MacKay ON MONEY

BY AUTHORISED FINANCIAL ADVISER CHRIS MACKAY

Everyone loves paying insurance premiums. Well maybe not everyone. There's some Cantabrian who has been advertising on Newstalk ZB saying he insured his house, contents and car with State Insurance but the gist of the ad seems to be his personal experience (presumably with his claims settlement) has caused him more angst than the Christchurch earthquake itself. You would assume he feels severely aggrieved if he has resorted to nationwide advertising. A Christchurch woman is also on the air expressing the same sentiments.

As I have noted previously in my articles, I have been reliably informed that even claimants in Christchurch who are lucky enough to have bought their cover through a broker are being "tested" but that people who have purchased on line, from banks, over the counter and over the phone who have to deal directly with insurance companies are having a terrible time. On a plane journey recently, I spoke to a Christchurch based flight attendant who told me his over the counter insurance company, had made an onsite appointment to see him in August 2014, only a year or so away. How's that for service?

Our firm was active in "fire and general" insurance for almost three decades but we merged that side of our business with some other general brokerage firms a few years ago to be part of the Rothbury group. It's now a hugely specialised area of insurance and requires qualified experts to provide professional advice and a claims advocacy service even for domestic insurance.

Reminiscing on my early years, initially our only provider was National Mutual Fire and General (NMF). They were a great crowd. Not long into my career, a young apprentice butcher, an existing life insurance client, wanted to insure his car. I told him what it would cost; he wanted to think about it and would "call me" and no policy was put in force. You guessed it. He had a prang, hit another car and it was all turning to expensive custard. From memory, the mum got involved and asked me if I could help, which I did. A senior NMF good guy (I still remember his name, Brian McGrath) agreed even though no car insurance policy had been written, it "probably" would have been and NMF paid out in full much to the relief of the young chap and his mum, dad and big brother who promised undying loyalty. All their future business (general insurance, life, superannuation, you name it) would come to me. Well that turned out to be a Tui moment. But regardless, NMF and I did a fabulous job.

Not long before I started my career, all the fire and general companies in New Zealand used to operate under what is known as "the tariff" system. What this meant, and I know it's hard to believe, was all companies charged exactly the same rate for the same risk. A red tariff book for the rules and regulations and policy details and a green tariff book for the rates. So for example, if you insured your contents in 1960 for say 5,000 quid (equal to about $214,000 today), you paid exactly the same if you insured with NMF, AMP Fire and General, NZI or State. Policy wordings were identical, so service and who paid claims best were what made the difference. The Commerce Commission would have had a field day. I'm not quite sure when the price fixing all changed but change it did 40 odd years ago.

Policies also changed. NMF got taken over by Commercial Union (CU) and they came out with their domestic "Shockabsorber" range. Another insurer we used, NZI came out with "Peace of Mind" policies. South British had "Supersurance". CU and maybe those other two also had this amazing open ended deal for a short while where you could nominate a contents sum assured and pay

Continued on page 6…

Continued from page 5…

the appropriate premium, but you would be covered for replacement value regardless. For example, you could estimate their worth and insure your contents for $50,000 but if you had a total loss of say $100,000, that's what CU would pay out. Pretty stupid really from a corporate viewpoint but great for my clients who invariably made serious miscalculations with the valuation of their physical assets. They changed that sweetheart deal. Funny that.

You could always buy house and contents policies that covered you for "indemnity" or second hand (or depreciated) value. So in very general terms, if the total property was worth (in today's dollars) $400,000 for example and the land was valued at $300,000, then the house had an indemnity value of $100,000. Alternatively you could buy "replacement" cover but where you specified the amount. Back then for example it cost around $1,000 per square metre minimum to rebuild, and so assuming the above house was 150 m^2, you would need replacement insurance of about $150,000 plus an allowance for architect's fees and demolition costs. Of course inflation was a biggie too and so you had to allow for building costs to go up by 10 per cent or 20 per cent, whatever building inflation happened to be. So the replacement value may have worked out at say $200,000. For

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contents, you needed and still do, to work out what the items that were able to be covered for replacement value would cost plus the other depreciated items, and do a tally room by room.

Then the rules changed again, for houses anyway. Some companies said "don't worry about an exact figure; just tell us how big the house is and we will charge the appropriate premium. We'll replace it no matter what it costs."

In the 90s, one of our longest standing and still most loyal clients was convinced by our fire and general manager to swap to the latest bells and whistles policies and a few months later thought we were simply brilliant. One of his kids left a folded up electric blanket on as the family headed off to school and work.

The ensuing fire in the front of the house, in particular the smoke damage, required about $100,000 to repair the building and a similar amount to replace the contents. The soot got in to absolutely everything, even shut cupboards and made up beds.

This claim story leads me nicely into claims' ratios and profits.

Insurance companies exist to offer a risk management tool (an insurance policy) to provide against the risk of a contingent, uncertain loss. Wikipaedia explains it further. "The transaction involves the insured (the policyholder or person buying the insurance) assuming a guaranteed and known relatively small loss in the form of payment (premium) to the insurer (insurance company) in exchange for the insurer's promise to compensate the insured (pay out a claim) in the case of a financial loss. The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated."

Lots and lots of insured people pool together to ensure the poor bugger who ends up having an insured event (house burning down, buildings being demolished by an earthquake, car being pranged, house being burgled and contents stolen) will receive enough money to pay for the losses suffered.

Furthermore "the size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure the insurer will be able to pay claims." But you do not want to pay a premium of $1,000 to insure your bike worth $1,500. It's not meaningful.

I have done some research into historical fire and general claims in New Zealand.

According to the Insurance Council of NZ's website, for the three years to September 2010, the loss ratio (claims paid out to net premium coming in) was 68 per cent, 65 per cent and 68 per cent. Add on business costs including staff and the combined ratios were 101 per cent, 98 per cent and 101 per cent. So there was only one year where there was an "underwriting" profit. In 2011, the loss ratio was 112 per cent and the combined ratio was 146 per cent. No profit. Only losses. Last year the loss ratio was 68 per cent and the combined ratio was 99 per cent. How do they make a buck then? Well hopefully out of underwriting profit, although that has only happened twice in the examples, but also out of the earnings on their investments, reserves and cash flow. Warren Buffett likes owning insurance companies, and he's a really smart cookie so there must be a dollar in it somewhere, and usually there is.

The Christchurch earthquake has obviously stuffed things up.

For the years ending September 2008 and 2009, the net earthquake premiums received (this does not include any EQC premiums) versus claims, produced wonderful loss ratios of 17 per cent and six per cent. These are beautiful numbers for insurance executives.

But then in 2010, drama; the loss ratio was 211 per cent, in 2011 it was 31,163 per cent (yes that is correct) and in 2012 it was 202 per cent. These make seriously bad reading for insurance bods. So the companies collectively anyway, are not ripping us off, recently anyway. It's been tough for them too. However they have a great model. If they have some losses, they will claw them back just as fast as they can in the next few years and we the punters have not got much choice. Self insure or spread the risk? I would pick the latter.

But we cannot feel too sorry for all these insurance companies. Take AMI for instance. I reckon they have negotiated a darling deal selling out to IAG and separating off the policies with earthquake claims into Government owned company Southern Responses. For years it seems that AMI undercharged their policyholders and didn't have sufficient re-insurance cover in force. In fact way less comparatively than their competitors. Rob O'Neill wrote: "The 2011 accounts further reveal AMI's $600m pre-quake reinsurance cover was not even adequate for the September quake, for which claims now total $664m". AMI was inept and unprofessional in my opinion and could not cover its liabilities. But as so often seems to happen with incompetence; it is frequently rewarded. If you have your own business and you do not perform, then you personally go broke. Your proverbials are on the line. But former AMI CEO, John Balmforth, according to AMI's 2011 financials was paid $869,369 in 2011 and a bonus of $122,700 for the 2010 year, putting him right up there with the big boys. Nice work if you can get it eh? And the company gets bailed out by Mr and Mrs Taxpayer.

All good if you were an AMI client who had an earthquake claim. Not so good if you had your policy with minnow Western Pacific. They had 155 claims from Christchurch but went in to liquidation back in 2011. Not enough reinsurance cover no doubt. Not sure what's happening with them now. AMI was too big for the Government to let it fail but John and Bill were not too worried about these little guys and their small handful of clients.

The Christchurch earthquakes have caused the companies and reinsurers to have a rethink. The reinsurers just to remind you, are the huge overseas insurance companies who have actually taken most of the earthquake claims on the chin. The Earthquake Commission (EQC) reduces its own risk by taking out its own insurance cover with possibly up to 30 of these offshore reinsurance companies. And this is lucky for New Zealand. The EQC had almost $6 billion in funds before the quakes (and none now), with the top-up provided by the reinsurers and the Government.

So it is probably the reinsurers who are calling the shots regarding how house insurance is to be arranged in future. No more open ended policies whereby you simply note the square metres. From now on it's the cost to rebuild it.

Here's information I have pinched from *Full Cover*, Rothbury's Autumn 2013 newsletter and the odd website.

There will be a number of ways to determine your sum insured. There will be calculators available to help you work out the rebuild cost of your home and reach a more accurate level of cover, which you can access through your broker. You may choose to get an insurance valuation from a building valuer or refer to a builder for an estimate.

WORKING OUT HOW MUCH IT WOULD COST TO REBUILD YOUR HOME

Different types of houses cost different amounts to rebuild, even those which are on the same street or in the same block.

When you start to work out how much it would cost to rebuild your home there are lots of things you will need to include and consider.

A good place to start is thinking about the overall quality of your home. It will (generally) fit into one of the following categories.

Standard – an average home with regular fixtures and fittings.

Quality – an above average home with some premium fixtures and fittings.

Luxury – if your home has top-of-the-range fittings like granite bench-tops, chandeliers and is architecturally designed.

You will need to talk to your insurer if your home would probably cost more than $2 million to rebuild.

In addition to building materials, demolition, removal of debris, consents and professional fees all add up to restoring your property to how it was built. This amount will differ from how much you paid for the property as that figure took into account other components including things like the value of the land, its location and what the housing market was doing generally at the time of purchase.

You will also need to include additional features, such as:

- Retaining walls
- Bridges
- Spa pools
- Driveways
- Alternative power sources like solar panels or wind turbines
- Swimming pools
- Tennis courts
- Fences

Special features such as private jetties, piers, wharfs or landings, culverts, permanent fiords or dams, cable cars and private utility plants such as wind or water mills, or diesel generators including any associated equipment, need to be factored in too.

If your property has any outbuildings like sheds, garages, etc you will also need to include them in your calculation.

It's important you get the sum insured for your house correctly reflecting the likely cost of rebuilding.

If your house is ever destroyed, the maximum you will get paid out is the sum insured, even if what you actually have to pay turns out to be greater. And if you insure it for more than it costs to rebuild, then you will not get the difference either.

So there you have it. A short history of fire and general insurance in New Zealand. Have fun doing your calculations!

These are generalised comments only and should not be taken as personalised advice. Disclosure Statements are available on request and free of charge.