

## Insurance Implications of Non-Conforming Buildings

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Thank you very much, I am in fact going to try to get you out to lunch much earlier. The man or woman hasn't been born yet who can suffer forty five minutes of insurance talk.

All I'm going to cover is just a few general remarks initially about insurance industry because, like the building industry and other industries there are a lot of myths out there that people tend to jump to instead of facts. I'll roll that into how our premiums get set, again a lot of urban myths in that space and I'll talk in general terms. Then I'll just talk about how do insurers go about protecting non-conformance issues and I'll finish off with, what they do about that. We will probably use the cladding issues as the issue du jour.

In general the insurance industry in Australia it's very active, covers just about every risk or almost every risk at a price. So that's the first thing to remember. In Australia we do risk based pricing on practically every class. If you have high risks your premium is going to be high. Determining how high the risks are, that's the trick we all have to get into.

98.6% of claims are payed in Australia every year. I think often feel like I've made everybody in the one point four percent residual. But there's usually good reasons why a claim isn't paid and that's that it generally comes down to one of two things - one of three things actually. There's a tiny percentage of people who lodge claims who don't have an insurance policy whatsoever. They are surprisingly difficult to deal with because you've got to go all the way through to the Ombudsman proving the person never ever bought a policy, and they know it full well.

Then you've got a certain number of people in Australia who lodge claims for things that legitimately didn't happen. You know so that the classic is, yes there was a burglary in the house but you know five, 72" plasma screens probably weren't there in the first place.

And then you've got this class of people who lodge for clients against policies that have nothing to do with the event and those can get very tricky as well. Classic example is, the 2009 fires in Victoria we had several MPs, who should of course have know better, make representations on behalf of clients who had lost motor vehicles. And we would set about going well why wouldn't this claim be paid? A car gets burnt and written off, it's covered by every insurance policy. What we'd often be told is that the person who's insured this policy, it was for twenty million dollars worth of cover on this car. How can the insurer not be paying? And of course it's compulsory third party policy - that's all they had on the car. There are a lot of people who make claims against policies that just simply never designed to cover that.

But that all boils down to one point four percent of people not getting what they want. One hundred and twenty million dollars a day is paid out in claims in Australia on average. Some of those are obviously going to be very, very big amounts but most of it is sort of mom and dad and business claims.

But one hundred and twenty million dollars a day, and I often like to try and imagine what would things be like if you took out the insurance industry? And that hundred and twenty million dollars wasn't going back

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into the economy every day? People would have to stop taking risks. They'd have to become far more conservative than what they are, because they wouldn't be able to leave home safe in the knowledge that if it does get all knocked off or burnt down or crushed, that they'll be able to recover from it. So it's a critical part of the industry. But it's not unlike other industries like the building sector that comes in for its fair share of criticism and introspection.

In fact I'm involved in the twelfth inquiry - commission of inquiry - into the insurance sector since 2011. Because we're constantly being examined about why we're setting prices so high for certain people. That leads me into how our premium are set. So I'll talk about this in two contexts if you like. The domestic market - you know the mom and dad's house. And then the highrise sort of residential and commercial places.

The first thing an insurer does when you say "I would like to insure this property," is they put a red pin on the map where the property is and they look up all of the externalized data for that. Like how often does it flood? How deep does it get when it floods? How intense is the rainfall, for example for a one in twenty years flood? How close is it to the coast or the wind speeds we can expect? What's the return period for hail of about four centimetres? A range of issues that they look at, that might occur at that site. That the first thing they do. The second thing they do is look at the actual asset that they can insure. How much does a person want to be compensated for and what is the likely performance of the building? Just to bring this back to this performance issue.

So the first thing the insurer does is, he asks when was the property constructed and from that, depending on the class of the property, they'll just assume absolutely everything. So this leads into the third point. How do we determine non-conformance in a property. If it's mum and dad's house or your house, the insurer asks you some really simple basic questions. What is your year of construction? From that they'll make some assumptions about what standard of borrowing you've got, how the house was put together, etc. They'll also ask some questions about the primary building materials being used. But if you go through your insurance questionnaire at the moment, they still only asking the very traditional types of materials. Is it brick, is it timber?

We've got a few insurers starting to ask the more exotic questions. Have you got EPS for example? That's going to become a big problem. So for a domestic market they're really looking at the replacement costs of all those things rather than their straight out performance. And you can get some very very unusual results and we often have to deal with clients who can't understand. So for example, a steel roof is far more resilient to hail and won't get penetrations and the rest of the property won't get damaged. But it's more expensive to insure in a hail zone because it's more expensive to replace. Because with the big dings in it you are going to have to replace it anyway.

So insurers are not terribly sophisticated when it comes to actually understanding the performance of each of these materials. They've got the huge benefit of looking over their shoulder and seeing how those materials performed in the past and what will it cost to replace say 130sqm of steel roof. That's how they do it. The main part of the pricing comes from the hazards, the frequency and the severity of those hazards.

So the easiest example for people to picture is, a house in the middle of Lismore. Let's say it's in the five percent AEP zone so its got a one in twenty year risk of flooding to a metre deep. A very standardized damage curve for that would be about one hundred thousand dollars worth of claim. That's contents and fixing up the building. So you get a five percent chance in any given year of suffering a one hundred thousand dollars claim. You don't have to be Warren Buffett or an actuary to work out that that's a five thousand dollar flood technical premium right there. Then you've got to add in fire, theft, accident, storm and all the other factors - the insurers profit, the insurance costs, and then in New South Wales you've got to add in about

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another thirty percent at the moment of government taxes. So a person in that scenario can be paying 8, 9 or even 10 ten thousand dollars, for a very standard looking home, even quite an old home.

So that's how insurers set premiums in the domestic market. They don't set foot in the property. They don't look at it. They don't bring it up on Google Earth, they don't do any of that whatsoever. They rely entirely on what the homeowner tells them. And that is something we're working on, we're trying to fix with local governments, getting some more parameters out of out of them, particularly floor heights and things like that.

The situation changes when you get into the commercial market, the strata market or in the industrial market. Over a certain level of sum insured, typically around the two or three million dollar mark, an insurer will send a relevant engineer in to have a look at the facility. Usually that's going to be somebody with a fire safety engineering background because that's where the insurance industry was born, out of out of that market.

But increasingly we're seeing real specialists in general risk engineering, for want of a blanket term, to look at look at the building in a holistic sense. And that's the only time and the only type of assets, where insurers will actually start working out what the building is made of. How will it perform based on my previous examples and how are these performance based solutions or alternative solutions likely to impact the frequency of an event going forward? And you can imagine that in that environment, they come across a lot of non-conformance issues.

You know that the cladding issue is something that we've been monitoring for a couple of years now. Lacrosse certainly brought that more into to focus for us, but there are bigger issues out there. And the previous speaker was talking about EPS. That's the number one thing that insurers don't like. Some of it's not particularly well educated and well understood, it's just the quantity of it being out there and the risk that it poses in terms of causing further issues to the buildings. For example these leaky issues, you know insurers in the North spend a lot of time cleaning up after wind driven water penetration and the issue you'll be battling for, you know we're just about to close off on cyclone Debbie, so there are still homes there not repaired simply because of the mould issue because you can't get the water out. You know you can't get down to this magic sixteen percent humidity.

So for your bigger assets were coming across non-conformance issues all the time and EPS is the main one. A week doesn't go by where I don't have one of these insurance engineers coming in with a funny looking building material – its usually a great education but takes a while to get there - and they'll explain why this doesn't conform or doesn't comply and what the particular risks are.

We're starting to see it in the highly energy efficient buildings, things with very very high star ratings on them, where a lot of exotics are being used. Now that's an insurer saying exotic building materials. For you guys they are probably stock standard things used all the time. But the further we go down the energy efficiency path, the more we're starting to use these composite materials and insurers will often lack experience with them. Even if they have got experience with them, often that experience isn't good. An example is some of the images in the previous presentation about the expandable polystyrene sprays and things like that giving you a good thermal efficiency and acoustic efficiency. Once an insurer sees that in a commercial setting you can expect that he's going to have real problems, and may even walk away from offering a price.

That leads through to the final point I want to make. What do insurers do when they find a building is non-conforming? For a start they essentially assume every building they are dealing with is non-conforming in some way. There is always going to be an issue and their concern is setting a price around it. It's very rare

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that an insurer won't offer cover on a building, it'll just change the quantum of what that premium is going to be. So right now we bring that back to the building cladding issue.

No insurers are walking away from those buildings. We developed an industry level protocol for what we might expect building owners to produce in terms of reports and identification of the material, to allow a fairly consistent assessment of the risk across the industry. But nobody in the industry is walking away from one of these buildings. I think that's important because we're getting increasingly frequent calls from members of parliament about the fact that insurers will not insure this building or that building, or they've walked away. Simply not true. But they will definitely risk manage it. So risk based management means high prices for high risk.

You may find that some people start to find those premiums unpalatable. Price signals in Australia because of risk based pricing do motivate change. We've got one company for example that will say to you under your present conditions, with the present fire safety system that you've got installed, the premium is one hundred thousand dollars. If you undertake these works over the next twelve months, we'll reduce your premium to seventy five or seventy thousand dollars. That's starting to become more frequent at the upper end. What we'd like to see happen is that that threshold starts to come down, so the small high rise buildings start to get inspected more often. I think it will happen as more exotic building materials start coming in. So the point is, it's all about risk-based pricing.

If the high risks are there, the premiums are going to shoot up and that price signalling is working across Australia to develop mitigation and approaches. Even if insurers do detect non-conformance, they're not going to necessarily deny selling a policy. They might deny a claim later on and that can always happen, but the key point is, we're here to work with the building industry to try and find those solutions to get the risk-based down. Some of the premiums particularly in strata in Australia are quite shocking in terms of their growth.

In 2009-2010, strata insurers started raising the price because it was a massively cross subsidised product before then. Average premium increase in 2010 was three hundred percent. You can't raise the price of anything by three hundred percent and not expect twelve government inquiries over the next seven years. In extreme cases I saw twelve hundred percent in one year. What was really going on was lifting the average unit holder's insurance cost up to about on parity with a homeowner in the same location.

So they were paying very low rates for a very long time. One of the problems we've really struggled with in our industry is first of all, they were all sharp accountants and actuaries who raise the price without too much thought for how that might be viewed out there in the world. And I can tell you that they've learnt that lesson. The price doesn't get shifted like that anymore.

But explaining it particularly to politicians was very difficult. For the best case I've got to tell you by anecdote is a former prime minister in a not too recent cyclone event up in Queensland, driving down one of the streets as they do, and then immediately rang us and said we don't understand why strata premiums have gone up so much and why they're so expensive because I did not see a single strata property that had fallen over or collapsed. That's the level of understanding that we're dealing with from decision-makers. Because it didn't fall over there's not a problem. So if you've got thirty seconds to explain well, the building code is a good thing and it's not going to let homes fall over and kill people, but it doesn't stop rain/water being driven at 120 kilometres an hour coming in on the fifth floor - overcoming the same size flashing that you've got on the ground floors as on the fifth floor.

As a result of doing that bit of education we got a strata engineering inspections scheme funded in North Queensland where a body corporate can now get a government sponsored engineer to come along and

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assess their building, not from a compliance or conformance perspective, but from an insurability perspective. That's something that's really new for us. So they'll go through the building and they'll look at all the issues that might lead to typically wind driven water penetration or things that have been inappropriately tacked on to the building, that are going to cause major structural issues and penetrations. So that's a big step for us and we're hoping to see that gradually bleed into the lower parts of the market. Possibly even dealing with the domestic market where we've got a demographic in Queensland of much older homes.

Everything's insurable for a price but if you've got a home built of fibro in 1972 in Cairns it's going to get very expensive and your options to insure are getting very low, because its pre-wind code. The paradox is, why is that home still there? And that is something we're trying to get government to help us out with. Somebody needs to go to that home and have a look to see how our grandfathers built this home. Obviously knew what they were doing because it survived for four or five major cyclones. We're looking at mirroring the strata engineering inspections at the domestic level where people can come in and rerate the home to give it cyclone compliance or whatever.

So these are the main things I want to cover.