

Reference: 20160145

22 July 2016



Thank you for your Official Information Act request, received on 12 May 2016.

You requested the following:

“...Treasury’s full report on sum insured house insurance.”

On 26 May 2016, we extended the time limit for the response by 35 working days because of the consultations needed to make a decision on your request.

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	23 June 2015	Treasury Report (T2015/1294): Home Insurance – Implications of Sum Insured Cover	Release in part

I have decided to release the document listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people
- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information, and
- information subject to an obligation of confidence, under section 9(2)(ba)(i) – where making the information available would be likely to prejudice the supply of similar information, or information from the same source, and it is in the public interest that such information should continue to be supplied.

There are some notes to add to the information being published:

1. Paragraph 58 of the report refers to the figures which insurers used to calculate sum insured amounts following the initial shift to sum insured values. Tower has subsequently informed the Treasury that when sum insured policies renewed in their second year, the company adjusted some sum insured values for renewal, where policy data and some assumptions with support from the Cordell calculator highlighted the previous sum insured was not adequate.
2. Paragraph 64 of the report refers to insurers offering customers full replacement cover for total loss from fire. Vero's cover is wider, covering total losses caused by any peril except natural disaster.
3. In Annex A, the list of companies and organisations consulted should refer to 'BNZ Insurance Services Ltd' rather than 'BNZ'.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested.

You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Craig Fookes
Team Leader, Financial Markets Team

TOIA 20160145

Information for release

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Treasury Report: Home Insurance – Implications of Sum Insured Cover

Date:	23 June 2015	Report No:	T2015/1294
		File Number:	SH-11-4-3-2-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note that the move to sum insured cover has exposed a large number of New Zealanders to underinsurance but is unlikely to crystallise into a significant insurance shortfall even after a major event Refer the report to the Minister Responsible for the Earthquake Commission Refer the report to the Minister of Commerce and Consumer Affairs	Friday 3 July 2015
Associate Minister of Finance (Hon Steven Joyce)	Note the attached report	Friday 3 July 2015
Associate Minister of Finance (Hon Paula Bennett)	Note the attached report	Friday 3 July 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
James Sergeant	Senior Analyst	04 917 6188 (wk)	s9(2)(a)	✓
Dillon Watts	Intern	s9(2)(a)	N/A	
James Beard	Manager, Financial Markets and International	04 917 6161 (wk)	s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Refer copies of the report to the Minister Responsible for the Earthquake Commission and the Minister of Commerce and Consumer Affairs.

Enclosure: No

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Treasury Report: Home Insurance – Implications of Sum Insured Cover

Executive Summary

Following the Canterbury earthquakes in 2011, most residential insurers in New Zealand moved home insurance policies from 'full replacement' to a capped 'sum insured' value.

The sum insured model provides some financial stability benefits as insurers are better able to capture and price risks. In the event of a natural disaster, insurers would be able to predict their overall liabilities with much greater accuracy. However, these arrangements effectively transfer responsibility for assessing risk to homeowners, and the evidence shows that many homeowners are not willing or able to calculate an accurate rebuild cost for their home. This potentially leaves them exposed to underinsurance (where the insurance policy would not pay out enough to rebuild a home fully after a natural disaster). This unexpected loss for individual policyholders could lead to pressure for government intervention if underinsurance occurred on a widespread basis after a major event.

Our work has shown the difficulties in measuring underinsurance. Every house is different and there is no single right answer about how much it would cost to rebuild after a disaster. But on the different measures we have explored, there does appear to be a degree of underinsurance across New Zealand. The figures suggest that 40-85% of homes could be underinsured by 10 to 50%. However, even after a major event, most houses are unlikely to suffer so much damage as to reach the limits of their cover, so the impact would be more limited than the figures suggest, though still serious for some individuals. We calculate that underinsurance shortfall varies between 0.3% and 7% of the total loss for a modelled Wellington reference event¹, with our best estimate being about \$135m.

We have heard nothing to suggest that the industry will move back to full replacement cover for home insurance, given the continuing risks from earthquake damage, although there have been some developments on the margins (for example, full replacement cover for fire damage).

Our discussions with insurers have shown that they recognise the risk to their reputations from widespread customer underinsurance. Insurers are continuing to work to encourage customers to assess their rebuild values carefully and there are developments in the valuation market which could provide tools which would make this easier.

Continuing public messaging will be important to maintain public awareness of the need for policyholders to have an accurate valuation for their home (as they should already have for their contents). A combination of stakeholders providing messaging could be an effective way to improve consumer knowledge of the issue and industry participants, consumer groups and the EQC all have a role to play in this area.

We do not suggest that the Government should lead on providing messages in this space, but we will continue monitoring this area, and will take opportunities to communicate messages based on the findings in this report, starting with feedback to the stakeholders we consulted during the project.

¹ A magnitude Mw 7.5 event on the main Wellington fault.

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Recommended Action

We recommend that you:

a **note** that:

- a. The move to sum insured residential insurance cover has exposed many New Zealand households to the risk of underinsurance
- b. Precise figures are hard to assess, but 40-85% of homes could be under insured by 10-50%
- c. However, for 95% or more of homeowners, this is unlikely to crystallise into a significant insurance shortfall even after a major event
- d. Industry participants are working to improve coverage levels and consumer information, but could do more
- e. Australian regulators have identified similar issues in the Australian market, where sum insured coverage has been in place for many years
- f. Treasury officials will maintain a watching brief and will include this topic as part of any review of the health of the insurance sector, And
- g. The Treasury will use the findings in this report as the basis for future communications in this area, starting with feedback to the stakeholders who contributed to the study.

b **refer** to the Minister responsible for the Earthquake Commission
Refer/not referred.

c **refer** to the Minister of Commerce and Consumer Affairs
Refer/not referred.

James Beard
Manager, Financial Markets and International

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Paula Bennett
Associate Minister of Finance

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Treasury Report: Home Insurance – Implications of Sum Insured Cover

Purpose of Report

1. The purpose of this report is to brief Ministers on the insights Treasury officials gained from consultation with the insurance industry and other relevant stakeholders on the shift to sum insured cover and the possible impact of the underinsurance that may result. A full list of companies and organisations consulted can be found at Annex A.
2. This report is for information only and no policy decisions are sought.

Structure and Content

3. This report sets out the issues arising from the shift to sum insured cover for home insurance in New Zealand and assesses the risks that individuals and the Government may face from underinsurance.
4. This report defines underinsurance as the situation where the maximum payout under a home insurance policy may fall short of the cost to rebuild or repair the property after a fire or natural disaster, leading to financial loss for the policyholder.
5. This report expands on the short section on sum insured cover in last year's Cabinet paper about the proposed review of the New Zealand insurance market (which was deferred at that time) [EGI(14)84].
6. This report focuses on insurance against physical loss to residential property rather than commercial buildings as insurance policies for commercial buildings have not changed dramatically in recent years. The report is also limited to financial loss rather than economic loss due to the difficulty of estimating the potential economic impacts of an event.

Key Conclusions and Implications for the Crown

7. There are some financial stability benefits that arise from insurers being better able to capture and price risks in the sum insured model. In the event of a major natural disaster, insurers would be able to predict their overall liabilities with much greater accuracy.
8. However, these arrangements transfer responsibility for assessing risk to homeowners. The evidence shows that many homeowners are not willing or able to work out an accurate rebuild cost for their home, and this potentially leaves them exposed to underinsurance.
9. Our analysis has shown that defining underinsurance remains problematic and variable. Every house is different and there is no single right answer about how much it would cost to rebuild after a disaster. But on the various measures we have explored, there does appear to be a degree of underinsurance across New Zealand with 40-85% underinsured by 10-50%, though the precise degree of underinsurance remains difficult to assess.
10. However, for 95% or more of homeowners, this is unlikely to crystallise into a significant insurance shortfall even after a major event.

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11. Insurers have suggested that a certain level of underinsurance (perhaps up to 10%) would not be problematic for individual homeowners, even where the home has to be completely rebuilt, because adjustments could be made in the design and construction of the replacement to provide an acceptable replacement within the available budget. Beyond this, householders would have to make more serious compromises or access their own resources (if available). In addition, a large number of policies have a demand surge built in (usually an additional 10%) which would help underinsured customers following an event, depending on the levels of additional costs that occur.
12. Our assessment is that, although underinsurance could cause difficulties for some householders after a major event, this would not lead to major pressure for Government to intervene since the EQC modelling shows that most losses would fall well below the sum insured limits.
13. Nonetheless, although the situation remains unsatisfactory for many policyholders, we do not see any need to impose requirements on insurers or brokers to deal with it, since there are sufficient actions already under way within the industry. Our discussions with insurers have revealed that they do not want widespread customer underinsurance, primarily for reputational reasons. Insurers are continuing work to encourage customers to assess their rebuild values carefully and the recent Vero product may provide a helpful model on how to do this. Banks are also likely to continue to exert pressure on customers with high loan-to-value (LVR) mortgages. We are also encouraged by the potential development of new ways of providing rebuilding valuations more closely tailored to individual addresses.
14. We do, however, think that insurers should recognise that most customers do not engage with the process of setting their insurance value. Insurers should, therefore, keep their default settings under review so that householders will receive a sum insured value that is adequate in most cases.
15. Continuing public messaging will be important to maintain public awareness of the need for policyholders to have an accurate valuation for their home (as they should already have for their contents) and to raise awareness of the unique types of costs that can arise after a natural disaster, such as building cost inflation, debris clearance and temporary accommodation. A combination of stakeholders providing messaging could be an effective way to improve consumer knowledge of the issue and the tools available.
 - Most of this messaging will come from industry participants, including insurers, brokers and valuers – though there is some anecdotal evidence that consumers believe this is driven by self-interest.
 - Consumer groups such as Consumer NZ will also continue to highlight the issue and the Commission for Financial Capability (which operates the 'Sorted' website) has expressed interest in continuing to disseminate appropriate messages. For example, one solution could be increased messaging about the low cost of additional cover as mentioned in paragraph 60.
 - EQC's role in this space is to provide homeowners with natural disaster insurance (in partnership with private insurers), raise homeowners' awareness of the natural disaster risks in their region, and show them practical things they can do to make their homes safer and prevent damage if there is a natural disaster.
16. We do not suggest that the Government should itself lead on providing messages in this space, but the proposed Insurance Summit or other industry events could provide an opportunity for Ministers to provide some messages to insurers and the public along the above lines.

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17. We propose to continue monitoring this area, in particular watching any regulatory developments in Australia, and will take other opportunities to communicate messages based on the findings in this report; starting with feedback to the stakeholders we consulted during the project.

The impact of the move to sum insured cover

18. This section sets out the impacts of the move to sum insured cover on insurers, consumers, mortgage lenders and the Crown.

Insurers benefit from the move to sum insured cover

19. The move to sum insured policies has transferred risk from insurers and reinsurers to consumers. The maximum loss which insurers face for each property is now precisely known, which helps to control their overall exposure after a major event and also limits the risk for their reinsurers.
20. This should slightly reduce the risk of the government having to provide support for any insurer in distress, since the losses payable on individual properties are more limited and quantifiable.

Consumers take on extra uncertainty

21. The move to sum insured cover means that consumers face the uncertainty of not knowing whether their sum insured would be sufficient to cover the replacement of their house, if it is destroyed (in addition to the existing uncertainty about how long it will take to arrange the replacement). If the final cost of the rebuild is more than the amount for which policy holders have insured their property, the cover will fall short in the event of a total loss. That was previously a risk only where consumers took the 'cash out' option under a total replacement policy and arranged the rebuild themselves, rather than relying on the insurer to do it.
22. The Government's interest in how the insurance market has developed derives from the effects on consumer welfare. Incomplete information, behaviour biases and moral hazard issues may result in an under-provision of insurance in the market reducing consumer welfare in the event of a claim. The effects are likely to be worse for lower income households where affordability and opportunity cost become bigger factors.
23. Widespread underinsurance might mean that after a major event, large numbers of householders could find themselves unable to rebuild their homes to the standard or size they had expected, or in extreme cases could not afford to rebuild their home at all. Alternatively, they would have to draw on their savings (if any) or increase their borrowings in order to make up the shortfall. This could produce bigger community and recovery effects after a disaster.

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Banks face risks to their mortgage book

24. The change to sum insured has also increased the risks that banks face, since banks (and non-bank lending institutions) use both the house and the land as a security against their mortgage portfolios. Most banks require the mortgagee to insure the property to cover their risk and to provide proof of this when the mortgage is taken out, but if the house is damaged or destroyed and the insurance cover proves to be insufficient, the bank's security will be reduced. The risk faced by banks is higher for high LVR mortgages where the mortgage represents a larger proportion of the potentially underinsured security.

The Crown faces an increased implicit liability

25. The move to sum insured has increased the risk of implicit liability costs to the Crown in the event of a major disaster. Although there would be no formal liability to the Crown, extensive underinsurance could lead to widespread complaints about insurers' practices and community pressure on government to make up the loss. Even if the number of individual cases were relatively small, there could still be community pressure from the groups affected, especially if the individual shortfalls were large.
26. This particular issue did not arise after the Canterbury earthquakes because policyholders had full replacement cover in place, though there were some disputes with insurers about the nature and speed of rebuilds and there was pressure in specific areas, for example uninsured land in the red zone. There was little pressure to provide support for homeowners without insurance at all, since the general public view was that people should take responsibility for their own decisions. However, it may be harder to resist demands for government action in a sum insured market since it could be argued that people had done the right thing in obtaining insurance but had information disadvantages in assessing the right level of insurance, leaving them short in the event of a disaster, particularly if the event itself had increased rebuild costs above previous estimates, for example through damage to land.
27. Based on our findings and the data presented below, there may be a large number of people underinsured (40-85% of households) who could call for government intervention in the event of a disaster. However, as previously acknowledged, this will not all materialise in one event and our analysis shows that a much smaller percentage of households (between 1 and 5%) would be affected so badly as to exceed their total sum insured cover. Our analysis shows that the average shortfall could range from \$20,000 to \$50,000 after the Wellington reference event, but this would not be evenly distributed and some households would be worse hit than others.
28. Pressure for Government support to those underinsured is more likely to come from those with substantial shortfalls. A substantial shortfall for a few would severely compromise their ability to rebuild a house to its previous standard, whereas, as explained earlier, a small shortfall could be absorbed with minor design changes.
29. If the Government decided to underwrite the insurance shortfall after an event, our analysis shows that the fiscal costs (or implicit liability) would be between \$18m and \$400m under our estimates for the Wellington reference event. Our modelling suggests a shortfall of around \$135m. Even if this fell entirely to Government, this would not be likely to cause major funding difficulties. Therefore from a Crown risk perspective, there does not seem to be a strong case for action at this time.

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The scale of the underinsurance problem

30. Defining the size of the potential risk faced by New Zealand is difficult, because it requires a view of the optimum level of insurance cover and accurate information about existing levels of cover.
31. Indemnity cover (such as a home insurance policy) involves reinstating the policyholder to the position that they were in, to the extent possible, prior to the happening of a specified event or peril. Where policies are written on a full replacement basis, this is limited by considerations of what is reasonable. Where policies are written on a 'sum insured' basis, there is also an upper limit on the amount payable. To achieve reassurance that the policy will reinstate the policyholder, the upper limit needs to be set at a level that will cover the maximum loss.
32. Not all homeowners will want or need this level of cover, for example if they were content not to replace their property to the same size or standard, or if they wish to reduce their premium costs and are prepared to manage some of their own risk. Although they would not be fully covered for total loss, they would still be fully covered for lesser claims, as New Zealand insurers do not operate the system of 'averaging' claims (in which claims for less than the total sum insured can be scaled back if the insurer believes that the house is underinsured).
33. However, for other homeowners, underinsurance could be a problem if they expect insurance to rebuild their home after a total loss, but end up falling short. This inadvertent underinsurance could arise from a lack of understanding of the new policy terms, exclusions in the policy, or a lack of understanding of the real cost of rebuilding.
34. Defining the level of underinsurance in New Zealand requires making assumptions about what is considered to be underinsured and finding the best methodology to calculate the level of underinsurance. During our research we heard a variety of figures for the amount of underinsurance nationally, ranging from \$55-\$310bn. These figures derived from different methods of calculating underinsurance, and are set out below. These figures are clearly worst case scenarios and are at a national level, whereas it is extremely unlikely that there will be an event which affects the whole country at the same time. To put these figures in perspective, the total cost of the Christchurch rebuild is estimated at \$40bn, of which \$18bn represents domestic repairs and replacement costs.

Calculation method	Total national underinsurance
1. Rebuild costs from Canterbury (IAG and Southern Response)	\$184 bn
2. On-the-ground rebuild valuations (Cost Construction Consultants)	\$155 – 310 bn
3. Comparison with modelled valuation costs (CoreLogic)	\$80 bn
4. Number of customers accepting the default sum insured value s9(2)(b)(ii)	\$74 bn

35. A detailed analysis of the methodology and the results from these different methods of calculation can be found in Annex B. We believe the figure based on rebuild costs from IAG and Southern Response offer the most accurate reflection of the scale of underinsurance in New Zealand, because the figures are based on the largest dataset of real costs incurred in rebuilding, and information from the largest domestic insurer. These figures suggest that 85% of homes are underinsured by an average of 28%.

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36. The figures are clearly only an estimate, as there are many factors which will affect the level of underinsurance. For example, the level of underinsurance per household is likely to increase over time due to inertia – policy holders generally prefer to hold their cover levels or increase them with inflation rather than regularly re-evaluate their exposures. Research from the United States shows that an individual house could be 15% underinsured within 13 months of setting the value, if the individual value is set on a portfolio index. This emphasises the importance of making sure the initial sum is set correctly and is continually reviewed.
37. On the positive side, we found no evidence of claims which had exceeded the total sum insured value for a property in the 18 months that the market has been using this system. This is a good sign as it confirms that the properties that have claimed so far have had adequate cover. However, this was based on a very small sample (as there are very few cases requiring total rebuild in a normal year) and rebuild and replacement costs are generally lower for a total loss as a result of fire rather than earthquake (because there is no land damage, and there is no area-wide demand surge) so this may not apply in the event of a natural disaster.

Modelling the impact of underinsurance after a natural disaster

38. These figures for underinsurance are on a national level, and would only become relevant if every home in New Zealand required rebuilding at the same time. To develop our understanding of a more likely situation, we have used the EQC modelling of a magnitude M_w 7.5 event on the main Wellington fault to look at a plausible worst case scenario (known as the Wellington reference event). Because this modelling is limited to one part of the country and because even after such a severe event, only a small proportion of homes would be totally destroyed, the model produces estimates of underinsurance ranging from \$18-\$400 m. Underinsurance of this level equates to less than 0.5% of the total estimates for underinsurance nationally, though the impact on individual households would still be serious.
39. The EQC model used analyses residential buildings covered by EQC which represents around 90% of the housing stock². The model uses the same data and processes that EQC uses for reinsurance modelling. Like all earthquake modelling, there is a large degree of uncertainty with the results due to the unpredictability of the events. Using this model we can estimate what the likely dollar amount of underinsurance in a worst case scenario. The main feature of the EQC model is that houses in the area of the earthquake will be affected to different degrees and the model consequently estimates that only a small proportion (1-5%) will suffer so much damage as to exceed their 'sum insured' limit even if they are considered underinsured.
40. By combining findings from the industry with the EQC disaster modelling we are able to get a sense of the levels of underinsurance in the Wellington reference event for the different definitions of underinsurance. We are able to add an extra dimension to the model to vary the percentage of homes that are underinsured, based on the data we received from industry. Table 1 shows the results from the modelling. The underinsurance shortfall varies between 0.3% and 7% of the total loss for the event, with our best estimate being about \$135m.

² Around 90% of residential dwellings have fire insurance and are therefore covered by EQC. The remaining 10% are not covered by EQC. This equates to 144,573 units in the EQC model for the magnitude M_w 7.5 event on the main Wellington fault.

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Table 1: Summary of different measures of underinsurance with variable percentage of homes affected

Underinsurance measure	Percentage of homes underinsured	Level of underinsurance	National underinsurance figure	Gross underinsurance shortfall in the case of Wellington reference event (underinsurance shortfall per household)	Number of homes affected in the Wellington reference event
1. Canterbury rebuild costs s9(2)(b)(ii)	85%	28%	\$184 bn	\$134.6 m (\$44,000)	3,030
2. Rebuild valuations	80%	25-50%	\$155-\$310 bn	\$105.5-\$399.2 m (\$40,000-\$57,000)	2,529-6,571
3. Modelled valuation costs	50%	10%	\$80 bn	\$17.9 m (\$20,966)	778
4. Number of customers accepting default values	40%	25%	\$74 bn	\$52.6 m (\$40,000)	1,285

Background – the move to sum insured cover

41. For the last 20 years most residential insurance in New Zealand was provided on a 'full replacement' basis. This calculated a premium based primarily on the size of the policyholder's house. If the house were destroyed in a fire or natural disaster, the insurer would be responsible for demolishing the wreckage, clearing the site and building a new house to the same size, standard and specifications as the homes condition when new.
42. Full replacement policies are unusual globally, as most countries base house insurance policies on a maximum specified amount, including Australia and the UK. In the USA, some insurers offer 'guaranteed replacement cost coverage', which pays to completely rebuild the home, but others insurers limit this to 120-125% of the insured value. Furthermore, unlike in New Zealand, the standard 'all perils' cover in the USA does not include protection against all types of natural disaster (for example, it usually excludes flood and earthquake cover).
43. However, since the Canterbury earthquakes, most insurers in New Zealand have moved to fixed sum (or 'sum insured') policies. These policies are the same as full replacement policies except that they cap the amount an insurer will pay on extensive damage (usually the total loss of a house) to the amount specified by the customer when taking out the policy or at the latest renewal. In most cases, however, the claimants will notice no difference, since most claims under such policies do not get close to the 'sum insured' limit.

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44. Only two companies have continued to offer full replacement policies: Medical Assurance Society (MAS) and Farmers' Mutual (FMG). These insurers said that they could continue to offer full replacement cover because they had different risks to the larger insurers as they targeted a more select group of consumers (medical professionals or farmers), and had a good spread of geographic risk. Other insurers also suggested that their small size of MAS and FMG made it easier for them to agree cover with reinsurers. MAS and FMG had not detected any trend of new customers seeking to move to them to take advantage of their full replacement cover, and in any case focused on steady organic growth. Two insurers (Tower and Vero) have also added new products to the market to reduce risks to policy holders associated with sum insured policies which are explored further in paragraphs 64-65 below.

Drivers of Underinsurance

45. This section examines the factors that drove insurers to switch to sum insured policies and the drivers of underinsurance in New Zealand since the switch.
46. The main reason for the move to a sum insured market that insurers gave was the need for insurers and reinsurers to understand better the exposure they faced, in light of their experience after the Canterbury earthquakes, when several insurers exceeded their reinsurance limits. The previous full replacement policies were calculated mainly on the size of the house, plus other factors, such as location, s9(2)(ba)(i)
47. In light of the Canterbury experience, reinsurers became uncomfortable with the open-ended exposure of full replacement policies. Furthermore, the experiences showed that costs were higher than expected and have continued to rise (for example due to enhanced building standards), further pushing insurers towards a system which caps their total exposure.

How did the market transition?

48. The main shift to sum insured was by insurance companies issuing consumers with a 'default sum insured' at the point of sale or renewal. The industry reported pressure from reinsurers to better quantify and understand the risk they were underwriting. This was either a figure of \$2,000 (+GST) per m² multiplied by the floor size of the property, or based on a simplified version of the Cordell calculator (see Box 1) using existing information held by insurers. Insurers did not expect the majority of customers to stay at this figure.

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Box 1: Online Rebuild Calculators

The online Cordell calculator is a tool provided by Cordell to provide an easy-to-use way to estimate the potential cost of rebuilding a home. This calculator draws on data from around New Zealand on many aspects of home construction and reconstruction. The information is updated regularly. Insurers generally use a tailored version of the Cordell calculator on their own websites.

The sum insurance figure also includes anticipated construction costs and allowances for professional fees, demolition, removal of debris and GST – things people often don't consider when thinking about the cost of rebuilding their home.

However the calculator is a guide only, and our industry research seems to suggest that it works well for basic homes but is inadequate for complex homes and homes built on difficult terrain such as slopes.

Research from IAG shows that the use of an online calculator is far and away the biggest factor in customers determining a sum insured value. 64% of IAG customers used an online calculator in setting their sum insured value whilst only a very small proportion (3%) used a quantity surveyor.

49. Premiums rose dramatically during this period of transition for two main reasons. Firstly, as discussed earlier, risk had not been adequately priced in the old full replacement cover (because of errors in valuation), meaning that customers were not paying sufficient premiums for the exposure that insurers faced. Secondly, premiums rose as they often do after a disaster, with insurers and reinsurers raising prices to cover the losses from the event.
50. Statistics New Zealand figures for the cost of 'dwelling insurance' show that household insurance premiums more than doubled (115%) between Q4 of 2010 (just after the first Canterbury earthquake) and Q4 of 2014. This compares to a 5.3% increase in the CPI over the same period. The EQC levy on home cover also tripled from 5c to 15c per \$100 of cover in 2012, with the maximum rising from \$50 to \$150 + GST.
51. As well as the price shocks, the market also reacted quickly to the pressure from reinsurers to produce a new style of insurance cover in a short space of time. This is a likely explanation for the high levels of consumer confusion reported by stakeholders. Many consumers did not fully understand the changes in the market and the transfer of risk they were now encountering.

There are various drivers of underinsurance...

52. Previously, consumers did not have to be financially literate in order to purchase residential home insurance. Insurance was cheap, easily available and required little or no input from consumers. With full replacement policies, consumers had to provide very little detail about their home before getting a policy.
53. However, the process has become more complex since the switch to sum insured policies.

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There is confusion between different house values...

54. Insurers noted that some homeowners may be confusing rebuilding cost with other measures of value when setting a fixed sum insured. The rebuild cost is not necessarily the same as the market value of the house, the rateable value or the cost of originally building the property. The rebuild cost is the amount it would take to completely rebuild a home in the event of a disaster – importantly including any demolition and removal costs that might be necessary before rebuilding can even begin. The rebuild cost also needs to be up to date, to take into account changes in building regulations since the house was built (for example better foundations, or double glazing) which could increase costs and should ideally make allowance for further enhancements to building standards that might be introduced after a disaster, as happened for foundations in some areas of Christchurch.

Consumers naturally struggle to price risk and have a short term view.

55. People have a strong tendency to accept the default or pre-set option, and this is clearly shown in the figures by the high proportion of consumers who stay at or close to the sum insured value suggested by the insurer. Academic studies have confirmed that individuals struggle to price the risk posed by uncertain future events, as they are more influenced by immediate costs and benefits than those delivered later. It is possible that customers may be more concerned about the risk of their premiums rising if they increase their insurance limit, than about the benefit of higher cover at some uncertain future date.

The majority of customers are accepting default sum insured values...

56. According to IAG data, 72% of customers either accepted or made marginal changes³ to their default sum insured when the market moved from full replacement policies. However, there were some notable differences with only 24% of new customers accepting the default sum (or close to it) compared to 78% of renewing customers. This suggests sum insured values are sticky once it has been initially set. More customers accepted the default value offered by their insurer if the insurance was bought direct rather than through an intermediary such as a broker. Vero, who make greater use of brokers than IAG, reported that only 50% of its customers accepted the default value.
57. Accepting the default value is tempting for many as it is easy and the default value is provided by an institution seen as having superior knowledge. These factors and the increasing complexity of the process required to input information about the property, increase the risk of consumers mistakenly undervaluing the replacement cost of their property, or simply withdrawing from the process and relying on the default values provided by the insurer. There is evidence from Christchurch of a small number of policyholders with full replacement policies receiving less money than expected due to inaccurate floor measurements, and the move to sum insured may increase the incidence of these problems in the future.

... but default values are not reliable

58. Insurers take no responsibility for the sum insured value. The provision of default values or calculators does not remove the responsibility on the policyholder to select the correct sum insured value. The default values are not necessarily reliable, as insurers do not use a consistent methodology for calculating default values following the shift to sum insured policies. Tower and Vero used a figure of \$2,000 per m² to calculate sum insured amounts. IAG, however, used a simplified version of a calculator (similar to Cordell) to generate a tailored default figure. This may lead to confusion in the market with consumers not knowing which method has been used and further strengthens the argument for consumers to individualise their sum insured to make sure their asset is fully covered.

³ Less than 5%

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Neither are professional rebuild valuation quotes.

59. Consumer NZ found evidence of a large variance in the rebuild valuations provided by professional companies when valuing the same property. For example, a difference between valuers of over \$400,000 for a property in Auckland and a difference of over \$475,000 for a property in Wellington. In addition, the valuation reports varied in their content and level of description. Some differences in the assessments between companies are to be expected, but variance of this scale is concerning, and underlines the difficulty of identifying an accurate sum insured value.

Insurers are reluctant to push additional cover...

60. Insurers indicated that they have been reluctant to push consumers towards extra cover for three main reasons. Firstly, they are concerned about appearing to 'up-sell' to consumers, particularly as insurance premiums have doubled in recent years. Secondly, there are limitations imposed on them through the Financial Advisers Act 2008, which impedes the amount of advice that can be given without a licence or qualification. Finally, some insurers expressed concern that making the renewal process more complicated might drive customers to start comparing providers rather than staying with their existing insurer. However, extra cover is relatively cheap to purchase due to the shape of the risk curve. An extra \$100,000 of cover can cost as little as \$45 additional premium per annum.⁴

Market moves to address underinsurance

61. This section examines developments in the New Zealand insurance market since the move to sum insured cover. Given these market moves, we advise that no direct government action is required at this stage other than perhaps some sort of moral suasion. This could be in the form of encouraging the industry to continue their efforts in educating consumers around the sum insured market and reviewing their portfolios to identify the properties most at risk of underinsurance.

Industry investment in consumer education

62. The industry reported that it had put a lot of resource into helping transition the market from full replacement to sum insured policies. This investment has been in the form of educating consumers about the changes and improving the sales process so that consumers have a greater understanding of the policy at the point of purchase. However, this investment is hard to quantify and there is no guarantee of success.

Shared database between banks and insurers

63. Banks have a clear interest in ensuring that the properties on which they have on their books are fully insured, particularly where the mortgage debt represents a high proportion of the value. s9(2)(b)(ii) s9(2)(b)(ii) s9(2)(b)(ii) Requiring customers to provide proof of cover on a regular basis would be administratively costly. s9(2)(ba)(i) shared database between banks and insurers to enable banks to check that customers had sufficient insurance cover in place. This would have taken the form of a property registry and was supported by both banks and EQC. However, the initiative was rejected by the Insurance Council of New Zealand in May 2013 as they were uncomfortable with sharing data in this way and had concerns about how it would be used, including competitive concerns, as banks market their own insurance products.

⁴ From AA Insurance online tool for 120m² house in Island Bay, Wellington moving from a Sum Insured of \$200,000 to \$600,000 increased yearly premiums by an average of \$45 per every \$100,000 additional sum insured cover. Data sourced: 2 June 2015.

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Vero and Tower returning to total replacement for house fires

64. The major market development in the industry has been Vero and Tower offering customers full replacement cover for total loss from fire. Both companies acknowledged the low magnitude and costs associated with total loss claims with fire and thus the ability to get reinsurance cover. Neither insurer charges an additional fee for this product. Vero do require an accurate sum insured value to be set in order to take advantage of this policy, either from an online calculator or a suitably qualified professional. In addition, Vero's new product includes an additional 10% uplift on the sum insured figure in the event of a natural disaster, which helps to address the issue of cover falling short after a major event.
65. To date, no other insurers have followed suit in offering this type of cover.

Developments in valuation

66. There have been continuous developments in the valuation space since the market transition to sum insured. A major development has been the arrival of CoreLogic into the market, who are developing an advanced calculator. This is built on data and technology which is used successfully in the US and Australia and claims to have an accuracy of 97-98% (based on validation of US rebuild costs). The product will be less user-intensive than the existing Cordell calculator which may mitigate some of the risks which arise from a complicated process. They aim to make property insurance as easy as motor insurance. The business model that CoreLogic propose is that insurers would be able to access the data so that they could pre-populate online application forms with the information for a specific address, and the customer would simply have to confirm it or add any further relevant details. The product is planned for release in late June 2015.

Insurance summit

67. There is a proposed insurance summit to: review the lessons from Christchurch (and potentially other areas such as Japan); discuss the impacts on NZ Inc., the insurance sector and the wider financial system; and come up with strategies for improving New Zealand's preparedness from an insurance and banking perspective. We understand that you received a request to open the summit and issue invitations, and have requested further information from the organisers on industry participation before agreeing.

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Possible changes to Earthquake Commission legislation

68. We understand that Ministers responsible for the EQC review are currently taking to Cabinet proposed reforms to form the basis of a public discussion document on options for reforming the EQC scheme. The reforms include extending the current EQC building cover and increasing the monetary cap from \$100,000+GST, to \$200,000+GST. Responsible Ministers discussed the proposed reforms with you on 30 March and 16 June, and you have now seen the draft Cabinet paper and discussion document. The extended building cover would include site works associated with the repair and replacement of the building and access to it. This would include some land repair work currently insured by EQC land cover (including for example, installing retaining walls to support or protect the building) but would otherwise remove land cover in all circumstances short of the total loss of the building site.
69. This reform would have the effect of reducing the cost to insurers of providing household cover for many properties, which should lead to a reduction in premiums, though this reduction is likely to be partially offset by an increase in the EQC premium. As EQC premiums are currently charged at a flat rate across the country, there should be some benefit to policyholders in high risk areas, which should help increase the affordability of insurance.
70. On the other hand, the removal of the separate EQC land cover will potentially increase the risk to insurers and households for properties which require significant siteworks (particularly retaining walls) to support the house, because at least part of the EQC building insurance will be expended on these repairs when the work would previously have been funded from the separate land cover. This would increase the risk for consumers as well if the total damage exceeded the sum insured.

Regulatory developments in Australia

71. Sum insured policies have been in place for many years in Australia and have raised similar issues about consumer understanding and the risk of underinsurance. The Australian Securities and Investments Commission (ASIC) has produced a number of reports on the subject since 2005, most recently in October 2014. ASIC's latest reports have set out a number of recommendations addressed to the industry, in terms of messages to consumers, sales process improvements and other areas of innovation. In addition, the Australian Financial Systems Inquiry (FSI) included a recommendation encouraging insurers to do more to provide tools and guidance to help consumers assess likely replacement values and purchase adequate cover.
72. ASIC has said it will continue to monitor insurers' actions in this area and we are awaiting the Australian Government response to the FSI. We will maintain contact with ASIC and the Australian Treasury to keep up to date with developments, as these may directly affect the Australian parents of many insurers operating in New Zealand, or suggest interventions that might also be useful in the New Zealand market. More detail on the Australian reports is provided at Annex C.

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Annex A

COMPANIES AND ORGANISATIONS CONSULTED

Insurers/Reinsurers/Brokers

- Aon Benfield
- Aon New Zealand
- s9(2)(ba)(i)
- FMG Insurance
- IAG (AMI, Lumley, NZI, State)
- Medical Assurance Society
- Munich Re
- Southern Response
- Swiss Re
- Tower
- Vero
- Willis Re

Banks

- s9(2)(ba)(i)
- BNZ

Trade Associations

- Insurance Council of New Zealand (ICNZ)
- Insurance Brokers Association of New Zealand (IBANZ)

Other Organisations

- Consumer NZ

Government

- Ministry of Business, Innovation and Employment
- Commission for Financial Capability
- Earthquake Commission
- Financial Markets Authority
- Reserve Bank of New Zealand

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Annex B


MEASURING THE SCALE OF UNDERINSURANCE

1. This Annex examines four different approaches to calculating the level of underinsurance nationally. The total figure varies from \$55-\$310bn, depending on which approach is used to measure the issue.

1) Rebuilding costs from Canterbury

2. One method to analyse the level of underinsurance in New Zealand is to compare customers' sum insured cover (per m²) with the actual rebuild costs arising from the Canterbury rebuild. The analysis extrapolates national outcomes from regional data and as such is not an exact like-for-like comparison. However, this comparison benefits from using recent actual rebuilding costs from a large number of homes (3,000).
3. Figure 1 uses data from IAG to compare the distribution of sum insured values (nationally) and rebuild costs (from Canterbury). If all homes were fully insured, the per m² cover levels and rebuild costs would be a near identical match. The figure shows a shortage of cover, represented by the gap between rebuild costs and insurance cover.

s9(2)(b)(ii)



4. Interestingly, IAG reported that the sum insured figures for homes in Canterbury more closely mapped the red rebuild curve. We believe this is due to the increased knowledge and awareness regarding rebuild and replacement costs in Canterbury following the earthquakes.

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5. We also obtained rebuild costs from Southern Response s9(2)(b)(ii)
s9(2)(b)(ii)
6. Based on feedback from the insurers s9(2)(b)(ii) we used a figure s9(2)(b)(ii) for the average cost of rebuilding a home. Using IAG's distribution of sum insured insurance coverage, s9(2)(b)(ii) 85% of New Zealand homes could be underinsured by an average of 28%.

2) On-the-ground rebuild valuations

7. Another approach is to compare insured values with estimates of expected rebuilding costs. Construction Cost Consultants (CCC) are a quantity surveying firm who have based their estimate of residential underinsurance on their experience in providing over 30,000 home rebuild valuations. They have found that 80% of homes are underinsured, with the value of underinsurance between 25-50%. To produce a national figure, they assume an average house price of \$435,000 and there are 1.78 million houses in New Zealand meaning that there is a national property portfolio of \$775bn. On this basis they find \$620bn worth of homes are underinsured to a value of between \$155bn-\$310bn.
8. CCC featured on 'Fair Go' on 8 April, in which they provided valuations for two homeowners to compare with the figures provided by online calculators, and from the default sum insured of \$2,000 per m². The results showed that the rebuild costs from CCC were 40% or more above the costs provided by the online calculator and at least double the figures produced by applying the default sum insured.
9. These figures indicate that underinsurance could be a serious issue for many homeowners, with wide gaps between the default sum, the results from an online calculator and the assessment by a quantity surveyor. It should be noted, however, that valuation firms may have an incentive to overstate the amount of underinsurance to increase their business. Furthermore, the clients seeking rebuild valuations are usually those who have already identified that their sum insured is too low and may have larger houses or unusual features which are known to be insufficiently covered by the online calculators. There are also different results between different valuers and quantity surveyors, which have been investigated by Consumer NZ (as mentioned in paragraph 59 of the main report). Finally, the national figures for underinsurance are based on comparisons with house prices, which are not necessarily a good proxy for rebuild costs.

3) Comparison with modelled valuation costs

10. CoreLogic, a valuation firm, published figures in early June suggesting that half of the homes in New Zealand were underinsured by at least ten per cent. This was calculated by using their new valuation product ('Sum Sure') to calculate a reconstruction cost for nearly every property in New Zealand (excluding apartment blocks or multiple dwellings with more than six units in them). CoreLogic then conducted market research on about 400 consumers to identify their current sum insured value. Comparing the two produced a value and percentage for underinsurance. Modelling these against the nationwide dataset produced an overall national figure for underinsurance of about \$80bn.

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4) Number of customers accepting the default sum insurance value

11. Another method s9(2)(b)(ii) to calculate underinsurance based on the number of people who had accepted the default values offered by insurers. Assuming 80% of the housing stock rolled over to the default values then 40% of the stock will be underinsured. This is because the default figure is based on the cost of rebuilding an average house, so half of those accepting the default value will be over insured and half will be underinsured. s9(2)(b)(ii) calculator to see how much these homes are underinsured – an average of 25%. This is similar to levels reported in Australia in 2005. Turning this into a national figure, s9(2)(b)(ii) the underinsurance risk to the NZ housing stock was around \$74bn.
12. The weaknesses of this methodology are the assumptions that default levels are on average set correctly and that there is an equal distribution of customers on either side of the curve. However, the number of people who rolled over onto default values is an important part of analysing the levels of underinsurance as this represents a large proportion of the market.

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Annex C

REPORTS INTO SUM INSURED COVER IN AUSTRALIA

1. Sum insured policies have been in place for many years in Australia and have raised similar issues, particularly after major weather events. The Australian Securities and Investments Commission (ASIC) reported on this issue in 2005⁵. ASIC reported surveys suggesting that between 27% and 81% of Australian consumers were underinsured by 10% or more against current rebuilding costs. The report identified the following reasons for consumers being underinsured (which match our findings in New Zealand):
 - Standard home building policies in Australia placed the burden of estimating rebuilding costs on the consumer, which was an intrinsically difficult task;
 - Consumers relied on their insurer for help in estimating rebuilding costs, but only a small number of insurers provided consumers with access to reliable or comprehensive tools for doing this;
 - Consumers and insurers did not increase the sum insured over time to keep up with changes in building costs generally, or consumers did not increase their level of cover after renovating the home;
 - Home building policies were complex and difficult for consumers to compare, and variations in cover made it difficult for consumers to appreciate the extent to which they may be underinsured.
2. ASIC issued a follow-up report in 2007⁶. The follow-up report found that most insurers had taken “some positive steps” to help consumers reduce the problem of underinsurance. Those steps included:
 - developing new products, in particular total replacement policies to ensure consumers were adequately covered;
 - improving calculators; and
 - promoting better education initiatives.
3. ASIC encouraged further measures to 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.
4. ASIC noted that consumers also had a responsibility to reduce the risk of underinsurance through the type of insurance they purchased and, where relevant, by using the available tools to select the appropriate level of cover.

⁵ Report 54, *Getting Home Insurance Right*, Australian Securities and Investments Commission (ASIC), September 2005

⁶ Report 89, *Making Home Insurance Better*, ASIC, January 2007

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5. The Australian Financial System Inquiry (FSI), which reported in December 2014, identified inadvertent underinsurance as a problem, particularly from natural disasters. The Inquiry encouraged insurers to provide consumers with enhanced guidance about likely replacement values and make tools available to help consumers purchase adequate cover. The FSI also suggested that the industry should do more to reduce the complexity of policies and increase consumer understanding of key features and exclusions, which would help consumers select the appropriate level of cover.
6. The FSI report built on the draft Australian Productivity Commission (PC) Report, which acknowledged that underinsurance was an issue, but noted that it was hard to quantify the extent of the problem due to problems in defining underinsurance. Furthermore, the PC Report found that while a significant proportion of households appeared to be underinsured, it was not known how many were making a rational choice and how many were underinsured due to market distortions or cognitive barriers. Finally, the PC Report found that the extent of underinsurance and non-insurance was not readily apparent in many cases because most insurance claims were for partial losses, and in these cases, the sum insured usually covered the loss.
7. This is particularly applicable to New Zealand due to the lack of good data on the sum insured market due to its age. This means that it is hard to judge whether there is an underlying problem until an event strikes as the large majority of claims since the market change have not been total loss or have been total loss as a result of fire, where the cost of rebuilding would normally be lower than the costs of rebuilding after an earthquake.
8. ASIC released two further reports in October 2014 exploring consumer experiences with the sale of home building insurance⁷. The reports were based on a review of the sales practices of twelve insurers, and a survey of consumers who had inquired about or purchased home insurance during 2013. The main findings were:
 - Consumers often asked questions and sought assistance from insurers about how best to estimate the sum insured, but most insurers had adopted a 'no advice' or 'factual information' business model which meant they were unable to provide consumers with the information and/or advice they needed;
 - Most consumers 'guessed' the sum insured value, often using faulty assumptions to do so;
 - For telephone sales, most consumers were not referred to available tools, such as sum insured calculators, to assist in estimating the sum insured. Consumers who paid the least attention when choosing the sum insured typically also believed that they were not at risk;
 - The price of premiums dominated consumers' reasons for inquiring and this focus limited the information they sought about policy terms. For these consumers, most insurers attempted to reduce the premium by reducing the sum insured and/or increasing the excess, potentially increasing a consumer's risk of underinsurance;
 - The online channel was used for speed of purchase. The phone channel was used 'to talk to a human' because consumers felt the need to consult the insurer or to have their quote clarified or verified. It was at this stage that consumers seemed most in need of assistance;
 - Consumers needed help from insurers to make better decisions, beyond simply providing Product Disclosure Statements to consumers.

⁷ Report 415, *Review of the sale of home insurance*; Report 416, *Insuring your home: Consumers' experiences buying home insurance*, ASIC, October 2014.

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9. ASIC's Deputy Chairman, Peter Kell, said when the reports were released that they 'make it clear that the home insurance industry can implement measures that will meaningfully improve consumers' understanding of their policy, and help ensure consumers buy a product that meets their needs.' ASIC would 'continue to monitor providers to ensure they are complying with their obligations to provide consumers with accurate information.'

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Notes:

- (1) Paragraph 58 of the report refers to the figures which insurers used to calculate sum insured amounts following the initial shift to sum insured values. Tower has subsequently informed the Treasury that when sum insured policies renewed in their second year, the company adjusted some sum insured values for renewal, where policy data and some assumptions with support from the Cordell calculator highlighted the previous sum insured was not adequate.
- (2) Paragraph 64 of the report refers to insurers offering customers full replacement cover for total loss from fire. Vero's cover is wider, covering total losses caused by any peril except natural disaster.
- (3) In Annex A, the list of companies and organisations consulted should refer to 'BNZ Insurance Services Ltd' rather than 'BNZ'.