

UNSETTLED

CLIMATE RISK AND CASH SETTLEMENTS IN HOME INSURANCE

A report, based on financial counsellor casework, into the practice of cash settlements in home and contents insurance claims following the October 2022 floods in Victoria.



FCVic

Financial Counselling
Victoria Inc.

August 2024

ACKNOWLEDGEMENT OF TRADITIONAL OWNERS

FCVic acknowledges the Wurundjeri Woi-wurrung people as the Traditional Owners of the lands on which our organisation is based.

We pay our respects to their Elders, past and present.

As the FcVic team works remotely across many lands, we extend our respects to the Elders of other Aboriginal and Torres Strait Islander communities throughout Victoria and Australia.

We recognise the continuing connection that First Nations communities have to land, water and culture, and acknowledge that sovereignty was never ceded.

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This report was researched and written by Dr. Antonia Settle.

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Financial Counselling Victoria Inc.

Wurundjeri Country

Level 6, 179 Queen Street, Naarm (Melbourne) VIC 3000

Telephone: 03 9663 2000

www.fcvic.org.au | admin@fcvic.org.au

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ABOUT FCVIC AND THE FINANCIAL COUNSELLING SECTOR

Financial Counselling Victoria (FCVic) is the peak body and professional association for financial counsellors in Victoria. We provide resources and support to financial counsellors and their agencies who assist vulnerable Victorians experiencing financial difficulty. We work with insurers, governments, banks, utilities, debt collection and other stakeholders to improve approaches to financial difficulty for vulnerable Victorians.

Financial counselling is a free, confidential, and independent service. It provides vital help for people experiencing, or at risk of, financial hardship. Financial counsellors are uniquely qualified professionals, specially trained to deal with complex financial matters. They assist more than 23,000 Victorians each year – including newly arrived migrants and refugees, family violence victim-survivors, and particularly pertinent to this report, individuals and families recovering from disaster.



EXECUTIVE SUMMARY

In the wake of the Victorian floods in October 2022, the use of cash settlements by insurers in home insurance claims has emerged as a major problem for households. Although there is some legitimate household demand for cash settlements, they primarily function as the default outcome of problem claims and thereby reflect widespread frictions in the insurance system. Moreover, these frictions are linked to the emergence of new climate risk.

This report responds to the identification by financial counsellors of cash settlements as a key issue in the wake of the 2022 floods in Victoria. As the ongoing work of financial counsellors supporting flood-affected households shows, claiming for major damage is too often a harrowing experience, and inadequate cash settlements too often the outcome.¹ Issues such as insurer errors in claims handling, “low-ball offers”, and long, drawn-out disputes are the everyday reality for financial counsellors working with distressed households. For households, it can be a bewildering, stressful, and often unfair process that imposes substantial losses to economic security.

Drawing on the work of financial counsellors working with flood-affected Victorian households, this report breaks down the problem of cash settlements to explore why problematic cash settlements occur, what the impacts for households are, and how policy can intervene to address each component of the cash settlement problem. In doing so, this analysis shows that cash settlements are effectively the pointy end of market frictions, which reflect key problems in the insurance system in the context of climate change.

By exploring this set of issues, this report gives voice to the despair that financial counsellors face every day in their work with households. It also highlights critical lessons about where weaknesses in our society’s risk management systems lie, and who bears the costs of system failure.

By combining the real stories of 2022 flood victims with concrete policy proposals, this report seeks practical intervention in policy debates about climate justice and the future of the insurance system. Without policy intervention that supports adjustment in the insurance system in response to new climate risk, we will continue to see the problem of cash settlements grow – at the cost of household economic security, as well as accompanying emotional and social costs.

¹ See, for example, the testimony of financial counsellor Kellie Davis on April 18th, 2024 (available at <https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommrep%2F27920%2F0002;query=id%3A%22committees%2Fcommrep%2F27920%2F0001%22>) as well as that of financial counsellors Lylia Martion, Laura Powell and FCVic Disaster Recovery Coordinator, Tracey Blythe, on February 1st, 2024 (available at <https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommrep%2F27738%2F0001;query=id%3A%22committees%2Fcommrep%2F27738%2F0000%22>)

Following a brief introduction, which outlines the issues that cash settlements pose for households and asks how these issues relate to climate change and what the prerequisites for effective policy interventions are, the report systematically explores each of the component issues within the cash settlement problem:

- Households are being forced to accept cash settlements because they have been deemed effectively underinsured, due to both exclusion clauses and the failure of sum insured policies to accommodate rising building costs.
- When insurers cannot access trades to compete repairs or rebuilds, they resort to cash settlement, regardless of the wishes of the household.
- Households opt to cash settle against their own best interest due to a loss of trust in the claims process.
- Cash settlements are often underquoted, but households are poorly equipped to assess cash settlement offers and often apprehensive about pursuing further disputes.
- Households that are poorly equipped to manage the risks associated with a cash settlement, including risks associated with project managing repairs or rebuilds, are left with no choice but to accept a cash settlement.
- There are no standard products available for households after incurring damage.
- Households are unable to build mitigation measures into repairs or rebuilds without incurring the transfer of risk associated with a cash settlement.
- There is no consistency in how banks manage cash settlements.

To address these concerns, the report proposes the following policy interventions:

Standardisation to improve the quality of coverage	Recommendations: 1.1-1.3
Greater flexibility in insurer rebuilds and repairs to accommodate mitigation and efficiency improvements in all policies	Recommendations: 1.4-1.5; 7.1-7.2
Stronger protections around underinsurance, claims processes, and cash settlements	Recommendations: 1.6-1.7; 2.1; 3.1-3.2; 4.1-4.6
Better processes for vulnerable households after cash settlements	Recommendations: 5.1-5.2
Better access to insurance products for damaged homes	Recommendation: 6.1
Clearer practices for banks in administering cash settlements	Recommendation: 8.1



Abandon like-for-like reinstatement so that households can swap out size for resilience and efficiency in “sum insured” repairs and rebuilds – see Recommendation 1.4

Improve efficiency by strengthening the independence of expert reports with the requirement that insurers commission reports via an independent body, such as AFCA or ASIC – see Recommendation 4.3

Introduce a new service to support vulnerable cash settlement recipients to project manage repairs or rebuilds – see Recommendation 5.1

CONTEXT AND OVERVIEW

Why are cash settlements such a problem for households?

Cash settlements are commonly offered to settle minor claims and damage to contents. In some cases, they are sought by households, primarily when the household feels that they can undertake the build at a cheaper cost, such as when the household themselves is engaged in the building industry. Yet cash settlements also function as the default when a claim falters. For example, a cash settlement is offered if the insurer does not have a builder to sign a contract with; if a claim is only partially successful – which might arise because there are complications like pre-existing damage that trigger exclusion clauses – or if the sum insured does not cover the full cost of required repairs or rebuilding.

Cash settlements are also a common outcome of a breakdown in the relationship between household and insurer by which disputes leave the household no longer able to trust the insurer to repair or rebuild in good faith. Hence, because cash settlements are often the outcome of something going wrong with a claim, they are often associated with negative experiences. However, cash settlements are also problematic in themselves, over and above the things that go wrong with claims to drive cash outcomes.

The key issue with cash settlements is the transfer of risk that they involve. If a household cash settles, for example, they have access only to the standard 6-year builders' warranty on work instead of the lifetime guarantee that accompanies insurer repairs and rebuilds. This is a direct transfer of the risk of poor workmanship from insurer to household.

Other aspects of the risk transfer arise due to shortcomings in the implementation of the insurer's contractual commitments. It is not uncommon, for example, for variations in the scope of works to arise as more damage derived from the insured event is uncovered during the course of repairs. In the case of an insurer build, the insurer covers the additional cost and manages the additional repairs for such damage. However, when the same problem besets a household that has cash settled, acquiring additional funds from the insurer to cover corresponding damage requires a complex dispute process, which does not, in practice, provide a reliable facility for due compensation, regardless of the insurer's legal indemnity.

The risk of being unable to rectify an inadequate cash settlement after settling is even more problematic when establishing insurer indemnity over cost overruns is less clear cut. For example, after a cash settlement has been finalised, there may be some grounds for appealing for additional funds to cover the higher costs that arise due to shortages of trades and labour that are typical of the disaster context. However, the obligations of insurers to compensate for the emergence of these higher costs after the claim has been settled is often unclear and the appeals process long and complex.

These issues speak to limitations associated with the role of dispute settlement as an accountability measure in the regulatory framework more broadly. Although there are regulated dispute resolution pathways, households often do not have the emotional or financial capacities to pursue them. This is especially so when households have already lost trust in their insurer due to problems in the claims process or when the dispute might delay their transition out of temporary accommodation back into their home.

The transfer of risk entailed in a cash settlement is thus constituted by a series of unknowns – how much repairs will cost, how long repairs will take, or even what the extent of damage is; combined with poor facilities for redress and the loss of the insurer’s lifetime guarantee.

These unknowns combine to cast substantive risk over the adequacy of the settlement sum, which adds both salience and complexity to the problem of assessing the adequacy of a cash settlement offer. That is, the cash settlement sum should compensate not only for the cost of repairing damage – or in the case of a partial settlement, the fair division of indemnity for total damage between the household and insurer – but also for the transfer of risk to the household. As financial counsellors make clear, this is an acutely problematic aspect of the cash settlement process. Not only are low-ball offers common, but information asymmetries between households and insurers are deeply problematic: households simply do not have the expertise to be able to determine if the cash settlement offered by the insurer is either fair or adequate.

Moreover, all of these concerns are particularly problematic for households who have pre-existing vulnerabilities. Although the insurer might go so far as to rebuild instead of cash settle outside of their contractual requirements in individual cases as an act of goodwill, there are no binding requirements to do so. As such, the insurance system offers no alternative to a cash settlement for such households, despite the limited capacities to manage these risks and to project manage repairs and rebuilds more broadly that might arise amongst those who, for example, have chronic health issues or mental health conditions; are elderly; are primary carers; or are low-income households.

As the stories in this report show, moreover, the stakes are extremely high for households. The family home is the most important asset on the balance sheet of Australian households and for many is the basis of economic security during retirement. The vast majority of households that accessed the support of financial counsellors in relation to cash settlements following the 2022 floods had insurance that, prior to the flood, they believed they could rely on to cover them for a disaster. That is, these households expected to have their homes reinstated by their insurer, but ended up, for various reasons, with a cash settlement that was in most cases substantially underquoted.

Even with a financial counsellor supporting them to dispute for a higher sum, the final settlement for most of these households remained inadequate to fully cover the cost of the repairs, thus ultimately posing an unexpected financial shock.

Most of these households are ineligible to access credit to cover the shortfall between the cash settlement that they received and the cost of repairs. For many, drawing down on superannuation is their only option to bridge the gap and undertake repairs. Others have no superannuation or other savings. Some remain living in damaged homes, while others are forced to put their damaged homes on the market. For most cash-settled households that financial counsellors see, the failure of their insurance to deliver the cover that they expected marks a permanent reduction in economic security.

Cash settlements and climate risk

The urgency of addressing the problem of cash settlements, however, is not only a question of necessary social reflection following an unprecedented flooding disaster, but of the urgency of reorienting the insurance system around the unfolding of new climate risk. In part, this is a problem of insurance affordability pressures, which emerge as insurers adjust premiums higher to compensate for the increasing cost of climate risk.

A nation-wide survey of insurance policyholders, conducted by CHOICE in 2023, found that for 87% of home and contents insurance policyholders their premiums had increased with their latest renewal notice.² As households respond to higher premiums by turning to cheaper policies, they ultimately reduce their coverage – be that through complex exclusion clauses that are hidden in the fine print, reductions in the sum insured, or cancellation of flood cover.

These dynamics were important drivers of cash settlements following the 2022 floods, by which the patchy cover of cheaper premiums exposed households to exclusion clauses and inadequate sum insured policies that forced cash settlements.

Similarly, the dynamics of disaster conditions generated high proportions of cash settlements. Specifically, the 2022 flood disaster exposed the inability of the system to adjust from “business as usual” cases of isolated claims to the mass disaster context that will become increasingly common as the climate changes.

On the one hand, insurer failures in ramping up operations exposed households to poor quality claims handling and a loss of accountability over third parties, as well as much longer time frames than pre-disaster norms. This generated poor outcomes for households at each step of the process, including long gaps between insurer communications with households, repeated mistakes in assessments of damage, long spells in temporary accommodation, and claims wrongly denied. These kinds of issues eroded trust between households and insurers, drawing out the duration of disputes and driving households to request cash settlements out of exasperation.

On the other hand, the disaster context exposed an array of product design issues. For some, the insurer was unable to honour their commitment to rebuild or repair due to a shortage of trades, forcing a cash settlement. Others were forced to cash settle because their sum insured product did not account for the spike in costs for materials and trades in the disaster context, leaving them inadequately covered for insurer repairs or rebuilding. Although seen predominantly in the Black Summer fires rather than the recent floods, any increases in building standards to upgrade disaster resilience can also force a cash settlement on households for whom the higher cost of rebuilding to new, higher standards overtops their sum insured.

These dynamics highlight how the frictions that arise from an insurance system ill-fitted to climate risk plays out as a problem of cash settlements for households. To be clear, this is not a problem of insurers being unwilling to cover additional climate-related risks, but rather arises from the challenges associated with disaster contexts and the affordability pressures that climate change is placing on insurance access. This plays out as a problem of households facing unpredictable limits to coverage that force them into negotiations with insurers in which they are deeply disadvantaged, risking the cornerstone asset of household economic security, and imposing often profound distress upon households.

² See CHOICE's 2023 report 'Weathering the Storm: Insurance in a changing climate' (available at <https://www.choice.com.au/consumer-advocacy/policy/policy-submissions/2023/august/climate-insurance-report>)

How can the problem of cash settlements be better tackled in the context of the climate challenge?

Given the structural issues that drive problem cash settlements, **strengthening the General Insurance Code of Practice (Insurance Code) to define limited circumstances in which cash settlements are acceptable will not solve the growing issues that cash settlements pose.** Although this is certainly an important preliminary step in addressing the problem of cash settlements, much broader changes inside and outside the insurance system are required to tackle this set of issues. This report puts forward a number of policy recommendations that directly engage the regulatory framework governing the insurance sector. However, these recommendations are premised on the implementation of two important policy packages:

1. **The establishment of a centralised, ongoing and dedicated disaster recovery financial counselling service** that can work with community legal services to meet the increasing demand for support that will accompany the growing role of cash settlements. An ongoing service is required for the development and maintenance of the workforce across disaster events; and for capabilities of rapid deployment to deliver the key early interventions that have been shown to mitigate the risk of escalating financial hardship and improve mental health and recovery outcomes. In a home ownership society, such as Australia's, this provides a critical preliminary step in adapting social services to the threat that climate risk poses to the built environment.
2. **A program of buy-backs and mitigation grants for all states and territories** to reduce exposure to climate risk in the housing stock and take the most risky homes out of the insurance market. This is an extremely important component of the overall need to reduce the damage that disasters incur by strengthening the resilience of the housing stock and thus reducing overall risk in the system. These kinds of policy interventions are crucial in addressing the insurance affordability pressures that must be addressed in order to tackle cash settlements.

In short, the policy response must be bold. **Cash settlements represent the cost borne by households of the inadequacy of the insurance system in managing climate risk. The policy response thus needs not only to reduce the risks that households face in undertaking a cash settlement, but to address the underlying affordability issues that are deeply undermining coverage, as well as to manage the operational and product design issues that are causing such substantial problems in the disaster context.**

This requires addressing overall risk in the system by supporting broader public policy efforts to improve the resilience of the housing stock. Reducing risk in the system is the only way to circumvent the affordability/quality trade-off, which threatens higher premiums as a response to any improvements to insurance contracts in the favour of households.

The insurance system is critically positioned at the interface of climate risk and the housing stock, and thereby finds itself at the heart of household economic security. It is time for the system to step up to the challenge.

POLICY PROPOSALS

What are the problems with cash settlements and how can those problems be addressed?

1. **Households are being forced to accept cash settlements because they have been deemed effectively underinsured**
 - a. **due to exclusion clauses; and**
 - b. **due to the failure of sum insured policies to accommodate rising building costs**

Insurance contracts are structured in such a way as to provide little certainty over coverage, although this is rarely recognised by households until after damage has been incurred and a claim lodged. Following the 2022 floods, financial counsellors in Victoria identified a substantial number of households that were offered cash settlements due to exclusion clauses. For some, maintenance clauses were invoked, for example, where the blame for water damage was placed on leaves clogging gutters. For others, water was assessed to have entered as a result of rust on the roof; triggering pre-existing damage clauses. Denial of coverage for flood, but not storm water, was also common. In these cases, damage is only partially covered, resulting in a partial cash settlement that is inadequate to cover the cost of repairs. Although these exclusions are presented in the fine print of the Product Disclosure Statement, they are poorly understood by households, who struggle to comprehend the sheer quantity of detail and its variation across different policies.

Similarly, it is common for households to unwittingly have a sum insured policy that is set at an inadequate value of cover, forcing the insurer to cash settle. Some households reduce their sum insured to make their coverage more affordable, without realising how much of that sum will be lost to ancillary costs like debris removal, expert reports and architect's fees. Insurer-commissioned expert reports by builders, engineers, hydrologists, and hygienists that are used to verify the cause of damage, inform decisions about rebuilding and issue safety clearances, can come at a cost of over \$30,000 within broader ancillary costs of over \$100,000 in a single claim. In many policies, this is drawn down from the sum insured, reducing funds available for actual building.

At the same time, there is urgent need for higher building standards to address climate resilience and energy efficiency, which adds additional costs to repairs and rebuilds. This has been less of a problem in the 2022 floods, but financial counsellors report that, after the Black Summer fires, higher standards pushed many households into cash settlements of a lesser value than the cost of rebuilding. The Insurance Council of Australia, for example, estimates that an increase in fire risk zoning adds between \$53,000 and \$273,000 to the cost of rebuilding the average home, depending on the zoning.³ As building regulations catch up to new dynamics of flood risk, this will become an increasingly significant problem in flood areas as well.

In general, then, **the problem of exclusion clauses and inadequate sum insured policies driving cash settlements can be expected to grow as climate risk continues to put pressure on insurance affordability, pushing households towards the patchy policies found at the cheapest end of the market.** Although it is noted that maintenance clauses were invoked in 2022 flood insurance claims right across the spectrum of policies, a level of discretion is also observed, which suggests that insurers working at tighter margins might well be more likely to rely on maintenance clauses as they do on more clear-cut exclusions.

³ See IAG's 'Bushfire Awareness Fire Facts' (available at <https://www.iag.com.au/sites/default/files/Documents/Announcements/IAG-Fact-Sheet-Bushfire-Awareness-Fire-Facts.pdf>)

This discretion is reflected in disputes related to claim denials based on maintenance clauses in the 2022 floods, around half of which were reversed by the Australian Financial Complaints Authority (AFCA).⁴ From this, it can be surmised that many more such disputes were reversed at an earlier stage of the dispute resolution process as well as more still that went undisputed, indicating that substantial grey zones in the applicability of exclusion clauses is playing out as illegitimate claim denials.

The implications for households of this uncertainty around coverage are clear. The distress and bitterness associated with discovering that purchased coverage is invalid presents an unacceptable toll on households. Moreover, inadequate cash settlements open up a funding gap in damage repairs that for many is insurmountable. This can equate to a substantial and permanent reduction in economic security for households, which in the worst cases pushes households to remain in damaged and unsafe property or to sell their damaged home at a major loss.

The problem of unintentional underinsurance driving cash settlements will only be tackled by improving the quality of insurance products available on the market. As explored in depth by Financial Rights Legal Centre, this requires a major overhaul of the standardisation regime to raise the bar across all products.⁵

At the same time, affordability must be addressed. While there is a critical role for buy-backs and preventative resilience measures in addressing affordability by bringing risk down, there is also an important role for insurers to play, which starts with abandoning the like-for-like principle of insurer repairs and rebuilds on sum insured policies. By providing a more flexible sum insured product, insurers can accept their responsibilities around improving the resilience of the housing stock while leaving fewer households falling short of insurer repairs.

⁴ See the General Insurance Code Governance Committee's *'Making Better Claims Decisions'* report, which was published in July 2023 (available at <https://insurancecode.org.au/app/uploads/2023/07/CGC-Thematic-Inquiry-into-Making-Better-Claims-Decisions.pdf>)

⁵ See Financial Rights Legal Centre's 2022 report *'Standardising General Insurance Definitions'* (available at https://financialrights.org.au/wp-content/uploads/2022/03/2203_StandardisingGIDefinitions_FINAL.pdf)

I CASE STUDY ON EXCLUSION CLAUSES

Lisa and Harvey's story: Lisa and Harvey have three children and work full time. When they made an insurance claim for damage to their home, which had been inundated during the floods, the home was declared a total loss. However, the insurer refused to undertake the rebuild and instead offered Lisa and Harvey a partial cash settlement, citing the "pre-existing damage" clause in Lisa and Harvey's insurance contract in relation to the stumps of their home. Lisa and Harvey's insurer argued that this exclusion clause omitted insurer indemnity for the stumps, as well as damage derived from the stumps, including the subfloor.

Lisa and Harvey did not understand how the stumps could be considered pre-existing damage, given they had no reason to believe, prior to the flood, that there were any issues with the stumps on their home. Lisa and Harvey had never had issues with cracks in their walls, however, these did appear after the flood, along with water damage to the subfloor and other parts of the house.

They disputed this with their insurer, however, their insurer insisted that this was a fair outcome, based on the engineer's report that the insurer had commissioned, and the definition of "pre-existing damage" in their contract.

Lisa and Harvey were offered a cash settlement of \$120,000 for damage excluding the stumps and subfloor, although this was increased to \$220,000 after Lisa and Harvey's financial counsellor raised concerns with the insurer about the determination of the sum offer. Lisa and Harvey cannot afford to reinstate their home with this sum, even though they are planning on doing a substantial portion of the labour themselves in order to save on costs. They need to either find ways to reduce the cost of materials and trades for the rebuild, or refinance in order to cover the cost of rebuilding their home, including restumping costs.

Lisa and Harvey are extremely disappointed by this outcome, which they felt was unfair. They had purchased what they understood to be full coverage for their home, which they expected would cover them in an event such as the floods. They felt that the insurer had been dishonest in promising them coverage, given that they could not have known that there was any issue with the stumps of their home.

Problem: Households are being forced to accept cash settlements because they have been deemed effectively underinsured due to the application of exclusion clauses

Solution: Standardise cover to reduce problem exclusions

RECOMMENDATIONS

<p>1.1 Develop a standard product that provides a minimum standard on key policy features for all product offerings</p>	<p>A standard product is crucial to improving consumer outcomes in relation to exclusions and clauses, not only insofar as it sets a standard of minimum cover that precludes problem clauses, but also insofar as it helps households navigate the insurance market and better understand what norms around coverage are. Importantly, the process of determining exactly what features are requisite in such a minimum product must involve consumer advocates alongside industry and regulators.</p> <p>Important features for such a product include those that will help to reduce unintentional underinsurance (1.2, 1.4 and 1.5); reduce the duration of claims (3.1) and reduce risk at the point of repairs and rebuilds (7.2).</p>
<p>1.2 Include debris removal, architectural fees, expert reports and temporary accommodation costs as inclusions over and above the sum insured</p>	<p>Variation in how various aspects of coverage are presented in the sum insured figure makes it hard for households to compare products and to understand what to expect from insurance coverage. This aspect of standardisation will support households to better understand how much money they will have for rebuild in the event of a total loss. This is helpful in reducing the likelihood of households falling short in building funds due to unexpected ancillary costs drawing down on their sum insured.</p>
<p>1.3 Tighten definitions on key clauses – such as “maintenance” and “pre-existing damage” – and standardise these, along with standard definitions of “perils”</p>	<p>As per 1.1, this is important for strengthening the capacity of households to navigate the market by developing a better understanding of policy norms. It is noted that definitions around “maintenance” and “pre-existing damage” have proved particularly troublesome in the 2022 floods as application of these exclusions varied across and often even within insurers.</p> <p>It is important that consumer advocates have a meaningful voice in negotiations around these definitions and that these definitions are comprehensive, for example, in defining what actions households must undertake in order to satisfy the definition of “maintenance.” Financial Rights Legal Centre’s 2022 Standardising General Insurance Definitions report provides useful detail on this set of issues.</p>

I CASE STUDY ON INADEQUATE SUM INSURED

Patsy and Jay's story: Patsy lives with her elderly husband, Jay. Both suffer a number of chronic health issues in addition to mental health concerns, have few family supports, and are largely isolated from the community. Patsy and Jay rely on the full Age Pension. Patsy and Jay's property flooded in 2022, but the flood water did not enter into their home. Some cracking in the walls appeared in the direct aftermath of the flood and they lost some items in their shed.

With the exception of a cash settlement to cover their lawnmower, their claim was denied by their insurer, which found no damage to the home itself. Over the coming months, however, the home became increasingly unstable, with large cracks appearing in the walls, ceilings, and floors; and doors no longer able to close due to jamming. With substantial draughts, the home became increasingly expensive to heat, and one room was no longer useable as it became increasingly detached from the rest of the house.

With the help of a financial counsellor, Patsy and Jay requested the claim be reopened. When the insurer made a second assessment of the damage, it declared the home a total loss. In tacit recognition of their mistaken initial rejection of Patsy and Jay's claim, the insurer did not deduct costs for expert reports from the sum insured. However, Patsy and Jay's sum insured was still insufficient. Their sum insured did not account for raising the floor to mitigate flood risk in line with guidance from the catchment authority and had not been updated over the years to reflect higher building costs, in general, and especially in the context of a major disaster. As a result, the insurer declared the sum insured insufficient and offered Patsy and Jay a cash settlement.

Patsy and Jay have little to no savings and remain in their damaged home. They are unable to make up the cost of rebuilding, or to embark on the project of managing a redesign to fit the budget of the cash settlement without support. They are aware that they will get a poor financial outcome if they put their damaged home on the market.

Problem: Households are being forced to accept cash settlements because they have been deemed effectively underinsured due to the failure of sum insured policies to accommodate rising building costs

Solution: Increase flexibility in sum insured policies to better accommodate rising costs

RECOMMENDATIONS

<p>1.4 Require insurers to provide greater flexibility in the design of rebuilds and repairs on all sum insured products so that rebuilds can be facilitated within smaller sum insured budgets</p>	<p>This addresses the problems of households receiving cash settlements due to their sum insured falling short of like-for-like reinstatement. The insurer thus must undertake responsibility for repairs or rebuilding within a budget that is determined by the value of damage covered by the insurance contract (i.e. by the insurer's indemnity).</p> <p>As such, households should be able to choose to repair or rebuild at a substantially smaller scale if that allows them to use the more expensive materials and designs required of higher building standards whilst staying within the budget of the insurer's indemnity.</p>
<p>1.5 Require insurers to provide an allowance for additional costs associated with rising building standards on top of the sum insured on all sum insured products</p>	<p>This must be provided as an addition, over and above the sum insured (like temporary accommodation and debris removal is in more expensive policies), that is allocated towards the higher costs associated with rising building standards for resilience and efficiency.</p> <p>This cost will vary according to local conditions and must be capped and monitored by an independent body, such as ASIC.</p>
<p>1.6 Require renewal notices to clearly state if the policy holder is likely underinsured <i>including</i> in relation to any increase in building standards that might exceed the allowance in 1.5</p>	<p>This needs to be clearly stated so that it is not lost amongst the extensive information that is disclosed by insurers. Any increase in building standards needs to be included so that households are aware of higher costs required for rebuilding.</p>
<p>1.7 Require component pricing including a component for higher building standards on both sum insured and total replacement policies</p>	<p>Component pricing is important for helping households to understand what they are covered for. Component pricing must include information about how much of their premium reflects risk associated with the location of the home, its building characteristics, and any applicable rise in building standards that might affect a rebuild. Component pricing is also important in accompanying the pricing-in of household-level mitigation into premiums.</p>

2. When insurers cannot access trades to complete repairs or rebuilds, they resort to cash settlement, regardless if the wishes of the household

The sheer scale of the 2022 floods drove substantial supply shortages, not only in materials but also in trades. With so many building projects going on across the east coast of Australia, insurers were in some cases unable to find a builder to sign a contract with. In these cases, the claim was cash settled, regardless of the wishes of the household.

Like so many of the insurance failures that are distinct to the disaster context, this issue lies largely outside of the control of the insurer. Yet, like in the claims handling problems that arose due to difficulties rapidly ramping up staffing, insurers can still do much better than they did in the 2022 floods.

Insurers do not wish to hold the risk of maintaining a claim over the extended period required for trades to again become available, due to the potential for large temporary accommodation costs to accrue, as well as the greater price risk on materials and labour. Yet insurers are ultimately better placed than households to bear these risks. Hence, although some households might choose to cash settle in these circumstances, others may not, and this should ultimately be the choice of the household. Moreover, the requirement that insurers carry claims to completion, even if trade shortages push timeframes out, provides an incentive to insurers to innovate and invest in their building panels.



CASE STUDY ON THE USE OF CASH SETTLEMENTS DUE TO THE UNAVAILABILITY OF TRADES

Margaret and Stan’s story: Margaret and Stan are in their mid-70s. Their home incurred substantial damage in the 2022 floods and many of their possessions were lost. Margaret and Stan lodged a claim on their insurance policy, but the insurer’s initial assessment of the scope of the damage included incorrect room measurements and a series of mistakes in the list of damaged contents that Margaret and Stan had provided. Margaret and Stan requested corrections be made, but problems continued to arise in the scope of works document, which itemises exactly what the insurer will replace or repair. Only after seven revisions of the scope of works were Margaret and Stan finally ready to sign a contract with a builder. By this point, nine months had passed since their home had been flooded.

After Margaret and Stan had finally signed with the insurer’s builder, they were informed that the builder was unable to find trades. The insurer cancelled the building contract and informed Margaret and Stan that they would have to cash settle. Margaret and Stan were given no option but to accept the cash settlement.

Margaret and Stan were offered \$50,00 for their contents and \$125,000 for building costs. A financial counsellor helped them to negotiate a higher amount to reflect the full cost of replacing damaged possessions and repairing their home, including an “uplift” to reflect the risk that Margaret and Stan accept by agreeing to the cash settlements. Three months after they had initially signed the contract with the insurer’s builder, they finally settled for \$81,000 for contents and \$275,000 for the building.

A year after the flood, Margaret and Stan were finally ready to find a builder in order to start on the process of rebuilding their home

Problem: When insurers cannot access trades to complete repairs or rebuilds, they resort to cash settlement

Solution: Allow households to opt for an insurer rebuild or repair, even if builders are unavailable

RECOMMENDATION

2.1 Require insurers to manage rebuilds and repairs in circumstances in which builders cannot be immediately secured

Although a household should be able to choose to cash settle at any time, the default position when trades are short must be for the insurer to hold claims over until trades are again available. This provides an important incentive for insurers to invest in their capacities to manage building panels and support the rapid completion of repairs and rebuilds.

3. Households opt to cash settle against their own best interest due to a loss of trust in the claims process

As the Federal Government's Inquiry into insurers' responses to 2022 major floods claims has shown, for many households, the process of claiming on home insurance has been deeply problematic. For some, the process is so frustrating that they are left no longer able to trust their insurer to complete repairs and rebuilds in good faith, even when the build is within the insurer's indemnity. Financial counsellors report that this is one of the leading reasons why their clients cash settle.

This speaks to the power imbalance between households and insurers in the claims process, which is exacerbated by operational issues faced by insurers in the disaster context. Financial counsellors report that some households, for example, found that dealing with their insurer was more stressful than dealing with the disaster itself. It is not uncommon for households to describe feeling like their life is on hold for the duration of the claim process. For those who pursue a cash settlement due to the resentment that has built up towards the insurer, accepting a cash settlement is a way to move on with their life and put the trauma of the disaster behind them. This decision might be the best way for a household to secure emotional wellbeing in the short term. However, it is often not in the best interests of the household in the long term.

Improving the experience of households in the claims process requires the kind of upgrades to insurer systems and processes that have been the focus of those such as ASIC in the Federal Government's Inquiry.⁶ In line with these, strengthening the enforcement of regulation and incentivising faster claims processing are recommended here. However, combating the distress that drives households to pursue cash settlement against their own best interests requires the regulation of a more equitable balance between households and insurers. The recommendations made across this report as a whole address this fundamental problem. In addition to these, however, it is important that the regulatory regime be strengthened through the enforcement of penalties in cases of regulatory breaches, and for the fast resolution of claims to be better incentivised.

⁶ See ASIC's submission to the Inquiry (available at <https://www.aph.gov.au/DocumentStore.ashx?hearingid=31291&submissions=true>)

CASE STUDY ON HOUSEHOLDS CHOOSING TO CASH SETTLE DUE TO A LOSS OF TRUST IN THE CLAIMS PROCESS

Jess and John's story: Jess and John have three small children. They were interstate visiting family when the flood hit their town so were unable to return home to raise their belongings above the floor. As a result, they lost almost all of their possessions. Jess and John were initially very proactive about moving their claim forward. They organised their own temporary accommodation and were quick to complete the extensive itemisation of their damaged belongings required of their claim. However, as time passed, Jess and John became increasingly frustrated with their insurer.

Eight months after their home had been flooded, they engaged the support of a financial counsellor to help them to push their insurer to progress their claim. By this point, they had completed six rounds of the scope of works document; each time having to check through every single damaged item that they had reported. The scope of works was still incorrect, and they had not heard back from their insurer for two months. In fact, the insurer had not once instigated contact, requiring Jess and John to call and wait on hold for never less than an hour to communicate with the insurer.

With no case manager provided by the insurer, Jess and John had to explain their situation anew every time they called. As a result, Jess and John were frustrated and fatigued by the claims process and reported feeling helpless and overwhelmed. Jess and John's declining mental health was also strained by inadequate temporary accommodation, which required them to move four times in the eight months since the flood. Jess and John's financial counsellor lodged an internal dispute requesting the insurer make contact with Jess and John to update them on the claim and finalise the scope of works. When the internal dispute went unheeded, the financial counsellor lodged a dispute with AFCA, but was informed that there would be a two-month wait time before AFCA could consider the dispute.

Following the AFCA lodgement, Jess and John's insurer made contact to inform them that their claim had been partially denied based on their hydrologist's report, which found that a substantial portion of the damage to Jess and John's house fell under an exclusion clause relating to the stumps on the home. With the support of their financial counsellor, Jess and John decided to pay \$5,000 to commission their own expert report from a builder, who also brought in an engineer.

The builder and engineer's report found in favour of Jess and John, that the damage had indeed been caused by the floods. Jess and John used their builder and engineer's report to dispute the exclusion. At the same time, they were still engaging with the insurer to try to have the scope of works corrected. In their final scope of works, for example, cabinetry and basins had been included for the bathroom but not benchtops, and the insurer was only offering them \$1,000 for the new air conditioner that they had installed at a cost of \$14,000 in the months prior to the flood.

At this point, Jess and John became so frustrated and exhausted by the claim process that they opted for a cash settlement, regardless of the outcome on the stumps dispute. Jess and John had already spent a huge amount of time on the claim, and did not want to take more time away from their jobs and their family nor to take on the additional risks and responsibilities of managing the rebuild. However, they had lost all faith in their insurer and felt that they had no choice.

The insurer agreed to cash settle and offered them \$240,000, which was increased to \$390,000 with the help of their financial counsellor. This amount covered damage associated with the stumps, thereby indicating tacit acceptance by the insurer that their initial partial denial had been mistaken even though the insurer did not formally accept liability for the stumps. As a result, the claim was not documented in the insurer's, nor in the Insurance Council of Australia's, data as a denial overturned by the disputes process in favour of the household. At AFCA, the dispute is documented as having been resolved before arbitration.

Problem: Households opt to cash settle against their own best interest due to a loss of trust in the claims process

Solution: Incentivise shorter claim timelines and strengthen enforcement of regulation

RECOMMENDATIONS

<p>3.1 Determine the duration of temporary accommodation as a function of the duration of the claim</p>	<p>This measure is important for its capacity to incentivise efficient claims and dispute management timelines on the side of insurers.</p>
<p>3.2 Increase the enforcement of penalties for breaches of the Insurance Code, as well as for those relating to ASIC regulation</p>	<p>There is substantial scope to incentivise improved practices by increasing the application of penalties, which are substantial but rarely imposed. This is an important step in supporting the performance of future regulation.</p>



4. Cash settlements are often underquoted but households are poorly equipped to assess cash settlement offers and often apprehensive about pursuing further disputes

The transfer of risk entailed in a cash settlement is substantial, even for households who have strong emotional and financial resources, and adequate time to devote to the task of project management. This is all the more so in the disaster context, when supply issues are at their worst. **The decision to accept a cash settlement, then, is a critically important decision for a household to make with potentially profound implications, not only for housing outcomes, but for economic security into the future.**

However, households are often provided with extremely little information upon which to make this decision. To be clear, the scale of information disclosure in insurance, like other financial services, has become a serious problem given the capacity of households to engage with technical detail. However, it remains common for insurers to fail to inform households even of relatively basic information, such as what the circumstances are that have led to the decision to offer a cash settlement and how the sum offered is arrived at.

Households, for example, continue to report receiving redacted quotes on costs that contribute to the cash settlement offer being provided to them by their insurer. This is confusing for households and appears deceptive, thus working against the trust that is so important to maintain throughout the claim. Similarly, information in the expert reports, which are relied upon by insurers to justify exclusions that result in cash settlement, are often of poor quality; not written for the consumer audience; and perceived as biased in favour of the insurer. This lack of reliable and trustworthy information on questions of such monumental importance to households drives feelings of helplessness and distrust and undermines the capacity of households to make informed decisions.

Moreover, households who have had negative experiences during the claims process know that the disputes process does not necessarily provide a manageable route to a fair outcome. In addition to concerns that households might have about the actions of their insurer in a dispute, there are barriers such as the requirement that two builders' quotes be submitted to dispute a cash settlement offer. These come at a substantial fee and may be entirely unavailable in the disaster context; disincentivising households from choosing to dispute, due to added cost, as well as uncertainty.

More broadly, the extended period of time required for disputing a cash settlement, in which a displaced household must remain in temporary accommodation, is a huge cost for a household to bear. These costs – combined with the distress, frustration, and sense of powerlessness that many households report experiencing through the claims process – may be perceived by households as overwhelming.

As a result, **household decisions about whether or not to dispute a cash settlement offer is in some cases driven more by concerns about anticipated problems related to the dispute resolution process than a rational assessment about the qualities of the cash settlement offer itself.** This is reflected in cases where households choose to accept a cash settlement offer that is manifestly unfair because they do not have the emotional and financial resources to endure a dispute.

For many such households, accepting an underquoted cash settlement means incurring a funding gap that poses very real and problematic costs for those households to fill. This is a familiar scenario for financial counsellors working in the 2022 flood context, who consult broadly with households. Some households chose not to pursue low-ball claims, while others could only do so with the committed support of a financial counsellor.

In order to ensure households are given the information that they need to assess a cash settlement offer, it must be recognised that disclosure can only go so far before it becomes a disservice to consumer understanding. However, standards around basic information to support households to understand the cash settlement that they are being offered must improve.

Strengthening the independence of expert reports is also critical and offers an exciting opportunity to wind back adversarialism in the claims process; reducing inefficiencies that arise when households commission their own expert reports to combat perceived bias in their insurer's expert reports.⁷ Moreover, given how high the stakes are for households, access to independent advice is critical.

Yet there are important systemic issues at play here too, insofar as the disputes process itself disincentivises legitimate consumer disputes, and thereby undermines the accountability measure that disputes provide to the industry. To be clear, the operational difficulties posed by the disaster context has a substantial role to play in issues such as the problematically long duration of claims (as well as disputes), which act as a strong deterrent for households in disputing a cash settlement. This is a difficult problem that must be tackled at a number of levels. However, it must also be recognised that such delays weaken the disputes process as an accountability measure and demand the strengthening of the regulatory regime in other ways as a consequence.

CASE STUDY ON THE DIFFICULTIES THAT HOUSEHOLDS FACE IN ASSESSING AND DISPUTING CASH SETTLEMENT OFFERS

Melinda's story: Melinda and her husband Paul live on a rural property that was flooded above the floor, causing damage to their entire home and much of their possessions, as well as some tools and other machinery in Melinda and Paul's sheds. Melinda and Paul lodged a claim for their house and contents, but soon found themselves in a series of disputes with their insurer after their insurer informed Melinda and Paul that their claim had been partially denied.

The insurer informed them that the insurer-commissioned expert building report identified a number of issues relating to maintenance, which excluded a substantial portion of the damage from the insurer's indemnity. Melinda and Paul found it difficult to understand the causation of damage being put forward in the report and how a lack of maintenance could lead to the damage that, to their minds, was clearly caused by floodwaters. Melinda and Paul eventually commissioned their own expert report at a cost of \$1,000, which they lodged with the insurer as part of the dispute.

In the meantime, Melinda and Paul had rejected a number of scope of works documents, which misrepresented their losses. Some of the scope of works documents had mistakenly swapped room measurements, others had items missing. Each time, Melinda and Paul checked the details on each of the items on the scope of works document and returned it to the insurer with corrections. But each time when they got the updated version, other mistakes had appeared.

Melinda and Paul also had to claim for damage that the insurer's tradespeople had caused during the strip out of the property. The insurer initially denied indemnity for this damage. Only after Melinda and Paul had lodged an internal dispute did the insurer accept responsibility, but even then, the damage was incorrectly identified in the updated scope of works, requiring further revisions.

For Melinda and Paul, the claims process was incredibly stressful. They felt powerless and exhausted, and found it increasingly difficult as time passed to continue to engage with their insurer. When the insurer offered to revoke the partial denial and provide a cash settlement, Melinda and Paul agreed.

When Melinda and Paul received the cash settlement offer, however, they noticed that it missed some of the tools that they had claimed for and was, therefore, underquoted. Melinda and Paul weighed up the cost of these omissions in the cash settlement offer against the cost of disputing the offer. They felt that the claims process had taken a toll on their physical and mental health and were worried that disputing the cash settlement offer would entail a further burden on their wellbeing. Melinda and Paul had lost confidence in the capacity of the disputes settlement process to deliver a fair outcome.

When Melinda and Paul examined the cash settlement offer with their financial counsellor, they found a number of other gaps. In addition to a number of expensive tools that had not been accounted for, they also realised that the cash settlement offer did not include tiling in the bathroom, and a number of key components in the kitchen which had been omitted entirely.

As well as helping Melinda and Paul to track through the fine print of the offer, their financial counsellor was able to advise them on non-financial costs. They estimated that the cash settlement offer was underquoted by at least \$100,000 in costs. Still, Melinda and Paul questioned whether they should bear these costs for the sake of their health, rather than pursue yet another lengthy dispute process.

Only with the committed support of their financial counsellor did Melinda and Paul reluctantly decide to dispute the cash offer. Melinda and Paul's dispute was ultimately successful, but they felt that this outcome would not have been possible for them without the expertise and assistance of a financial counsellor.

Problem: Cash settlements are often underquoted but households are poorly equipped to assess cash settlement offers and often apprehensive about pursuing further disputes

Solution: Provide better information and support to households in assessing cash settlement offers

I RECOMMENDATIONS

<p>4.1 Require insurers to provide details about their decision to cash settle based on a standard template</p>	<p>This must include an explanation of how the circumstances of the claim relate to the stipulations in the Insurance Code that govern when a cash settlement is appropriate and when it is not (noting that these stipulations need to be tightened up so that there is less discretion available to insurers around cash settlements, as mentioned on page 11).</p> <p>As previously outlined by Financial Rights Legal Centre, this template also must include detail on any exclusion clauses applied (for example, identifying what reasonable maintenance has not been undertaken; what outcomes would have resulted from correct maintenance; and what damage has been sustained as a result of the household's failure to undertake this maintenance).</p>
<p>4.2 Require all expert reports to comply with a standard template</p>	<p>Where expert reports are drawn upon to justify a cash settlement offer, these must be written to a template that ensures both a suitable level of detail as well as the use of language that is appropriate to the consumer audience.</p> <p>This template must be mandatory and must be determined in collaboration with consumer advocates.</p>
<p>4.3 Require expert reports requested by insurers to be contracted by an independent body such as AFCA or ASIC</p>	<p>By requiring the insurer to apply to an independent body to commission expert reports, the potential for bias in reports – be that bias perceived or actual – is decreased. This provides a key opportunity to wind back the adversarial nature of the claims process and reduces the inefficiencies thus entailed in the use of expert reports as adversarial tools in the dispute process.</p>

<p>4.4 Require insurers to provide unredacted details of all costs contributing to the total sum offered, which must be based on quotes that are realistically attainable for the household</p>	<p>It must be the insurer's responsibility to present details about the sum offered in a format that is tailored to the needs of households. Instead of providing redacted quotes that black out the discounted rates that are accessible to insurers through their own builders, insurers must provide quotes as part of the documents that detail the cash settlement offer in prices at retail market rates.</p>
<p>4.5 Make uplifts mandatory</p>	<p>This is important in recognising the shift of risk from insurer to households in a cash settlement, over and above the issue of actionable quotes. The percentage at which the uplift is set will depend on the distinct circumstances of the claim and must reflect specific risks associated with the disaster context.</p>
<p>4.6 In addition to the establishment of a centralised, ongoing and dedicated disaster recovery financial counselling service, increase funding to the Insurance Law Service, as well as community legal services more broadly</p>	<p>Households need access to support in making cash settlement decisions, through both the specialist disaster funded financial counselling services that have proved so invaluable following the 2022 floods, and the Insurance Law Centre and disaster funded community legal services.</p>

5. Households that are poorly equipped to manage the risks associated with a cash settlement, including risks associated with project managing repairs or rebuilds, are left with no choice but to accept a cash settlement

Managing repairs and rebuilds is a difficult task that requires key technical, organisational, financial, and communication capabilities. There are many reasons why households might be compromised in their capacity to manage a cash settlement rebuild, including age, English proficiency, health status, and caring responsibilities, as well as the level of trauma experienced during the disaster event.

For these households, it is critical that the support of financial counsellors is available throughout the claims process. However, once a claim has been settled, there are no further services available to support vulnerable households to manage the building process. This exposes vulnerable households to extreme stress, as well as the risk of exploitation, such as elder abuse by family members; exploitation by external actors, such as builders; and online scams, to which older Australians are particularly vulnerable, especially those who are isolated.

Additionally, for those who are struggling financially, it can be very tempting to use cash settlements to repay debts used for living expenses, leaving households short of sufficient funds for repairs and rebuilds. Households in receipt of Centrelink benefits also face specific challenges relating to benefit payments. Services Australia must be notified of a payout, and there are rules and timelines around using lump sums for repairs. These conditions can be confusing and difficult to accommodate and can result in the sanctioning of benefit payments. Moreover, households are often unaware of these conditions.

It is important that options are opened up within the claims process to avoid cash settlements amongst vulnerable households. **The recommendations offered by this report go some way to addressing this issue. However, where cash settlements cannot be avoided, it is important that new support services are developed so that whatever settlements are ultimately realised by vulnerable households can be utilised to secure the best outcomes for household stability and wellbeing.**

Establishing such a service recognises the systemic dimension to this issue insofar as cash settlements are particularly common amongst vulnerable households because they are more likely to fall short of the kind of top-of-the-range full replacement coverage that make cash settlements a less likely outcome.

CASE STUDY ON VULNERABLE HOUSEHOLDS BEING FORCED TO ACCEPT CASH SETTLEMENTS

Fatima's story: Fatima and her husband Ahmed live in rural Victoria. They have no family and few social supports in the local community. Due to their substantial difficulties with English language and isolation from the community more broadly, Fatima and Ahmed were poorly prepared for the flood. Their home incurred substantial damage and they lost many of their possessions. The language difficulty made the claims process extremely difficult, especially when their claim was partially denied.

Fatima and Ahmed's insurer commissioned a hydrologist's report, which identified water damage to the inside of the home deriving from both floodwater and rainwater as a result of the storm. However, because Fatima and Ahmed did not have flood cover, their insurer provided them with a cash settlement for the storm water damage only.

Fatima and Ahmed were apprehensive about accepting the cash settlement because they did not feel confident managing the repairs process, but felt that they had no choice. Specifically, Fatima and Ahmed have had negative experiences with tradespeople in the past and are worried that they will be exploited again. The extreme financial hardship that Fatima and Ahmed find themselves in further limits their options.

Fatima and Ahmed had hoped that their insurer would undertake the repairs for the storm water damage, given their considerable vulnerabilities. However, their insurer informed them that they have no option but to cash settle as some of the storm water damage cannot be repaired without flood water damage first being repaired.

Problem: Households that are poorly equipped to manage the risks associated with a cash settlement, including risks associated with project managing repairs or rebuilds, are left with no choice but to accept a cash settlement

Solution: Introduce a new service to support vulnerable cash-settled households to rebuild

I RECOMMENDATIONS

<p>5.1 Establish a support service, similar to the role of Service Navigator in Queensland's Resilient Homes Fund, that supports vulnerable households to manage repairs or a rebuild</p>	<p>This requires providing consistent and independent case management support to households throughout the repair or rebuild process, including supporting households with making decisions, sourcing quotes, and negotiating with builders. More than a conventional project manager, however, this role entails specialist skills in working with households with complex needs.</p>
<p>5.2 Limit circumstances in which cash settlements can be offered to households by defining specific circumstances that qualify for cash settlement in the Insurance Code</p>	<p>Although this measure does not specifically target vulnerable households, by reducing the number of cash settlements overall, it can be expected that fewer vulnerable households will be offered cash settlements.</p>



6. There are no standard products available for households after incurring damage

Amongst the many frictions that emerge as a result of the longer duration of claims in the disaster context, the issue of coverage for damaged property has become a common problem for those who cash settle.

With no products on the market that are specifically designed to cover damaged properties between the disaster event and rebuild commencement, households are left with no option in between over- and under-insuring. That is, even if the home has been stripped back to its frame and has no floors or walls, the household must choose to either continue to pay their old premium, which was set at a rate to cover the complete and habitable home; or forego insurance entirely, leaving the home exposed both in regards to public liability, as well as any further damage, and formally puts the household in breach of mortgage conditions.

This has become a much more significant problem as the gap has lengthened between the damage occurring and building actually commencing, at which point builders' insurance becomes active.

Moreover, this is exacerbated by rising premiums, which are common in the wake of a disaster. Some households have continued and struggled to pay their subsequent premiums – even though the cost has gone up significantly, instead of down following damage – because they are concerned that cancelling their premium during the claims process will impact the claim outcome. Households need a product specifically designed for damaged homes so that they have the option to switch insurer during a claim and can secure coverage after a cash settlement.

CASE STUDY ON THE LACK OF INSURANCE AVAILABILITY AFTER A CLAIM HAS BEEN CASH SETTLED

Jack’s story: Jack’s home was heavily damaged in the floods, requiring that the floor and lower walls be stripped out to leave only the frame, ceiling, roof and outside shell of the house intact. After the strip out, however, Jack’s insurer partially denied the claim, and a long dispute ensued. Many months later, the claim was finally closed with a cash settlement, which resulted in the insurance over the property being cancelled by the insurer.

With the shortages of trades and materials that were being experienced at the time, Jack knew that it would take a number of months before he would be able to get the rebuild started, at which point insurance over the property would be provided by the builder. In the meantime, Jack could not find an insurer who would insure his damaged home. He called a number of insurers and used the online tool on the Insurance Council of Australia’s website but could still not find any advice on how to cover his property. He reluctantly gave up, leaving the shell of his home uninsured.

Jack found this frustrating and stressful. He felt that he was not in a position to pay for repairs if another weather event generated more damage and – as a small business owner – was conscious of the risk of having no public liability insurance. Although Jack’s bank did not pursue him on the insured status of his home, he was aware that he was formally breaching his mortgage contract by not having his property insured.

Problem: There are no standard products available for households after incurring damage

Solution: Provide a product for covering damaged homes

RECOMMENDATION

<p>6.1 Insurers must develop a product that is specifically designed for damaged homes</p>	<p>This must reflect the underlying condition of the home and include public liability insurance.</p>
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7. Households are unable to build mitigation measures into repairs or rebuilds without incurring the transfer of risk associated with a cash settlement

Flood mitigation measures range from very expensive options – like raising homes on stilts – to minor adjustments that can be undertaken in a rebuild – such as positioning power points higher up walls, and thereby sparing damage to electric wiring from future floodwaters. In between is an array of design improvements that reduce the damage caused by flooding by either limiting the entry of flood water or reducing the absorption of water inside the home. Similar measures are available to mitigate storm, cyclone, and bushfire risk.

By reducing damage, these measures reduce the cost of repairs, and thereby address the affordability problem by reducing a property's risk profile. Moreover, and importantly for households, less damage also means households can be back in their homes sooner after a weather event.

Although there is some flexibility that may be offered by insurers on a one-off basis, there is no requirement for insurers to incorporate such mitigation measures in repairs and rebuilds, outside of any requirements imposed by building standards. In fact, the principle of **“like-for-like reinstatement” that is conventionally built into insurance contracts not only does not require but effectively denies the possibility of any additional improvements in efficiency or resilience being undertaken during the repair or rebuild process, beyond those required of building standards.**

Like-for-like reinstatement is designed to limit costs being borne by insurers of the “betterment” of homes over and above repairs to damage that fall within the insurer's indemnity. However, it has come to function as a limitation on the capacity of households to reduce their future risk, forcing households who wish to improve resilience in their homes to cash settle. Yet given the transfer of risk entailed in a cash settlement, the reinstatement principles function as a disincentive for households to build resilience into repairs and rebuilds in order to reduce risk in their home. This is a poor outcome for households, but also a very poor show of commitment by the sector to confronting the climate challenge.

Abandoning the principle of like-for-like reinstatement is the first step to dealing with this set of problems. Recommendations 1.4 and 1.5, which support insurers to build back better with sum insured policies, go a long way towards precluding cash settlements amongst households who wish to build mitigation into repairs and rebuilds. These requirements must also be implemented for total replacement policies, so that households have greater flexibility to incorporate mitigation into insurer repairs and rebuilds.

Aside from accommodating the wishes of households who wish to build back better without having to cash settle, these measures are key to addressing the affordability problem by bringing risk down. They are also imperative of the climate action that must be demanded of the sector. For this, building resilience into rebuilds and repairs must be mandatory.

Recommendation 7.3 addresses this, proposing that insurers include a combination of measures in repairs and rebuilds, over and above those required of building standards. This is particularly important in high flood risk areas, as reflected in the aftermath of the 2022 floods, where many rebuilds were subject to no binding requirements at all to improve flood resilience.

Moreover, the opportunity to assess mitigation opportunities at the individual household level must be incorporated into the scope of works process that is undertaken by the insurer's risk assessor.⁸ This provides an opportunity to inform households and insurers of improvements that the household might wish to pursue within the flexible "sum insured" or "total replacement" policy proposed in recommendations 1.4 and 7.1; that the insurer might pursue as an addition within the build back better allowance proposed in recommendation 7.3; or that the household might seek to pursue outside of the insurance process.

8 I am grateful to Annabelle Butler for this important recommendation.

CASE STUDY ON HOUSEHOLDS WHO CHOSE TO BUILD BACK BETTER BEING FORCED TO CASH SETTLE

Madeleine's story: During the 2022 floods, the downstairs rooms of Madeleine's home were inundated. Madeleine lodged a claim with her insurer immediately, but was unable to find temporary accommodation in her area. She moved into the single upstairs room in her home, along with her husband, pets and their belongings, where they were without access to most electrical appliances and power for the duration of the remediation process.

This process has been particularly lengthy, due to poor claims handling and poor workmanship on the part of the insurer's trades. Madeleine has had to lodge a number of disputes with her insurer throughout the process of strip out and drying. During this period, she has undertaken extensive research on the risk that her home faces of future floods, as well as the options for improving her home's resilience to floods.

When Madeleine approached her insurer about replacing flood damaged materials in the downstairs areas in her home with flood resilient materials, her insurer informed her that it would not be possible to make any changes to the design or existing materials, even if she opted to pay for any additional costs herself. Her insurer informed her that her only option for making any such changes is to cash settle.

To resolve their claim, Madeleine put her professional career on hold and her husband had to take considerable time off work. They did not wish to assume the additional responsibilities associated with a cash settlement; however, they are also adamant that they do not want to incur the same damage again. They have chosen to cash settle so that they can repair their home with resilient materials, in the hope that they will face much less disruption if their home floods again.

More than 18 months after floods, Madeleine's home is remediated and they are in negotiations to have their claim cash settled so that they can find an architect and builder who will work with resilient materials in order to build back better.

Problem: Households are unable to build mitigation measures into repairs or rebuilds without incurring the transfer of risk associated with a cash settlement

Solution: Require insurance to build back better within insurer rebuilds

RECOMMENDATIONS

<p>7.1 Require insurers to provide greater flexibility in the design of rebuilds and repairs in “total replacement” policies so that better resilience and efficiency measures can be built in without necessitating a cash settlement</p>	<p>Where recommendation 1.4 applies to “sum insured” policies, this recommendation addresses the same in “total replacement” policies. This requires abandoning like-for-like reinstatement so that households can chose to build greater resilience and energy efficiency over and above relevant building standards.</p> <p>This includes allowing both flexibility in design up to a cap (for example, that is equivalent to the reinstatement value of the home) and allowing households to opt to pay for additional costs arising from these improvements.</p>
<p>7.2 Require insurers to include potential resilience and efficiency improvements as a standard step in the scope of works</p>	<p>The assessment undertaken for the scope of works offers an opportunity to assess for potential improvements in efficiency and resilience.</p> <p>This assessment can then be shared with households, as well as be used to inform works required of recommendation 7.3, below.</p> <p>This requires substantial training for loss adjusters to establish expertise in household-level resilience and efficiency measures.</p>
<p>7.3 Require insurers to implement a mandatory combination of resilience and energy efficiency improvements, over and above building standards on all insurer repairs and rebuilds</p>	<p>This is effectively an additional build back better allowance that must apply to “sum insured” and “total replacement” policies, which speaks to the responsibility of insurers to lead on upgrading the housing stock in the interests of both resilience and efficiency.</p> <p>This measure requires a minimum value for mitigation improvements to be set, as well as a schema to be established of eligible improvements that accommodates variation in resilience and efficiency measures at the household level, given the localised nature of both perils and local building standards.</p>

8. There is no consistency in how banks manage cash settlements

When a household that carries high mortgage debt on their property is cash settled, the insurer usually pays the settlement out directly to the bank, allowing the bank to withhold the settlement in part or in whole. This allows the bank to impose an approval process for the disbursement of building funds, as well as allocate funds directly to pay down mortgage debt, thereby reducing funds available for the repair or rebuild process.

There are, however, no standard policy settings that govern what actions banks will undertake. This uncertainty exacerbates the stress that households experience in these circumstances, who might be facing the possibility of negative equity on top of the more immediate problem of securing safe housing.

Policy needs to be standardised, and information resources need to be developed so that households can better understand their circumstances; better negotiate with their banks; and better plan for how best to utilise the cash settlement that is ultimately available to them to secure housing stability and broader wellbeing. This requires specifying bank actions at various loan-to-value thresholds and clarifying the options available to households, including the right of households to challenge bank decisions.

CASE STUDY ON UNCERTAINTY IN THE TREATMENT OF CASH SETTLEMENTS BY BANKS

Jeremy's story: Jeremy's home incurred substantial damage in the 2022 floods but was ultimately cash settled for \$400,000 following a long dispute with his insurer. When the settlement was finalised, it was paid directly to the bank. However, the bank informed Jeremy that he would not have access to the settlement sum as the bank had decided to withhold it.

Jeremy had a substantial mortgage on his home prior to the floods, which the bank informed him had now reached an untenable loan-to-value ratio, given that both his house and land had suffered a substantial loss in value. In short, Jeremy would need to renegotiate his loan now that the underlying asset that provides collateral on his loan had been damaged. However, at the same time the bank informed Jeremy that he was not in a position to have his mortgage renewed. As a result, the bank had decided to transfer his entire cash settlement sum to pay down his mortgage, leaving him with no funds available with which to rebuild.

Jeremy was not sure if this was legal and had difficulty understanding what the norms are around banks and cash settlements. Jeremy had been in contact with a financial counsellor at an earlier stage in his claim and referred back to the financial counsellor again, who helped him to negotiate the availability of a portion of his funds for rebuilding.

With no clear guidelines governing the banks response, however, Jeremy found the negotiation period extremely stressful. Jeremy was alarmed by the lack of certainty around the outcome of the negotiations and found it difficult to gauge what constitutes fair practice. Jeremy complained that he felt that he was at the mercy of the bank's goodwill.

Problem: There is no consistency in how banks manage cash settlements

Solution: Standardise policy on how banks manage cash settlements

RECOMMENDATION

8.1 Develop standards for clear and consistent bank actions in relation to cash settlements, as well as information resources for households

Standards must cover bank actions at various loan-to-value ratios, as well as options available to households including dispute resolution processes.



 <p>VICTORIA State Government</p>	 <p>FCVic Financial Counselling Victoria Inc.</p>
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