ASIC

Australian Securities & Investments Commission

REPORT 89

Making home insurance better

January 2007

What this report is about

In September 2005, we released a report on home building underinsurance *Getting home insurance right* (the 2005 report). The 2005 report comprehensively examined the causes of home building underinsurance in light of the devastating Canberra bushfires in 2003, where over 400 homes were destroyed.

This report examines what steps insurance companies had subsequently taken to tackle the causes of underinsurance since the release of the 2005 report.

Research included:

- meeting with the major insurers to discuss any improvements made or planned since the 2005 report,
- surveying the practices of 16 insurers,[1]
- comparing web-based calculators offered by insurers in 2005 and 2006 to determine the extent of any changes,
- researching the websites of the Insurance Council and the Insurance Disaster Response Organisation, and
- discussing the effects of Cyclone Larry with the Insurance Council and the Cyclone Larry Taskforce.

We also surveyed insurers about their experience following Cyclone Larry in Queensland in early 2006. This report explores the issues arising from that disaster, particularly the extent of underinsurance.

Acknowledgements

- We would like to thank those insurers who responded to our survey and discussed this topic with us and the Insurance Council and the Cyclone Larry Taskforce for their assistance.

[1] For details of insurers and products surveyed in 2006, see the Appendix.

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Executive summary

Why consumers are underinsured

The 2005 report identified several reasons for underinsurance:

- Most home building insurance policies pay only the 'sum insured' on total loss. This amount is based on an estimate of rebuilding costs.
- Nearly all standard home building policies placed the onus on the consumer to calculate rebuilding costs and left the consumer to carry the risk of getting it wrong.
- Consumers generally relied on their insurer for help, however, only a small number of insurers provided consumers with reliable tools for estimating the cost of rebuilding their home.
- The sum insured may have been sufficient to cover rebuilding costs when the policy was taken out. However, rebuilding costs may change at a greater rate than annual increases in the sum insured, resulting in the consumer becoming underinsured over time.
- A sum insured that will meet the cost of rebuilding a home in a one off total loss will not cover the surge in building prices that occurs after a mass disaster.

How insurers are helping consumers to reduce the risk of underinsurance

The 2005 report challenged the insurance industry to change some of its practices in order to reduce the risk of underinsurance. The industry has embraced this challenge and developed a range of initiatives over the last 12 months addressing underinsurance. The most important changes are summarised in Table 1.

Table 1: Improvements since 2005 at a glance

	2005 survey of 16 insurers	2006 survey of 16 insurers[2]
Total replacement policies	Offered by one niche insurer (covering project homes in some capital cities)	Offered by a further two major insurers with another 2 insurers considering introduction within 6–12 months
Extended replacement policy	Offered by one niche insurer (covering strata titles)	Offered by a further two major insurers with another 4 considering introduction within 6–12 months
Sophisticated elemental web-based estimating calculators	Offered by 3 insurers	Offered by 7 insurers

[2] 15 of the 16 insurers surveyed were the same insurers from the 2005 survey.

	2005 survey of 16 insurers	2006 survey of 16 insurers[2]
Simple cost per square metre web-based calculators	Offered by 7 insurers	Offered by 4 insurers
Greatest variation between the lowest and highest estimates obtained using web-based calculators	103%	54%
Average sum insured	$209,322	$225,858
Educating consumers about underinsurance at renewal	only 3 insurers suggested that consumers review level of cover	7 insurers suggested that consumers review level of cover

The most significant of these changes is the introduction of policies providing broader cover for consumers such as a total replacement policy and an extended replacement cover policy.[3]

Other changes include:

- insurers are using higher indexation rates to increase the sum insured on renewal of a home building policy,[4]
- most insurers have implemented education strategies to communicate with consumers about underinsurance and the need to be adequately insured,[5] and
- the average sum insured in the 2006 survey was $225,858, representing an increase of 7.9% from the average sum insured of $209,322 in 2005.

However, while many insurers who participated in the review have actively engaged with the issue of underinsurance some insurers have made no or minimal changes to their practices. For example, some insurers only offer a cost per square metre calculator to estimate a sum insured. This leaves consumers at risk of being underinsured, either because the calculator ignores building features which increase rebuilding costs, or because the dollar figures have not been updated and do not reflect current costs.

We will continue to work in these areas.

[3] This adopts our recommendation to consider the viability of such policies: see 2005 report, p. 46.

[4] This adopts our recommendation to ensure increases in sums insured at renewal accurately reflected changes in building costs: see 2005 report, p. 38.

[5] Half of the insurers surveyed in 2006 take the opportunity to educate consumers about underinsurance just before renewal. This adopts our recommendation: see 2005 report, p. 38.

Lessons from Cyclone Larry

In March 2006 Tropical Cyclone Larry devastated the towns of Innisfail and Babinda on the Queensland north coast. Our review of preliminary information available after the cyclone identified the following issues:

- Preliminary estimates from some of the insurers surveyed indicated that at least 50% of homes were underinsured.
- Insurers surveyed estimated that building costs increased by at least 50% immediately after the disaster.
- Many older homes did not comply with anti-cyclone building code requirements introduced after Cyclone Tracy. This had two effects: the sum insured may not have taken into account the extra building costs associated with meeting these standards and the house was more likely to be a total loss after a cyclone.

Preliminary indications are that most insurers did not take a strict approach to paying claims, and in many cases settled claims for amounts greater than the policy allowed. Government also provided financial assistance. Consumers cannot expect that financial support from insurers and government for a failure to be properly insured will always be forthcoming.

These lessons will be reviewed and reconsidered as further information becomes available.

Conclusion

Since the 2005 report, most insurers have taken some positive steps to help consumers reduce the problem of underinsurance. Those steps include:

- developing new products, in particular total replacement policies which ensure consumers are adequately covered—if their home is accidentally destroyed their insurance will pay to rebuild it,
- improving calculators, and
- promoting better education initiatives.

We encourage further measures be undertaken such as:

- investigating whether total replacement and extended replacement policies can be more widely available and commercially viable, and
- educating consumers about underinsurance and the availability of web-based calculators.

Most insurers have taken steps to improve the tools available to consumers and help address the risks of underinsurance. However, consumers also have a responsibility in reducing the risk of underinsurance via the type of insurance they purchase and, where relevant, by using the available tools to select the appropriate level of cover.

Section 1: Why consumers are underinsured

What we found in 2005

The 2005 report identified the following reasons for underinsurance:

- Most home building insurance policies in Australia are 'sum insured policies.' These policies require the consumer to nominate a specified figure (based on an estimate of rebuilding costs) on the amount that will be paid out in the event of a total loss.
- Estimating rebuilding costs can be a difficult task, requiring expert or technical assistance. However, nearly all standard home building policies placed the onus on the consumer to calculate these costs and carry the risk of getting it wrong.
- Consumers generally relied on their insurer for help in estimating rebuilding costs. However, only a small number of insurers provided consumers with reliable tools for estimating the cost of rebuilding their home.
- Consumers might overlook the need to increase the sum insured over time to keep up with changes in building costs generally, or because of specific increases in rebuilding costs. Rebuilding costs can be significantly increased by:
  - new or enhanced building code requirements, and
  - renovations to the insured's home.
- Insurers increase the sum insured annually. Our 2005 report found that insurers used three different measurements to increase the sum insured under their policies: the consumer price index (CPI), the 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 CHIP can be seen as a more precise measure then a consumer will become underinsured if the level of cover is only increased by the HBI or CPI.
- Even if a consumer correctly estimates what it would cost to rebuild their home in a one off total loss, it is almost impossible to know what it will cost to rebuild a home that is destroyed in a mass disaster. The surge in building prices that occurs after a mass disaster can be very unpredictable.
- Insurers adopted different definitions of the sum insured. This figure may or may not include additional costs (such as demolition costs) and the consumer might not always realise that they may have needed a higher level of cover to meet these costs.

Section 2: How insurers are helping consumers to reduce the risk of underinsurance

Since the 2005 report, most insurance companies have made a significant number of improvements designed to help address the problem of underinsurance. In general, the insurance industry has recognised that consumers need access to better policies and better information if the risk of underinsurance is to be addressed systematically.

Changes in policy cover

In the 2005 report, we encouraged insurers to explore different types of policies with a view to minimising or removing the problem of underinsurance. In particular, we encouraged insurers to explore whether it was commercially viable to offer the following policies:[6]

- *Total replacement policies*—The insurer agrees to pay all rebuilding costs, not just those costs up to a specified amount.
- *Extended replacement policies*—The insurer will meet potentially higher rebuilding costs higher than the nominated sum insured where the house is destroyed in a mass disaster.

Total replacement policies

Estimating the precise cost of rebuilding is complex; it is also impractical for consumers to obtain estimates from architects, builders or quantity surveyors.[7] A total replacement policy avoids this problem by shifting the onus of estimating rebuilding costs from the consumer to the insurer.

At the date of writing, two insurers have introduced total replacement policies. This type of policy is common in New Zealand and the United States, where they are called ‘guaranteed replacement policies’.

One insurer, under its total replacement policy asks each consumer 9 specific questions about their home relating to the construction of walls, year built, number of floors, roof type, number of bedrooms (average size or large), number of bathrooms, garages and carports (number of cars accommodated) and any other improvements (e.g. pools, tennis courts, decks, granny flats).

These questions do not require any expertise on the part of the consumer and the consumer does not need to refer to other experts to answer them. The answers to the 9 questions are fed into a new calculator, which is

[6] 2005 report, pp. 47–48.

[7] 2005 report, p. 19.

invisible to the consumer and allows the insurer to determine an estimated rebuilding cost.

Another insurer with a total replacement policy still requires the consumer to estimate a sum insured but this will only be relevant in the calculation of the premium. Consumers are referred to the web-based calculator and call centre employees to determine an appropriate sum insured.

The introduction of total replacement policies will significantly address the problem of underinsurance by providing for the full replacement cost of the home.

However, consumers should read the exact wording of these policies, as there may be a small risk of a gap between the amount paid out and the actual costs of rebuilding when:

- there is a cash settlement and a period of time passes between the time of cash settlement and the time of rebuilding, or
- building codes change after the loss and before rebuilding, particularly in response to a disaster.

The extent of this risk will depend on the length of time before the consumer commences rebuilding.

Extended replacement policies

Under an extended replacement policy, the insurer will pay up to a certain percentage over the sum insured if necessary to meet the costs of rebuilding. Typically, the additional amount is 20%–50% above the sum insured. This type of policy is the current standard policy in the US.

Two insurers have adopted extended replacement policies that provide an additional 25% or 30% above the sum insured. While this type of policy would offer some relief for consumers who suffer a loss in a mass disaster, we note that after the ACT bushfires building costs increased by 50% between November 2002 and January 2003. Similar increases appear to have been experienced after Cyclone Larry.

One of the insurers offering an additional amount of 30% as an optional feature requires the consumer to obtain a written building cost valuation from a licensed builder or quantity surveyor in the last 6 months. The consumer will have to obtain a new valuation every 6 years.

We estimated the cost of a valuation for an average home to be between $400 and $600. This is likely to be a major barrier to consumers taking up this option.

At the time of writing, we are aware that 2 other insurers are considering introducing a total replacement policy and 4 insurers are considering introducing extended replacement type policies.

Estimating the sum insured with web-based calculators

Consumers generally need specialist assistance to estimate rebuilding costs but it is often impractical to refer to builders, architects or quantity surveyors. Many insurers now provide consumers with access to web-based calculators. There are two types of web-based calculators used in Australia:

- *Cost per square metre*—this calculates the cost of rebuilding based on the size of the house and type of building materials.
- *Elemental estimating method*—this seeks information in approximately 30 categories including the size of individual rooms, ceiling heights and the period of construction.

One of the main recommendations of the 2005 report was the adoption of more sophisticated web-based calculators.[8] This type of calculator uses the elemental estimating method that we believe provides a more realistic estimate of rebuilding costs than the cost per square metre calculator. In particular the cost per square metre calculator does not identify, or take into account, increases to building costs resulting from features such as the slope of the land or high quality internal finishes.

Of the 16 insurers surveyed in 2006, 5 did not provide for a web-based calculator to help consumers determine an appropriate rebuilding cost.[9]

There are now 7 insurers using the more comprehensive web-based calculator. However, 4 insurers still provide consumers with a calculator that estimates rebuilding costs based on a simple formula where the size of the house is multiplied by the type of materials.

We reviewed the operation of web-based calculators by testing the estimated results for a house in the ACT. It was one of 5 houses we had already tested in the 2005 report. The house is 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:[10]

- In the 2005 report the variation between the lowest and highest estimates of rebuilding costs for this house was 103%[11] with the lowest estimate at $80,000 and the highest value estimate at $162,445.
- In 2006 the variation between the lowest and highest estimates obtained by using web-based calculators in 2006 was 54% with the lowest estimate at $116,725 and the highest value estimate at $180,000.[12]

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[8] 2005 report, p. 30.

[9] AAMI used a complex web-based calculator until 30 August 2006.

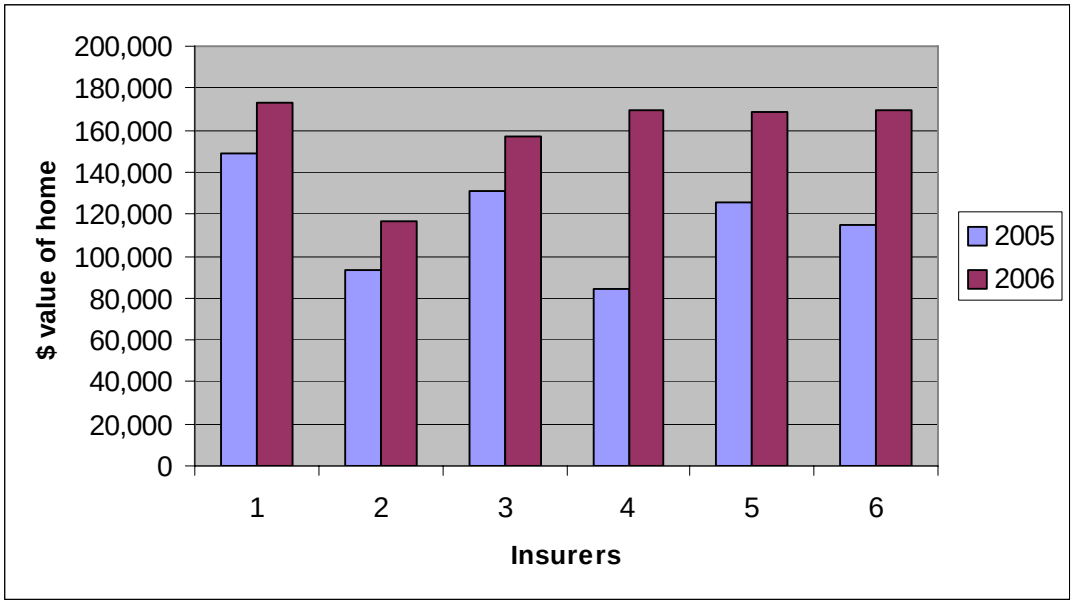
[10] Further characteristics of the 'Ainslie-Fibro' home are set out in Table B.1: see 2005 report, p. 76.

[11] 2005 report, p. 32.

- The lowest estimate increased by 39% from 2005, and the highest estimate increased by 21%.
- The 2 lowest estimates were produced by a cost per square metre calculator.

The degree of variation has been significantly reduced. However, a figure of $116,725 obtained with a simple calculator would still leave consumers at grave risk of being underinsured. This indicates a continuing risk of underinsurance for consumers with the 4 insurers that still supply only a cost per square metre calculator.

Chart 1: Comparison of sum insured between six calculators for fibro house in Ainslie ACT



The accuracy of any calculator also depends on how frequently the cost information it uses to make its calculation is updated.[13] In our 2005 survey of insurers, we found that while one insurer updated its calculator every 6 months, the majority updated them annually and one insurer updated it every 18 months.[14] The 2006 survey found that calculators are now updated more frequently. Of the 11 insurers that used a web-based calculator, 3 were updated every 3 months, 1 every 6 months and 7 every 12 months.

The insurance companies that are monitoring usage indicate that less than 10% of their consumers use the web-based calculator, with one company indicating that the amount of usage is closer to less than 0.5%. More

[12] One insurer's calculator estimated an amount of $97,250 but this did not include supplementary costs so was excluded from this comparison.

[13] 2005 report, p. 35.

[14] 2005 report, pp. 35–36.

insurers are, however, making these calculators available on their web sites for their customers with an increase from 3 insurers in 2005 to 7 insurers in 2006. Insurers are also directing customers to their websites in targeted materials. One insurer noticed a sizable lift in use of its web-based calculator as a result of targeted messages it had sent to its customer base about underinsurance particularly since January 2006.

Updating the sum insured

In the 2005 report, insurers indicated that they used a range of different methods to revise the recommended sum insured on renewal. The 2006 survey indicated that this is still the case. Methods used include the Consumer Price Index (CPI), Cordell Housing Price Index (CHIP), Housing Building Index (HBI), Rawlinsons Building Price Index (RBPI), and by way of a fixed amount.

Percentage increases on renewal in 2006 varied from 3% to 8.6% with 2 insurers using CPI alone to update the sum insured by 3% and 3.6%. We believe that there is a greater risk of the consumer being underinsured where the annual increase on renewal is based solely on CPI or the RBPI. We note that one insurer in the 2006 survey commented that over the past 6 years the percentage increase in housing costs has been more than double the percentage increase in CPI, primarily as a result of a shortage of skilled tradespeople.

We consider that CHIP is likely to produce a more accurate estimate of rising costs as it tracks both changes in the costs of materials and labour both by city and region.[15]

Generally, insurers have increased the percentage figure used to calculate amounts on renewal since the 2005 report. One insurer increased its percentage yearly increase from 3% to 6% from May 2006, and 5 insurers increased their percentage yearly increase from 2005.

In the last 12 months to June 2006 building costs have increased by an average of 4% Australia wide.[16] Higher indexation rates do not significantly tackle the problem of underinsurance.

The 2005 report found that:

- most insurers did not inform consumers about the method by which the suggested increase was determined, and
- only 3 insurers suggested in renewal notices that consumers may wish to review their level of cover.[17]

[15] 2005 report, p. 42.

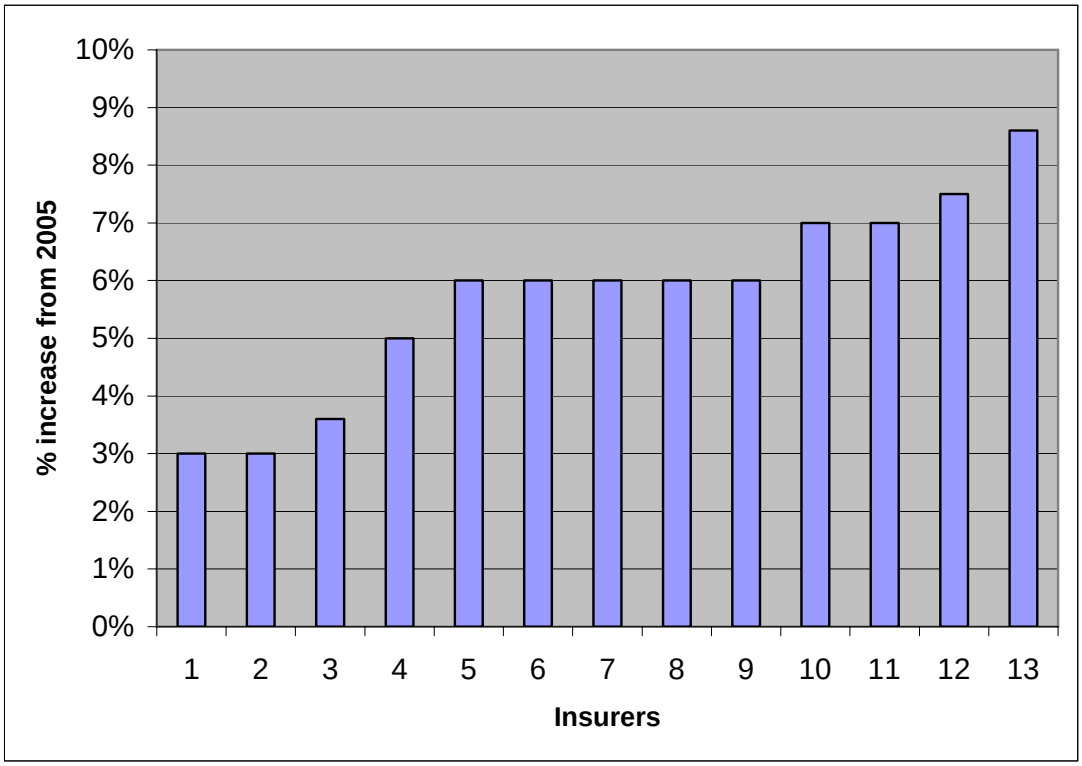
[16] Reed Construction Data Cordell Building Indices-Cordell Housing Index Price (CHIP) state figures as follows: NSW 2.1%, WA 5.4%, SA 6.6%, Vic 2.3% QLD 3.8%.

The 2006 survey revealed that 7 insurers now take the opportunity to educate customers about underinsurance on their websites and/or in mail outs and renewals. One insurer includes a separate notice alerting consumers to the risks of underinsurance on renewal. Consumers are directed to its web-based calculator to check the adequacy of their sums insured. Of the insurers surveyed, another 6 insurers are also considering educating their consumers about underinsurance on their websites and/or in renewals or mail outs within the next 12 months.

Most of the insurers surveyed indicated that they are not in a position to provide consumers with individual advice about the adequacy of the sum insured. However insurers provide consumers with access to generic tools such as a calculator and/or recommend the consumer pay a licensed builder or quantity surveyor to estimate rebuilding costs. We note that a total replacement policy avoids the limitations in this approach.

In the 2006 survey, 6 insurers disclosed to some extent that the insured sum had been increased. Consumers are generally told that annual percentage increases in the sums insured are made to keep in line with inflation, rising values and costs. One insurer disclosed the percentage increase on renewal of 5% with another disclosing an increase of 3%, 'to account for increases to the cost of living'.

Chart 2: Percentage increase of principal sum on renewal from 2005



[17] 2005 report, p. 41.

Average sum insured

For the insurers surveyed in 2006, the highest average sum insured was $277,519 and the lowest average sum was $184,000. The average sum insured across all insurers in 2006 was $225,858.

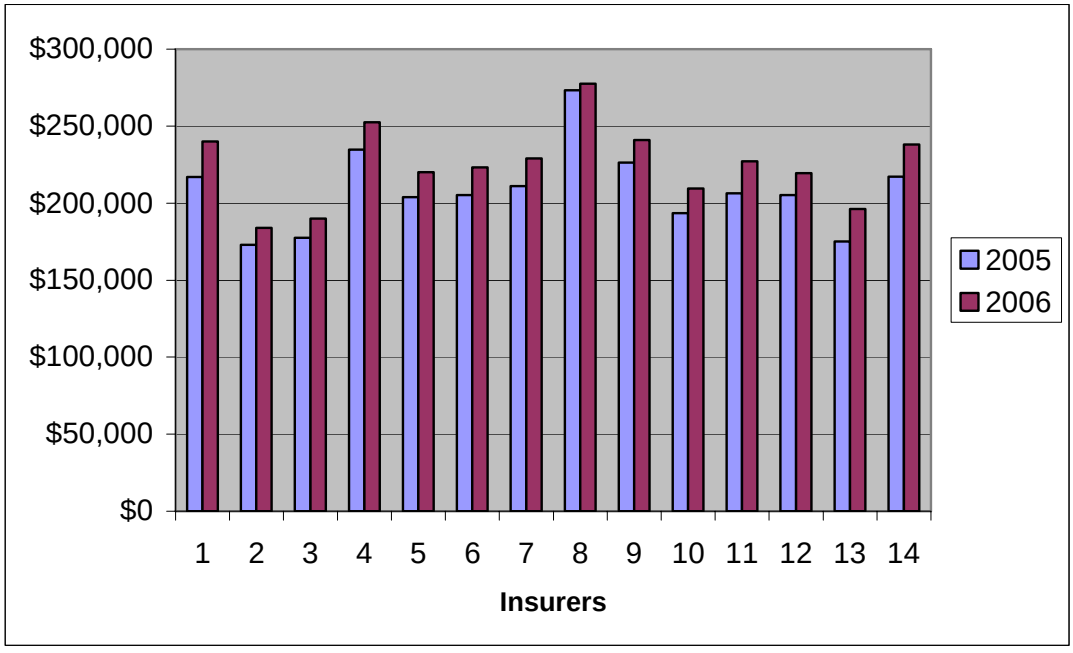
The percentage increase in average sum insured for each insurer from 2005 to 2006 varied from 1.6% to 12%. The average overall percentage was 7.9%.[18] There was some regional variation in the pattern of average increases with 17% in the Northern Territory, 14% in Western Australia and 10% in Queensland and Tasmania.

Insurers with high percentage increases in average sum insured had correspondingly high indexation amounts of 6% to 7.5%. These insurers also conducted educational campaigns in renewals, mail outs and websites, to encourage the consumer to review their insured sum.

Increase in average sum insured probably reflects the increase in:

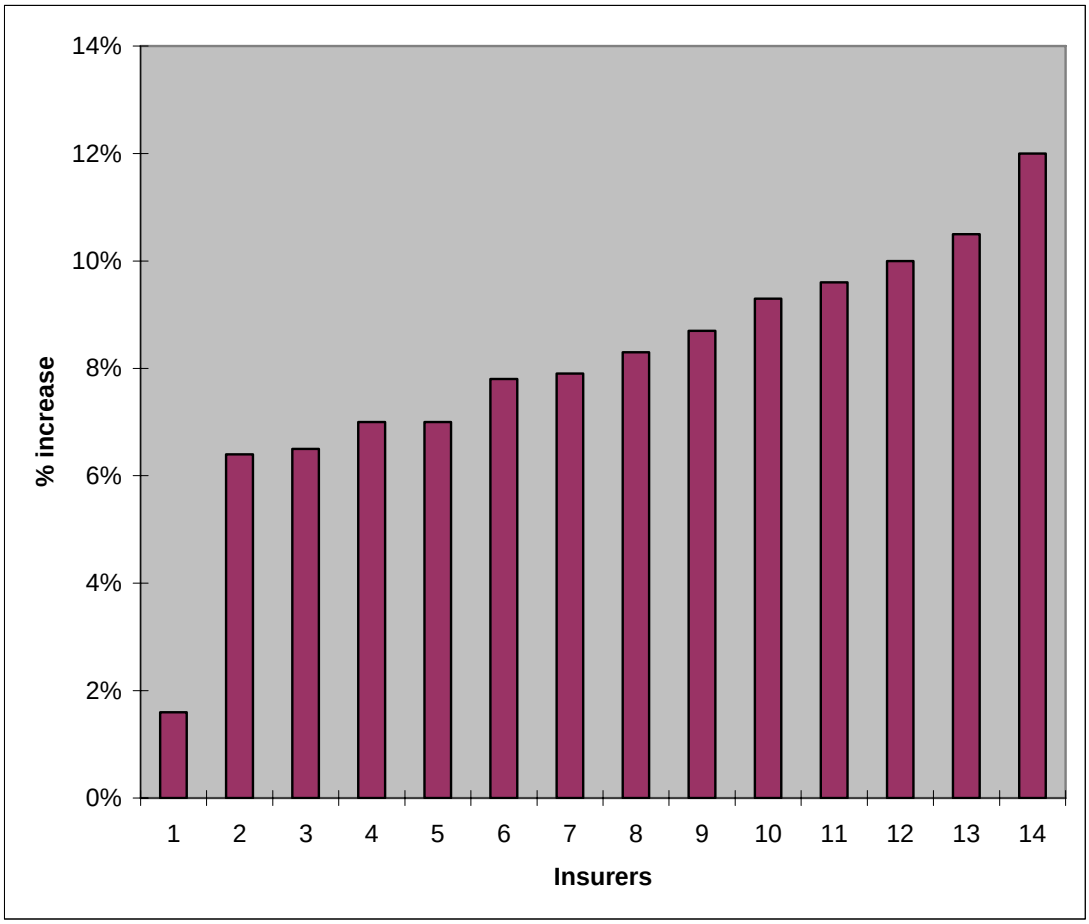
- the percentage used by insurers to update sums insured, and
- education measures targeting consumers.

Chart 3: Comparison of sum insured in 2005 and 2006



[18] One insurer introduced a 2-tier rating structure to make premiums more attractive on higher sums insured. Rates are reduced for amounts over $150,000 or $175,000 depending on type of policy. This may have encouraged consumers to insure for a higher amount.

Chart 4: Percentage increase of average sum insured from 2005



Premiums

Our 2006 survey revealed that 11 insurers structured their premium rates so that the percentage of premium proportionally decreased for higher sums such as $300,000—that is, to get an increase in cover of 30%, from $300,000 to $390,000, they would not have to pay another 30% in premium. However, at least three insurers did not adopt this approach.

A 2000 survey of consumers found that many consumers were prepared to pay a further $75 to increase their cover by $90,000.[19] These consumers may therefore be able to obtain a higher level of cover for less than they think, either through their own insurer or by shopping around, depending on the approach taken by their insurer to charging for increases in cover.

Consumers concerned about their premium may also be able to reduce the amount they pay by agreeing to pay a higher excess in the event of a claim. The 2006 survey revealed that 11 insurers enable consumers to easily change the amount of excess online to reduce the amount of premium.

[19] 2005 report, p. 64.

By shopping around the consumer may be able to obtain the same cover for less premium or a higher level of cover for a similar premium. Taxes on premiums for home building insurance policies can add significantly to the cost of the policy. A lower premium will also result in the consumer paying less tax on the amount of premium and result in greater overall savings to the consumer.

Adjusting sum insured during policy term

In the 2005 report we noted that the gap in time between the date the policy is taken out and the date that a claim is made may contribute to underinsurance. This will happen, for example, where rebuilding costs have increased during that time and the sum insured has not.[20]

The 2006 survey has revealed that 5 insurers adjust the sum insured during the policy term. The sum insured is increased by a percentage according to the number of months since the policy was taken out.

Educating consumers about underinsurance

Insurers are using different educational measures to inform consumers about underinsurance. These measures include:

- Enhanced information targeted messages in mail outs and renewal notices (as discussed above), and on websites, including messages, where applicable, encouraging homeowners to refer to an insurer's web-based calculators in order to check their level of cover.
- Research into the behaviour of consumers, based on consumer surveys or reviews of claims data. This enables insurers to provide targeted messages that consumers are more likely to respond to.

General Insurance Code of Practice

The new General Insurance Code of Practice should also have a role in reducing the risk of underinsurance.[21] In the 2005 report we noted that it is difficult for consumers to understand exactly what costs are covered by their policy and the extent of those costs.[22] This code commits general insurers to provide better and clearer information to consumers regarding what is covered in their policies.

[20] 2005 report, p. 45.

[21] The General Insurance Code of Practice was launched in July 2005 and came into force on 18 July 2006.

[22] 2005 report, p. 47.

Section 3: Lessons from Cyclone Larry

Effect of Cyclone Larry

On 20 March 2006 the North Queensland region around Innisfail and Babinda was devastated by a category 5 cyclone: Tropical Cyclone Larry. Wind speeds of up to 290 km/h cut a swathe over 150 km wide causing extensive damage to residential, industrial and agricultural property in an area half the size of Tasmania. Initial estimates were that, in the worst affected areas, up to 99% of homes, 50% of private businesses, and 25% of government buildings sustained significant damage. Electricity supply and road and rail access to the region were also severely disrupted.[23]

In the first few months after the event, overall losses were estimated by the Insurance Council [24] to be approximately $600 million. By 1 November 2006 insurers had received 25,796 domestic claims with an estimated cost of $321 million.[25]

As at 31 July 2006 the Insurance Council reported that almost half of the home building claims have been settled. The insurance industry has been working closely with the Cyclone Larry Operation Recovery Taskforce to help rebuild the homes and lives of those affected as quickly as possible.

Insurers have been meeting regularly with the Queensland Government's Building Coordination Centre, based in Innisfail, to identify and resolve issues such as waterproofing all homes before the next wet season and prioritising, where possible, those homes in need of re-roofing.[26]

Extent of damage from Cyclone Larry

Houses built in mid 1960s to mid 1980s that had not been renovated suffered the highest percentage of roof damage of all housing types. The majority of houses in this category predated the revision of the Queensland Building By-Laws that incorporated many of the lessons from Cyclone Tracy (Darwin 1974). A substantial proportion of older houses that had been refurbished, including some structural improvements, fared much better.[27]

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[23] http://www.loc-gov-focus.aus.net/editions/2006/september/larry.shtml-Australia's National Local Government Newspaper online- September 2006 edition.

[24]The Insurance Council of Australia Annual Review 'Highlights 2005/2006', May 2006, p. 14.

[25] Information provided by the Insurance Council of Australia on 1 November 2006.

[26]http://www.ica.com.au/corpaffairs/mediareleases.nsf/c94e71bde9284239ca2569f2000f8b99/dff8329280d43672ca2571bc00810e5f.

[27] Tropical Cyclone Larry CTS technical report TR51, September 2006, p. 40.

Increase in costs after mass disasters

Mass disasters can cause huge and unpredictable increases in rebuilding costs:

- After Cyclone Tracy in Darwin in 1974, building costs increased by 75%.
- After the Newcastle earthquake in 1989, costs increased by 35%.[28]
- After the ACT bushfires in 2003, building costs increased by 50% between November 2002 and January 2003.[29]

Preliminary reports following Cyclone Larry would indicate that there was a significant increase in local building costs after the disaster. Insurers surveyed estimated that building costs increased by at least 50% immediately after the disaster. Initial estimates by the Insurance Council are that as many as 50% of houses in the affected area were underinsured to some extent, although it is difficult to ascertain until all claims are paid out and work completed. [30]

Increases in local building costs after the disaster are likely as a result of a number of factors including:

- the remote nature of the location and the breadth of the damage path,
- limited availability of builders and initial difficulties in accessing sites, particularly due to ongoing rains, and
- the fact that many of the homes were older structures and were not compliant with new cyclone building codes.

Cyclone Larry occurred in a regional area where communications and access were restricted in the worst affected areas. The long period of rain following the cyclone also contributed to the damage.

Local builders were quickly booked up for the next two years. The cost of enticing builders from interstate and accommodating them locally also added to the cost of rebuilding. The widespread damage contributed to the lack of accommodation for tradespeople, with one insurer commenting that even caravans had been flattened.

Three insurers surveyed indicated that costs of compliance with the Cyclone building codes may have added an estimated $15,000–$25,000 to rebuilding costs although it will only be possible to fully ascertain these costs when building work is completed.

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[28] 2005 report, p. 14.

[29] 2005 report, p. 51.

[30] Information provided by the Insurance Council of Australia, 1 November 2006.

Insurers' response to Cyclone Larry

In 2000 the Insurance Disaster Response Organisation (IDRO) was set up to coordinate the insurance industry response to disasters. It aims to enable the industry to work with government and emergency services to provide the best possible response and recovery service for the consumers who have been affected by a disaster.[31]

After Cyclone Larry struck, insurers set up 24-hour call centres to deal with initial inquiries and provide advice. More than 100 loss adjusters and claims personnel were sent to the disaster-affected area immediately after the disaster.[32]

The insurers surveyed in August 2006 indicated that they were ressponding in a variety of ways to increase the amount payable under the policy:

- One insurer allowed for the sum insured to be increased at any time, in particular after a cyclone warning.
- Another insurer has applied pro rata indexation since the last renewal in order to minimise the extent of underinsurance to compensate for the substantial gap in increased costs between the date the insurance is taken out and the date of the claim.
- Some insurers were more lenient in relation to accomodation periods with one insurer extending the period from 12 to 24 months.
- Insurers made ex gratia payments.
- One insurer has not pursued policy exclusions such as poor maintenance, structural defects, non-compliance with building codes, pre-existing damage, termite damage and failure to repair fences.

We note that a flexible interpretation of their policy has had positive outcomes for those insureds. However, it does not address the cause of the problem, namely underinsurance as a result of escalating building costs and costs of compliance with the building code.

Natural disasters such as Cyclone Larry also reveal a level of non-insurance, where consumers choose to take on the risk themselves. Whilst the level of non-insurance is not an issue dealt with in this report such a decision effectively results in financial support from the government and community.

[31] http://www.idro.com.au/about/default.asp.

[32] The Insurance Council of Australia Annual Review 'Highlights 2005/2006', May 2006, p. 14.

Lessons to be learned from Cyclone Larry

Our August 2006 survey of insurers highlighted further lessons that can be learned since the release of the 2005 report and in light of Cyclone Larry—particularly about 'inadvertent underinsurance' resulting from a disaster (i.e. where underinsurance is not apparent when a policy is taken out):

- No two disasters are the same. With Cyclone Larry, conditions such as location and the continued bad weather after the cyclone exacerbated the level of underinsurance. Overall, insurers who responded to the August 2006 survey estimated that building costs increased by at least 50% immediately after the disaster.
- Estimates are that at least 10% of the 8,000 houses damaged were in a poor state of repair—and most of these were rental properties.[33] Failure to properly maintain the home can result in significantly more damage.
- Deterioration of fasteners, sheeting and metal frames due to rust and rotted timber compromised the structural performance of the home and contributed to further damage from Cyclone Larry. Undetected damage from previous cyclones and incomplete repair after previous events or during renovations also contributed to further damage.[34]
- The impact of demand surges cannot be adequately reflected in policies with a fixed sum insured. While some insurers allowed for an adjustment of the sum insured during the term of the policy to bring the sum insured in line with rising costs, building cost surges of at least 50% cannot be incorporated into these policies.

Building code requirements

Responses from three insurers surveyed indicated that building code requirements relating to cyclone standards may have contributed to the surge in building costs adding $15,000–$25,000 to reinstatement costs.

One insurer surveyed has changed its pricing structure in cyclone prone areas. Two insurers surveyed have embarked on an educational campaign about underinsurance in such areas.

One insurer commented on the need to incorporate increased code compliance costs into its comprehensive calculator but also recognised the difficulty of doing so. One provider of building cost information now provides in its estimate of building costs building code requirements and other building requirements such as BASIX in New South Wales.

[33] Information provided by the Cyclone Larry Taskforce, 26 October 2006.

[34] Tropical Cyclone Larry CTS technical report TR51, September 2006, p. 74.

Importance of home maintenance

Consumers should be aware of the importance of ongoing inspection and maintenance of the home and of relevant construction standards.[35] Most of the insurers were lenient in not excluding claims on the basis of poor maintenance after Cyclone Larry.[36] Consumers should not rely on such a flexible approach in the future.

The requirement to maintain the home in good condition is a common feature of home building insurance policies. A review of policies offered by 10 insurers showed that this feature was referred to in all policies under the different headings of:

- 'Exclusion'
- 'Risk to cover'
- 'Precautions you need to take'
- 'General conditions'
- 'Your responsibilities'.

Failure to take reasonable care in the maintenance of the home may result in non-payment or reduction of payment of an insurance claim. This duty of care may extend to:

- maintaining the home in good or sound condition (i.e. keeping it watertight, structurally sound and secure),
- ensuring compliance with statutory obligations relating to the safety of the property,
- repairing faults and fixing defects such as roofs, gutters, drains, water pipes and tiles, and
- informing the insurer immediately if the home has fallen into a state of disrepair.

Consumers should carefully examine the wording of their policies to check what they need to do.

[35] Tropical Cyclone Larry CTS technical report TR51, September 2006, recommendations made in the report, p. 76.

[36] Information provided by the Cyclone Larry Taskforce, 26 October 2006.

Section 4: Has home insurance improved?

What insurers are doing

Since we released our 2005 report, insurance companies have taken steps to reduce the problem of underinsurance by:

- introducing alternative types of policies such as total replacement and extended replacement policies,
- making the indexation of the sum insured at renewal more realistic by using costs indexes such as CHIP and or other sources rather than relying on CPI alone,
- educating consumers to re-evaluate their sum insured each time they renew their policy in light of increased costs and/or any renovations,
- making greater use of sophisticated web-based calculators that give more accurate estimates of rebuilding costs,
- educating consumers about underinsurance on websites and in renewal mail outs,
- undertaking research in disaster prone areas,
- undertaking research into consumer attitudes to insurance and risk.

Most insurers surveyed in 2006 plan further educational initiatives in renewal mail outs and on websites within the next 12 months.

We commend these measures. We encourage insurance companies to continue to make improvements in all of the areas discussed in this report and particularly to investigate the viability of the more widespread introduction of total replacement policies. This step alone ensures that consumers are adequately insured—if their home is accidentally destroyed, they can afford to rebuild it.

Consumer responsibilities

Consumers also have a responsibility in reducing the risk of underinsurance. They should:

- consider the relative merits of alternative policies, including total replacement and extended cover policies,
- make use of the tools and aids that have been developed by insurers to determine appropriate levels of insurance to cover property and other assets,

- assess the sum insured over time and not just when they take out their insurance policy. Greater access to sophisticated online calculators means consumers can now do this more readily and conveniently,
- ensure that their home is well maintained, reducing the risk of a total loss.

At greatest risk of becoming underinsured over time are:

- consumers who have been insured for ten or more years and who have not recently reviewed building costs,
- consumers who have renovated their home and not increased the sum insured to cover any improvements, and
- consumers who live in areas where there have been significant changes to building code requirements, which mean that any replacement home will have to be built to a higher and more expensive standard (increasing rebuilding costs). This was the case with homeowners affected by Cyclone Larry.

Further work by ASIC

We will continue to actively monitor developments in the marketplace by:

- monitoring advertising and complaints,
- furthering consumer education,
- creating consumer tools,
- examining insurance products,
- monitoring web-based calculators, and
- undertaking further research into the industry, including targeted reviews of practices where particular problems are identified.

Appendix: Companies and brands surveyed in 2006

Group	Brand	Survey	Calculator review[37]
Allianz	Allianz	Yes	Yes
Australian Unity	Australian Unity	Yes	Yes
CommInsure	CommInsure	Yes	Yes
Hollard	Hollard	Yes	Not applicable
IAL	NRMA	Yes	Yes
	SGIO	Included in NRMA	Yes
	SGIC	Included in NRMA	Yes
	CGU	Yes	Not applicable
Lumley	Lumley	Yes	Not applicable
	Wesfarmers	Yes	Not applicable
Promina	AAMI	Yes	Yes[38]
	APIA	Yes	Yes
QBE	Western QBE	Yes	Not applicable
	QBE Intermediary Division—QID	Included in QID	Not applicable
RACQ	RACQ	Yes	Yes
Suncorp	Suncorp	Yes	Yes
	GIO	Included in Suncorp	Yes
TIO	TIO	Yes	Yes
Westpac	Westpac	Yes	Yes

[37] Comparisons were made with those companies reviewed in 2005. Hollard, Lumley, Wesfarmers and QBE brands did not have web-based calculators at the time of review.

[38] AAMI used a complex web-based calculator until 30 August 2006.