ombudsman Service and Insurance Brokers Dispute Facility**

The Insurance Ombudsman Service (formerly Insurance Enquiries and Complaints Ltd) and the Insurance Brokers Dispute Facility are industry-based external dispute resolution schemes.<sup>69</sup>

They have jurisdiction to investigate, conciliate and if necessary determine matters referred to it by insured persons who have a complaint or dispute with their insurance company or insurance broker respectively.

The Insurance Ombudsman Service was not able to separately identify complaints that relate to underinsurance of a home. Staff of the service advise that they have the impression that very few complaints relate to underinsurance issues.

About 18% of complaints to the Insurance Ombudsman Service relate to claims on building insurance policies. There were 303 such complaints in 2003/2004.<sup>70</sup> About seven times as many disputes are handled by insurance companies' internal dispute resolution procedures.<sup>71</sup>

The Insurance Brokers Dispute Facility handled 103 complaints in 2003 and from 134 to 183 complaints in each of the previous four years. A search of their published complaints records revealed two where home building underinsurance was an issue.

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<sup>69</sup> See <http://www.iecltd.com.au/index2.html> and [www.ibdltd.com.au](http://www.ibdltd.com.au).

<sup>70</sup> Insurance Enquiries and Complaints, *Annual Review 2003/2004*, p. 18.

<sup>71</sup> There were 2210 disputes about home building policies reported under the General Insurance Code of Practice: Insurance Enquiries and Complaints, *Annual Review 2003/2004*, p. 21.

## Companies and brands surveyed

The following table identifies the companies and brands involved in each of our surveys.

**Table A.1: Companies and brands surveyed**

Group	Brand	Insurer survey	Policy survey	Calculator review
Allianz	Allianz	Yes	Yes	Yes
Australian Unity	Australian Unity		Yes	Yes
Comminsure	Comminsure	Yes	Yes	Yes
Defence Services Homes	Defence Services Homes		Yes	
IAG	NRMA	Yes	Yes	Yes
	SGIO	Incl in NRMA		
	SGIC	Incl in NRMA		
	CGU	Yes	Yes	Yes
Lumley	Lumley	Yes		
	Wesfarmers			
Promina	AAMI	Yes	Yes	Yes
	APIA	Yes	Yes	Same as AAMI
QBE	Western QBE	Yes	Yes	
RACQ	RACQ	Yes	Yes	
Suncorp	Suncorp	Yes		Yes
	GIO	Yes		Same as Suncorp
TIO	TIO	Yes		
Westpac	Westpac	Yes	Yes	Yes
<b>Total</b>		<b>12</b>	<b>10</b>	<b>8</b>

# Appendix B: Review of web-based calculators

## Description of homes

### Ainslie—Fibro

A small single-storey 50 year-old fibro home, with 3 bedrooms, 1 bathroom and medium-sized veranda. Built on a flat block of land.

### Ainslie—Brick veneer

An average-sized, contemporary single-storey brick veneer home, with 4 bedrooms (built in wardrobes), 2 bathrooms, large veranda, concrete swimming pool, 2 self-contained air conditioners, security system, and a large carport. Built on a flat block of land with a concrete slab.

### Engadine—Brick veneer

An average-sized, contemporary single-storey brick veneer home, with 4 bedrooms (built in wardrobes), 2 bathrooms, medium-sized veranda, above ground swimming pool, single air conditioner, fireplace, and a large carport. Built on a flat block of land with a concrete slab.

### Elwood—Federation

An average-sized Federation single-storey solid brick home, with 3 bedrooms, 2 bathrooms, prestige finishings, ducted reverse-cycle air conditioning, fireplace, security system, and a large carport. Built on a flat block of land with extensive fencing and paving.

### Townsville—Timber

A small contemporary single-storey timber home, with 3 bedrooms (built in wardrobes), 1 bathroom, ceiling fans, solar hot water system, and a large carport. Built on a flat block of land.

**Table B.1: Characteristics of homes used in web-based calculator review**

Description	Ainslie (ACT 2602)	Ainslie (ACT 2602)	Engadine (NSW 2233)	Elwood (VIC 3184)	Townsville (QLD 4810)
<i>General features</i>					
Period of construction	Contemporary	Contemporary	Contemporary	Federation	Contemporary
Construction standard (average/quality/prestigious)	Average	Average	Average	Prestigious	Average
Slope of land	Flat	Flat	Flat	Flat	Flat
Number of levels	1	1	1	1	1
Building area	100 sq/m	222 sq/m	220 sq/m	150 sq/m	150 sq/m
Ceiling type	Vaulted/angled	Flat	Flat	Flat	Flat
Ceiling height	2.7m	2.4m	2.7m	3m	2.7m
<i>Construction materials</i>					
Building made of	Fibro frame, timber floor boards	Concrete on ground	Concrete on ground	Timber frame, timber floor boards	Timber frame, timber floor boards
Walls made of	Fibro frame	Brick veneer	Brick veneer	Brick, solid	Timber frame
Roof materials	Pitched, metal covering	Pitched, concrete tiles	Pitched, concrete tiles	Pitched, concrete tiles	Pitched, metal covering
<i>Number and size of rooms</i>					
Number of bedrooms	3	4	4	3	3
Number of bathrooms	1	2	2	2	1
Size of bathroom 1	Small	Small	Medium	Small	Small/medium
Size of bathroom 2		Medium	Small	Medium	—
Number of kitchens	1	1	1	1	1
Size of kitchen 1	Small	Medium/large	Medium/large	Small	Medium
Number of laundries	1	1	1	1	1
Size of laundry 1	Medium	Medium	Medium	Small	Small
<i>Internal features</i>					
Air conditioning (and type)	—	Self contained (2)	Self contained (1)	Ducted (RC)	—
Ceiling fan (Y/N?)	N	N	N	N	Y
Dishwasher (Y/N?)	N	N	Y	Y	N
Fireplaces (Y/N?)	N	N	Y	Y	N
Intercom system (Y/N?)	N	N	N	Y	N
Linen closet (Y/N?)	N	Y	Y	Y	N
Security system (Y/N?)	N	Y	N	Y	N
Smoke detection system (Y/N?)	Y	Y	N	N	N
Solar hot water heater (Y/N?)	N	N	N	N	Y
Wardrobes—built in (Y/N?)	N	Y	Y	N	Y

Description	Ainslie (ACT 2602)	Ainslie (ACT 2602)	Engadine (NSW 2233)	Elwood (VIC 3184)	Townsville (QLD 4810)
<i>External features</i>					
Number of carports	0	1	1	1	1
Size of carport 1	—	Large	Large	Large	Large
Garage door opener (Y/N?)	N	N	Y	N	N
Driveway (size?)	Small	Medium	Large	Medium	Large
Single storey veranda (size?)	Medium	Large	Medium	—	—
Awnings (Y/N?)	N	N	N	Y	N
Clothesline (Y/N?)	Y	Y	Y	Y	Y
Garden shed (Y/N?)	N	N	Y	N	N
Mailbox (Y/N?)	Y	Y	Y	Y	Y
Swimming pool, concrete (Y/N?)	N	Y	N	N	N
Swimming pool, above ground (Y/N?)	N	N	Y	N	N
Fencing (minimal/average/extensive)	Average	Average	Average	Extensive	Average
Paving (m/a/e)	Average	Average	Average	Extensive	Average
Retaining walls (m/a/e)	Minimal	Minimal	Minimal	Minimal	Minimal
<i>Additional information used to obtain quotes</i>					
Age of home	50	20	30	100	30
Deadlocks on doors (Y/N?)	N	Y	Y	Y	N
Key window locks (Y/N?)	Y	N	Y	Y	N
Local alarm (Y/N?)	N	Y	Y	N	N
Alarm with back to base monitoring (Y/N?)	N	N	N	Y	N
Someone currently living in home (Y/N?)	Y	Y	Y	Y	Y
Someone normally home during the day (Y/N?)	N	N	N	N	N
Last 10 years—bad record (Y/N?)	N	N	N	N	N
Last 3 years—number of insurance claims (Y/N?)	0	0	0	0	0
Who lives in the home	Own and live in home	Own and live in home	Own and live in home	Own and live in home	Own and live in home
Birth date of oldest insured	27 April 1960	1 Jan 1960	1 Jan 1950	1 Jan 1970	1 Jan 1975
Postcode	2602	2602	2233	3184	4810
Years with home insurance	8	10	20	5	5
Number of claims	0	0	0	0	0

# Appendix C: Experiences from the ACT bushfires

Some of the key findings from our survey of people who lost property in the ACT bushfires have been presented in earlier sections of this report where appropriate. This appendix includes more information about the responses to ASIC's survey.

## Overview of ASIC's survey

### Survey methodology and limitations

Based on our initial investigation of the issues, we developed a survey form. A copy of the survey form is available with the electronic version of this report on our website at [www.asic.gov.au](http://www.asic.gov.au)

At ASIC's request, the Bushfire Support Unit<sup>72</sup> arranged for the survey to be distributed by mail to every homeowner who lost their home in the bushfires. Surveys were distributed to all the people who registered with the Bushfire Support Unit to apply for the financial assistance offered by the ACT Government (that is, all or almost all of the non government owners of the 407 properties destroyed).<sup>73</sup>

We received 133 completed survey responses from owners who held home building insurance policies at the time their property was destroyed or damaged by the fires, representing 33% of the 401 affected insured private owners.<sup>74</sup> Fewer than ten surveys were returned to ASIC, address unknown.

Whether or not the survey respondent was an owner-occupier or a landlord was not recorded, and so whether or not there was a higher or lower response rate from one or the other group is not known. Similarly, it is not possible to know whether a higher rate of response was received from homeowners who were underinsured or those who were adequately insured.

### Demographic information on respondents

#### *Postcode*

Of 132 people who provided postcode information, 125 people from postcode 2611 responded, six people from postcode 2902 and one from postcode 2601.

<sup>72</sup> See [http://www.bushfirerecovery.act.gov.au/assistance/recovery\\_centre.htm](http://www.bushfirerecovery.act.gov.au/assistance/recovery_centre.htm) for details and contact information.

<sup>73</sup> 488 'homes' were destroyed of which 81 were owned by ACT Housing (Taskforce report, p. 3 and p. 96).

<sup>74</sup> The 407 private dwellings, less six uninsured properties.

*Income*

The following table shows the income levels of survey respondents.

**Table C.1: Survey respondent income levels**

Annual household income	No of consumers
Less than \$20,000	7
\$20,000–\$59,000	31
\$60,000–\$99,000	47
\$100,000 +	35

Source: ASIC's ACT bushfire survey, 2004

*Contents insurance*

125 respondents also had contents insurance. Eight did not (note that some respondents were landlords.)

**Housing***Housing type*

Almost all homes were constructed in or after 1970 (as no owner had lived there longer, and there was a cluster of owners who had lived in their properties from the early 1970s). This is consistent with the age of the suburbs affected by the bushfires,

Virtually all homes in the survey were either one story (96) or two stories (36), with only one three story property. They were mainly three or four bedroom homes.

Most homes (89 or 67%) were constructed of brick veneer. Other construction methods included brickwork—cavity (13), brickwork—solid (10) and combination (15). Most homes (68%) were constructed on flat ground or a gentle slope.

**Table C.2: Gradient of land**

Angle of slope	No of consumers	Percentage
Flat (<5 degrees)	32	24.1%
Gentle slope (5–14 degrees)	59	44.4%
Moderate slope (15–35 degrees)	34	25.6%
Steep slope (>35 degrees)	6	4.5%
Unsure	2	1.5%
<b>Total</b>	<b>133</b>	<b>100%</b>

Source: ASIC's ACT bushfire survey, 2004

*Period of ownership*

Homes had been owned from a few weeks to 33 years. Forty-one consumers (31%) had owned the property for more than 20 years. The average period of ownership was 15.27 years.

**Insurance policies***Period of insurance*

Policies had been in force with the same company (or its predecessors) between one and 32 years. The average length of time the consumer had held the policy was 11.9 years.

*Amount of insurance*

Amounts insured at the time of the bushfires ranged from \$100,000 to \$650,000. The average sum insured was \$250,749. This figure is higher than the average level of insurance across Australia of around \$200,000.<sup>75</sup>

Respondents reported initial amounts insured in the range \$20,000 to \$250,000 as best they could recall. However, many qualified their response or reported an amount in a wide range.

Most consumers had held a policy with the same insurer for the period they had owned their home; 15 consumers had carried over the value insured from a previous insurance policy with another insurer, with eight consumers reporting they couldn't remember whether they had changed insurer. Some consumers changed insurance company but did not carry over the value from the previous company as their motivation for changing was to have increased cover.

**Point of purchase**

Most policies were arranged directly with the insurer (91). In all, 29 consumers reported arranging insurance through a lending institution and ten consumers reported that they arranged insurance through a broker.

However, in three of the eight cases where the broker was identified by name, the intermediary was not a broker but a lender (two credit unions and one bank).

**Incidence and extent of underinsurance**

Survey respondents were asked to specify the sum insured and to give details about rebuilding quotes obtained and the quote accepted. The quote accepted was used as a proxy for the rebuilding costs (i.e. the true value of the insured property).

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<sup>75</sup> See Section 1.



This had several limitations. First, some consumers did not rebuild, and so their responses could not be used. Second the quote accepted may vary from the true value of the insured property in two ways.

The consumer may have been forced to rebuild a smaller or lower quality house as they could only afford to spend the sum insured. In these cases the quote accepted will be less than the true value of the property and the case will not be identified as one where the consumer was underinsured.

Alternatively, the consumer may have built a larger or better quality house than the destroyed home. In this case, the consumer may or may not have been underinsured, but in any case the degree of underinsurance will be exaggerated.

In examining the responses on underinsurance, it is necessary to consider the particular benefits payable under the insurance policy. The primary difference is between those policies that include demolition costs and architect and other professionals' fees as part of the sum insured and those that do not.

Insurers most frequently represented in the sample issued both *global sum insured* policies and *sum insured plus benefits* policies.

To accurately estimate the rate of underinsurance among consumers who lost their house in the ACT bushfires, it would be necessary to know for each consumer, or for each consumer in a sufficiently large random sample:

- the sum insured (plus additional policy benefits),
- the cost of rebuilding the home incurred by each consumer, and
- the additional costs actually incurred.

The 133 respondents to our survey are not a random sample of the owners of the approximately 407 private homes destroyed. Therefore, it is not possible to know whether they are typical.

Even within the sample it has not been possible to estimate the rate and degree of underinsurance.

Only 59 consumers had rebuilt at the time they were surveyed. Of these almost all built a home substantially different to the home destroyed. In most cases, the home was larger and/or had higher quality internal or external finishes. Only four consumers rebuilt a substantially similar house of the same size. Only four rebuilt a smaller house.

While it is possible that many or even all of the 59 consumers who rebuilt were adequately insured, there is no way of knowing for sure. In some cases, the consumer was clearly underinsured, including one where

the consumer rebuilt a larger project home at less than \$1000 per square metre rather than the higher quality home that was destroyed.

Of the 74 consumers who did not rebuild, nine received insurance payouts that were less than the sum insured. In at least some cases, their insurance policy provided for indemnity cover<sup>76</sup> rather than replacement if they did not in fact rebuild.

Of the remaining 65 consumers, seven obtained quotes for rebuilding; in six cases the lowest quote obtained was more than the sum insured, and so we can conclude that in at least these cases the consumers were in fact underinsured.

In most other cases, the consumer reported obtaining or making an estimate of rebuilding costs from other sources, including architects, builders, loss assessors, neighbours with similar properties, the ACT Bushfire Recovery Centre, own experience in the building trade or a combination of these.

This led many consumers to believe that they could not afford to rebuild. It is clear from the variations between sum insured and the estimates of rebuilding costs that most of those who did not rebuild were significantly underinsured.

Deborah Light detailed the case histories of a number of consumers who were extremely concerned about aspects of the relationship with their insurance companies in a 2004 article 'Burnt Offerings'.<sup>77</sup> The article particularly concentrated on the issue of underinsurance, although aspects of claims handling procedures were also discussed.

## **Claims experience and satisfaction levels**

The survey asked whether consumers were satisfied with their insurance payout.

Out of the 59 consumers who rebuilt, 43 were satisfied. 53 of the remaining 74 consumers (who had not rebuilt) were satisfied with the payout. However, several respondents indicated they while they were satisfied that the insurer had complied with their contract, they were not satisfied that they had an adequate level of cover.

The survey did not ask consumers directly whether they were satisfied with the way insurers had handled their claim. There were several strong responses, both negative and positive. Some examples are set out in the following case studies.

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<sup>76</sup> That is payment for the actual value of the building rather than the replacement cost.

<sup>77</sup> *The Bulletin*, 17 February 2004, pp. 32-37.

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## Case studies

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'Under the circumstances we feel that we were treated fairly by our insurer, even though we were ignorant of the fact that we were underinsured.' (Case 133)

'It was a nine-month battle of never returning calls. If you happened to catch them at their desk we would ask questions like: Is GST included? Are the fences included? Is the carport included? The answer would be ... "we'll get back to you" and they never did. A solicitor was engaged and he received the same treatment. I wrote a letter to the Chairman of [the insurance group] and relayed the "customer service" I had received having been with the insurance company for over 20 years with *no claim* to Home Building and Home Contents Insurance. The matter was settled [in] a little over a week at the rebuilding quote supplied.' (Case 67, emphasis in original)

'We insured with [insurer] for \$370,000. Thank god! PS: Even \$370,000 was not enough ... [The insurance amount paid was \$420,000]. [Insurer] added 10% to cover GST; they also came to us and other clients with extra money to cover CPI errors in their system. Well done [insurer]—you're the best!!!' (Case 76)

'[Insurer A] were very helpful in processing the claim and responded quickly. However, I characterise their response as legalistic, only doing what was required in the contract, and no more. In fact, they cancelled the contract upon payout with the following implications: (1) cancelled public liability coverage; and (2) a new policy contract would not have access to the "years of insurance" discount no matter how long the previous policy had been held. The company eventually extended public liability coverage. However, this legalistic approach contrasted with the more helpful approach of other insurers at the time, notably [insurer B]. [They] not only increased their payout by 10% without prompting (to cover GST related increases) but were very proactive in offering assistance with fencing and signage and with rebuilding.' (Case 93)

'We are generally very happy with [insurer's] support. We should have calculated out contents insurance amount more carefully. Underinsurance on building probably involved the following: big sudden increase in building costs; the unforeseen level of total destruction, involving everything, including house, carport, fences, all landscaping, concrete and brickwork such as driveway, footpaths, garden walls and paving, even the rotary clothesline; the additional cost of some better quality features compared to the original property.' (Case 7)

'The company continually tried to take small points to try and reduce the payment in any way they could (e.g. attempting to say foundations could be reused, which they could not because they were fire damaged and also not up to the current regulations). They also attempted to say the price per square metre was too high (an overestimate!) yet they supplied the guidance on the estimations (which for Canberra were too low anyway—and building prices have increased significantly since the bushfires). Also attempted to reduce payout by cost of slab for the (totally destroyed) metal garage—but this slab was cracked by the heat.' (Case 54)

### **Ex gratia payments**

About 35 of the 133 homeowners surveyed reported that their insurance company made an ex gratia payment (i.e. one that they may not have been legally required to make under the terms of the insurance policy).

The most common costs met by an ex gratia payment were additional rental accommodation (e.g. for an additional three to 12 months after the typical 12 months required by the insurance contract), and an amount to compensate for an increase in the consumer price index between the date of the insurance contract and the date of the loss.

Several consumers reported that they felt the insurer had been generous in calculating the amount of money payable for building costs, other ex gratia payments related to GST, landscaping and survey fees. One insurer paid \$33,000 extra when the consumer alleged that the underinsurance flowed from incorrect advice by the insurer.

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### **Case study**

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'\$38,468.74 was ex-gratia. We wrote to [insurer] some months after the fire and asked them to reconsider our claim because we had been underinsured through their incorrect advice.' (Case 105)

## Appendix D: Comparison of premiums and sum insured

Chart D.1 Premium charged for same sum insured for brick veneer house in the ACT

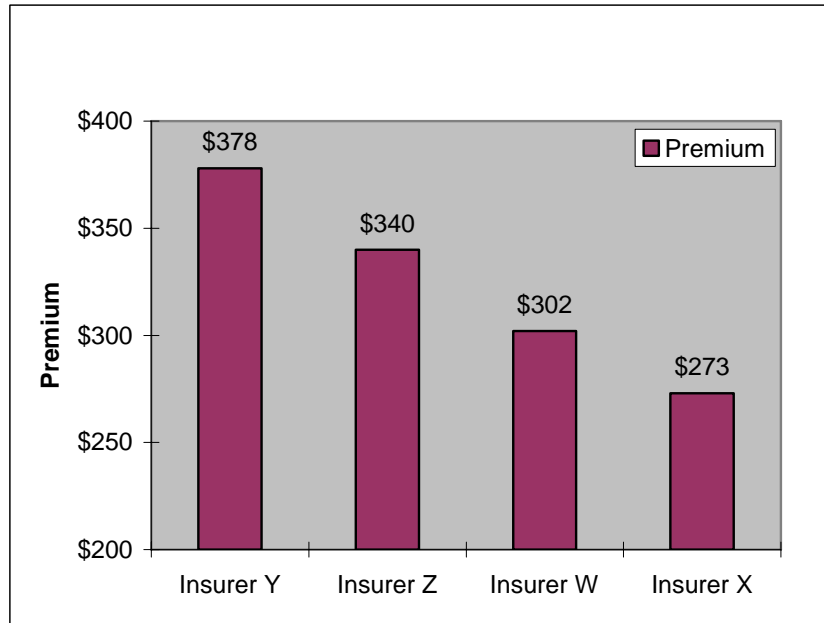


Chart D.2 Premium charged for same sum insured for brick veneer house in NSW

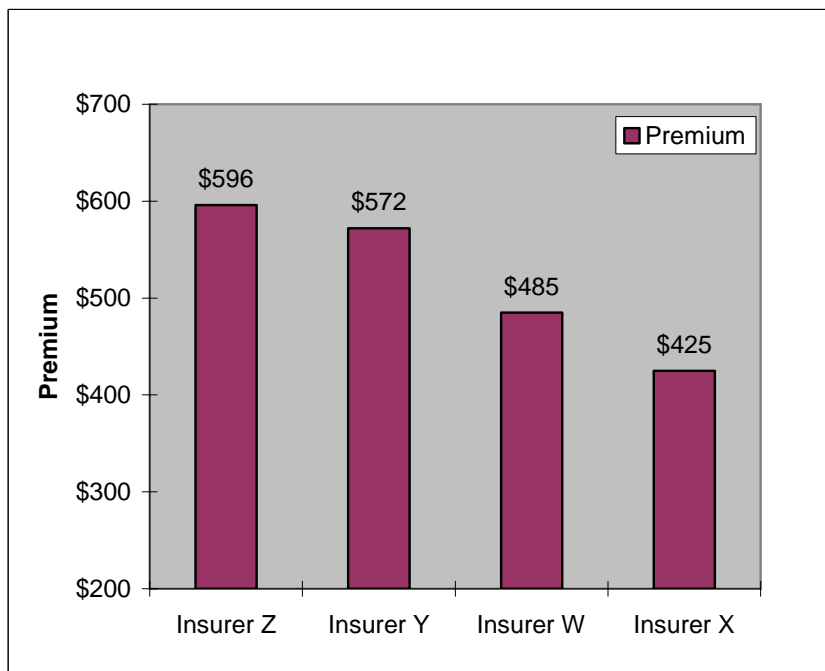


Chart D.3 Comparison of sum insured and premium for fibro house in the ACT

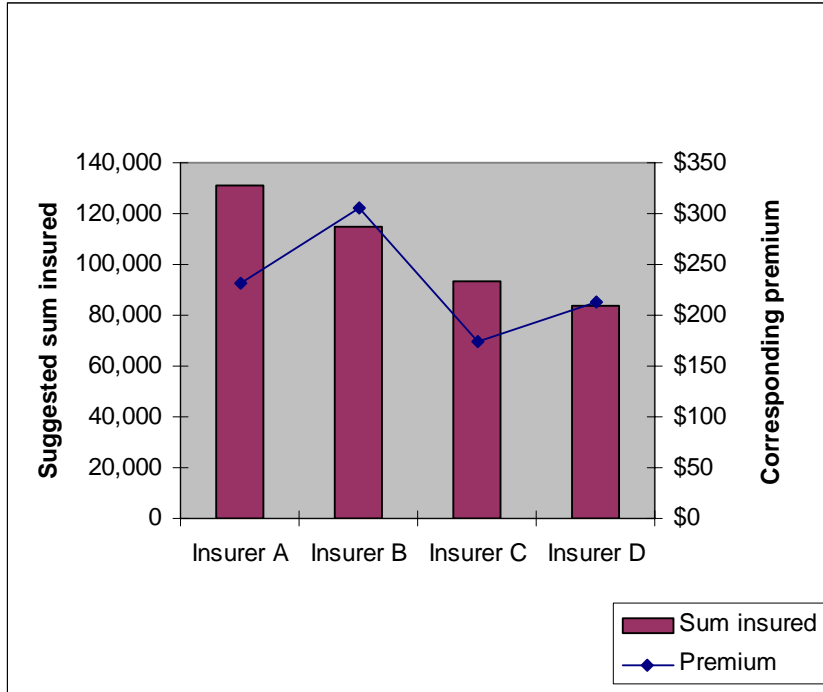


Chart D.4 Comparison of sum insured and premium for house in Engadine, NSW

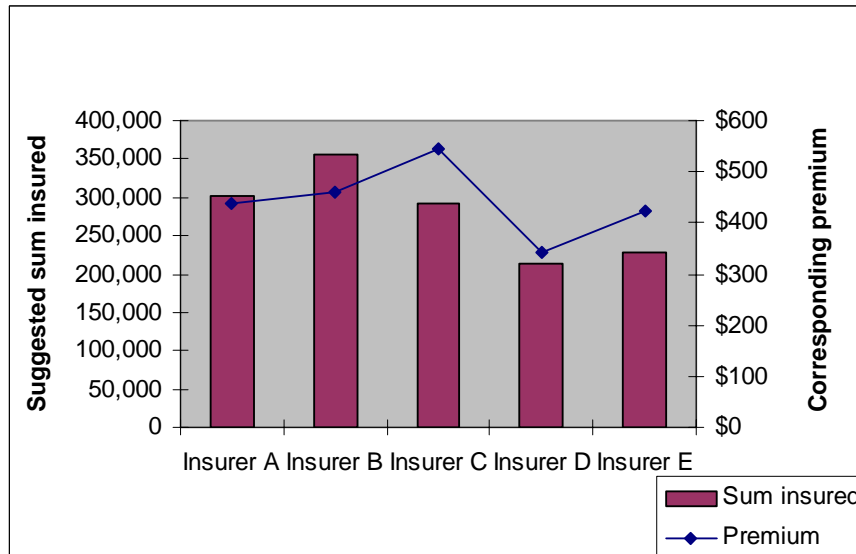


Chart D.5 Comparison of sum insured and premium for house in Elwood, Victoria

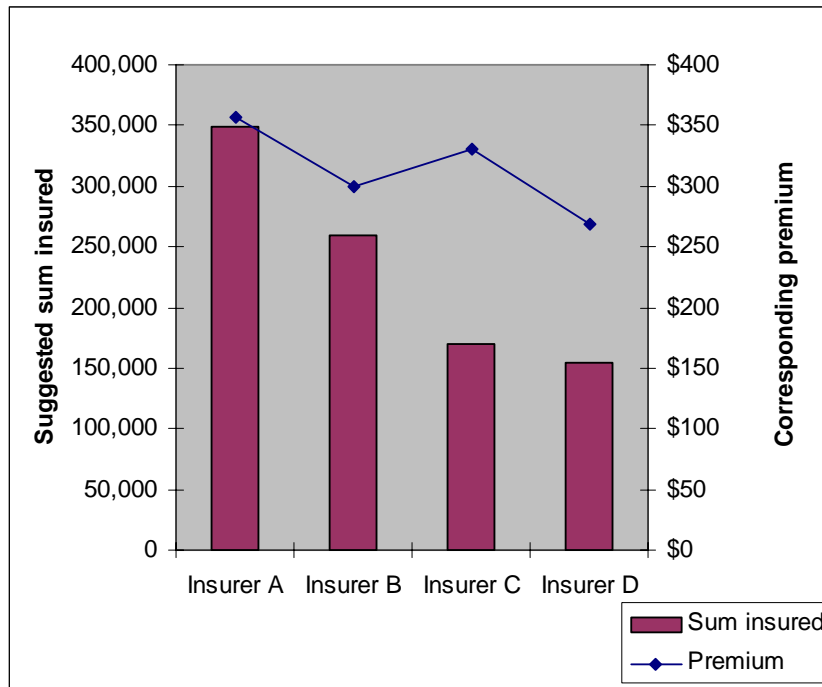


Chart D.6 Comparison of sum insured and premium for house in Townsville, Queensland

