INSURANCE FOR PROPERTY INVESTORS

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PROPERTY 101

BONUS CHAPTER

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A GUIDE TO INVESTING IN NEW ZEALAND WITH A FOCUS ON AUCKLAND

Introduction

Earthquakes, fires, floods, explosions, burglary, malicious damage – it all happens every year somewhere. I even know of an instance where the actual house was stolen. The good news is that in exchange for paying regular premiums, an insurer guarantees to compensate you for loss or damage to your property and any chattels which are covered by the policy. Having insurance cover for all your properties is a necessity for finance, and commercially sensible.

This e-book is designed to give you some insights into insurance, but I can only outline what is typically involved so please don't take what I have to say as gospel. You need to undertake your own research about what different insurers will provide and their individual terms and conditions, as they vary between insurance companies and change regularly. As I say below, one of the easiest ways of getting the 'best bang for your buck' out of insurance is to use a fire and general insurance broker. They know the market and should be able to tell you who is best, and why.

As a note, reading about insurance is not very exciting. However, if you have an event that requires an insurance claim, I am sure insurance will suddenly become very interesting and important to you. So have a quick read below and make sure you have the basics covered off.

Basics

There are two broad types of cover:

1. Accidental damage – this is the most comprehensive option, and covers you for accidental loss or damage.
2. Restricted or defined risk cover – this covers you for specified events only.

There are three main types of compensation:

1. **Full replacement:** Your property or belongings will be repaired or replaced so they are 'as new' and there is no specified dollar figure. To many Kiwis this is the gold standard of house insurance. However, it is being phased out as the insurance industry struggles to recover from the impact of the Christchurch earthquakes and the spiralling rebuild costs.

2. **Fixed sum insured:** This is a type of replacement cover, but in this case your property or belongings are insured up to a specific dollar amount. You will often need a valuation to support the amount stated in the policy. This is becoming the norm for houses in New Zealand, and switches the onus to the property owner to know exactly what the property is worth, and ensure it is adequately covered. I guess this will become the new gold standard, provided you have your cost estimates right.

3. **Indemnity:** Your property or belongings are covered for the amount they were worth at the time they were lost or damaged, i.e. the second-hand value. This is also known as present day, current, or market value. It puts you back in the position you were the day the item was lost. This is a slippery slope and open to interpretation and arguments with your insurer.

FIXED SUM HOUSE INSURANCE

- Note the fixed sum is the maximum the insurer will pay; it is not a guarantee of a payout for that exact amount.

- It is important that you get this right – under-insuring means the cost of rebuild won't be covered; if you over-insure your premiums will be unnecessarily high. I prefer to over-insure because really insurance is cheap. It is also tax deductible for investment property, so you only pay two thirds of the cost if your tax rate is 33%.

- To be fully covered you need to factor in construction and material costs, fences, decks, pools, architect, planning and consent fees, as well as any demolition and removal costs. Don't forget costs for slab foundations, underground services, landscaping, retaining and drainage.

- Special features need mention too – many homeowners expect 'like for like' cover for construction materials, and angry villa owners in Christchurch have had their matai floorboards replaced with particle board due to 'materials in common use' policy.

- Be careful to state your floor area accurately. Some homeowners have been caught out when the policy has incorrectly recorded the size of the house, and their payout has been short.

Working out the rebuild cost is causing some angst among the general public, and online calculators seem to be producing wildly varying results.

Your best bet might be to engage a professional valuer (for a standard property) or a quantity surveyor (for a more complex property) to assess a realistic rebuild value, and this is becoming more common to de-risk insurance on more valuable or more complex buildings. You won't need to go to this extent every year – your insurer will know building cost inflation so you can adjust accordingly. Don't forget to update every time you renovate. Remember to add GST (at 15%) if the estimate is GST exclusive.

RULE OF THUMB

A property investor I know with a large portfolio says that he got sick of paying for so many insurance estimates on his properties, so he came up with his own formula, which he thinks works: use two or three online calculators (e.g. as found on insurer, bank or need2know websites), average them, and add 10%.

INDEMNITY ON CHATTELS IS SOMETIMES A RORT

Excesses on chattels can make insurance a rort. Consider indemnity on a laptop that cost $1,500, and you purchased it four years ago. Your excess is $500. The laptop is functioning perfectly well and does what you need. It gets stolen and you claim insurance. The insurer says:

- Depreciated value is $600
- Your excess is $500
- They will pay you $100

I would have thought indemnity means '*put you back in the position you were in*' with a second-hand laptop. But it really means depreciated value less your excess. The outcome of this can be that you think you have chattel insurance but really you are paying for something that has little benefit when you go to claim. It was for this reason I cancelled my office chattel insurance for laptops and phones – indemnity less excess equals nothing to claim, yet you pay lots of money for the policy. A waste of money in my case.

GENERAL POINTS

- Most insurance policies will specify an excess, which is an amount you must personally contribute towards any claim you make. It is usually in the vicinity of a few hundred dollars, and the lower your excess, the higher your premiums will be.
- In order for your cover to remain valid you must pay your premiums on time and ensure you fulfil your obligations as defined in the insurance policy document.
- You must always provide correct information when taking out an insurance policy or making a claim. If it is discovered that you haven't, any claims you make may be declined, or your policy cancelled. You must also update your information if your circumstances change.
- You must never admit liability for any incident regarding a claim, as it could jeopardise your insurer's ability to obtain compensation.
- Most policies require that you inform your insurer as soon as possible after an insurable event occurs, and you may also obliged to submit your claim within a certain timeframe.
- If your claim is the result of criminal activity, e.g. theft, arson, vandalism, you must notify the police immediately.

CASE STUDY

Using a good insurer

I had an incident where our home caught fire late on a Sunday evening. When the fire department arrived, they told us to call our insurance company. We were surprised – at 10pm on a Sunday night? Sure enough, half an hour later, a representative from the insurance company arrived.

It was AMI and I have to say they were fantastic. My builder turned up (he had just finished our renovation), and AMI approved him to restart work the next morning. I am told that not all insurance companies are so easy to deal with. I have heard stories from clients about how difficult some companies can be. They are quick to take your premium but difficult to get payment from, and seek to avoid liability when asked to pay. So don't just buy on price; check out the company's reputation for paying out. It's amazing what you can find out by googling a company.

House insurance

House insurance covers the building and things that are permanently affixed to it. It does not generally cover chattels such as carpets, window coverings, furniture, barbeques etc. You need to arrange contents insurance to cover those and most insurers offer house and contents packages that are cheaper than taking out separate policies.

It is a requirement under the Residential Tenancies Act that rental properties are insured. It will also be a condition of your home loan.

If your property is on a unit title that has a body corporate, it is the body corporate's responsibility to insure the building, and your premiums will be part of your annual levy. However, they only cover what is on the exterior. You still need to insure your interior and chattels in a separate policy.

When you initially insure your house, you need to know the following information *(make sure it is accurate):*

- The address of the house
- The size of your house (in square metres)
- Type of construction
- Age of house
- Whether it is built on a slope or flat land
- How many rooms it has
- Detail of electrical fitness – How old is the house? Has it been re-wired or is it old wiring? If the house is old, sometimes the insurance company will require a report from an electrician saying the house is electrically safe.
- Whether there is an alarm or security locks

I won't go through all the details of what is typically covered under a house insurance policy here, so advise you to read your policy. However, a few things are worth noting:

- Most types of gradual damage, such as wear and tear and corrosion, are not usually covered. Many companies try to mitigate (reduce) loss by arguing 'wear and tear' or depreciation on claim submissions.

- The Earthquake Commission (EQC) provides insurance cover for natural disasters. If the EQC doesn't fully cover the cost of rebuilding or repairing your home, your house insurance will make up the difference. The EQC will pay a maximum of $100,000 for dwellings, and additionally will cover land damaged within eight metres of the house or outbuildings.

- Note there are new excesses for natural disasters, i.e. events such earthquakes, tsunamis, floods or storms. Again due to the Christchurch earthquake costs, fences, driveways and swimming pools now attract a $5,000 excess because these fall outside the EQC scope. Consequently, the insurers bear the full brunt and are passing those costs on to homeowners.

- If your property (or part of your property) doesn't have building consent, it may not be covered if the illegal building work is the reason for the claim. If the illegal work is destroyed due to another cause, your insurance won't cover the cost of rebuilding it.

- Faulty materials, design or construction are potentially not covered if they caused the problem – you have to take out a claim against the manufacturer, architect or builder as per the leaky homes saga.

- Under some policies, homes that are vacant for significant lengths of time (typically 60 days) are potentially not covered unless you have written agreement from your insurer.

As part of your obligations under the policy you will usually have to do some or all of the following:

Inform your insurer if the property is tenanted, i.e. a rental property.

- Care for your property responsibly, including locking up when you leave it, maintaining it in a reasonable condition, and, under some policies, having your chimney cleaned annually.

- Inform you insurer if you intend to undertake renovations. You may have to have separate insurance during construction if the work is major.

- Contact your insurer before undertaking any repairs to damage caused by an insured event. (If the matter is urgent because there is further immediate risk to people or property, it can be a good idea take photographs to show them what you have done, and keep the receipts if you had to use tradespeople.)

METHAMPHETAMINE DAMAGE

Important note: Many insurance policies only provide minimal cover (up to $25,000) if damage is caused due to tenants using, storing or manufacturing unlawful substances in your house, e.g. 'P' labs. If your house has been used as a 'P' lab, it will require decontamination which involves a complete refit including wall linings, insulation, paint and carpet. This is more likely to cost in the vicinity of
$60,000 to $100,000.

This means it is highly likely you are underinsured in this area, which I find grossly unfair. Investors would be wise to check for 'P' damage by testing houses before purchasing and seeking specific extensions on their policies to cover damage if they perceive their houses are at risk. Most insurance companies will not offer this if asked directly, but larger brokers (and some banks) have more sway with insurers, so if you arrange your insurance through them you may be able to obtain higher (or full) cover. However, you will have to ask and possibly push a little to get it. As an alternative to insurance, some investors install monitored 'P' lab and methamphetamine detectors in their houses.

Damage caused by a 'P' lab **fire**, on the other hand, is typically covered.

CASE STUDY

A client of GRA had a house on a full site in West Auckland. She insured her property through her banker and didn't think much about the policy when she took it out. To her dismay, the property turned out to be tenanted by a gang who operated a 'P' lab in a systemic fashion throughout the house. Until discovery they were the perfect tenants, paying premium rent and never missing a payment.

The site contamination was one of the worst to occur in New Zealand, with the entire house being condemned and all of the soil on the site having to be removed to a depth of 750mm. Long story short, the cost of deconstruction, removal of the deconstructed house, soil removal and replacement, and reconstruction was $800,000. A standard insurance policy limit for this would have been $25,000. By good luck, her banker's policy (through their negotiated standard exemption to cover all damage from methamphetamine labs) meant the entire $800,000 was covered and she was fully compensated. She did lose rent, but this policy was worth $775,000 to her.

Moral of the story

Read your terms and conditions, and discuss with your insurer whether they limit cover for damage from drug use or manufacture in your dwelling. It's a growing problem in New Zealand.

Contents insurance

Contents insurance covers many of your belongings that are not considered part of the building, such as carpet, furniture, window coverings, appliances, clothes and personal belongings.

It is worth considering for a rental property to cover carpets and drapes, as well as any furniture or appliances you have provided. These may be covered under some house insurance policies, but you need to check that the cover provided is adequate for your needs.

Again I recommend you read your policy to see exactly what is covered, but there are a few things worth mentioning here:

- You are covered for loss of belongings due to burglary but sometimes not theft. So what is the difference? Burglary is when something is stolen after forced entry into your home. Theft is when your belongings are stolen by someone you have invited into your home (or, in some cases, by someone who has entered uninvited through an open door). Find out how each is distinguished before choosing an insurer.

- Wear and tear is not covered, nor is damage caused by mildew, rot, insects, rodents and vermin. Some policies will cover possum damage to contents, others won't.

- I recommend sitting down one day and preparing a list of all chattels in your family home and any rental property with significant chattels, identifying what they cost you and where you got them. Then walk around taking photos on your phone of each room, inside your wardrobe, inside your kitchen cupboards or your garage. Send the list, along with photos, to your insurance company to put on file. In the event of a major contents claim, you will be completely dependent on this information, proving that yes, you had 30 pairs of shoes, or 22 fishing rods, etc. I had my bach robbed and photos were invaluable. The insurer even paid out on some Cuban cigars that were stolen – because they were in a photo.

In addition, they want proof of purchase, i.e. receipts or invoices. I found this out the hard way when my house in Auckland got burgled when I last moved. My possessions were nicely packaged for shifting and a thief helped himself and stole a car-load. Luckily I got it on video, including the plate of the thief's car and his face. While the insurance company paid out, the police did nothing even though they had the guy's name and address.

Landlord insurance

Landlord insurance provides extra cover for tenanted properties and is in addition to house insurance, not instead of it. Some insurers will cover the landlord's contents (up to a certain value) as part of the standard policy, others will do so for an additional premium. There are also packages that combine house, contents and landlord insurance under one policy.

House and contents aspects aside, the main advantage of landlord insurance is the cover it provides for loss of rent (under defined circumstances). In exchange for a few hundred dollars a year, this type of insurance can provide you with some peace of mind. However, policies can differ markedly as to the events they will cover and how much compensation they will give, so do thorough research before deciding on a policy. In particular, find out the maximum rent the policy will cover ($500 per week is average) and the period of time for which you can claim lost rent under various circumstances.

Typically, landlord insurance policies will provide cover for some or all of the following:

- Loss of rent if a tenant leaves without giving notice, if they are evicted, or if the house is uninhabitable due to an insured event.
- Malicious or deliberate damage by tenants or their guests.

There are some very specific conditions you must fulfil in order for your landlord insurance cover to remain valid. They include:

- Screening tenants responsibly, including checking references.
- Having a written tenancy agreement.
- Undertaking regular inspections (some policies say every three months, others every six).
- Keeping an eye on rent payments, issuing a 14-day notice if they are late, and applying to the Tenancy Tribunal to have tenants evicted if rent is more than 21 days in arrears.
- Obtaining a bond.
- Collecting rent in advance.
- Having current house and contents insurance.

All of these conditions may make the policy impossible to claim on and impractical to take out. Read the terms and conditions and make sure it is not an insurance rort where you pay for something you are unlikely to be able to collect on.

Risk protection insurance

While not strictly related to property ownership and investment, there is a place for other types of insurance. Income protection or trauma insurance could provide you with the means to hold on to your property portfolio or family home should you suffer a major misfortune. Term life covers you if you or your partner die, replacing your income with a lump sum.

If your property portfolio cash flow is negatively geared overall it will probably be requiring regular contributions from your personal income to keep it afloat. If your income were to suddenly stop, you would not only find your household bills difficult to pay, you could lose your portfolio as well. Income protection insurance won't cover you if you just can't find a job, but where it comes into its own is if you can't work due to illness, disability or injury, and will typically pay 75% of your pre-tax income. Some policies will also provide cover for redundancy.

Trauma insurance, which pays out a lump sum in the event you suffer a serious illness or injury, could be an additional layer of comfort and is relatively cost-effective. Term life insurance covering death looks after your beneficiaries, paying off debts with a lump sum pay-out. A blend of risk insurances is best, and you should take advice from an appropriately qualified insurance agent over assessing your needs.

Personally, I think having a positively geared portfolio is the best insurance, but risk protection insurance is beneficial for most investors. Make sure you have cover in case you are sick, incapacitated or dead, to protect your household from the disaster such events can cause.

Finding an insurer

Using an insurance broker who deals with many insurance companies can be good leverage of your time. They know the ins and outs of each policy and can tell you who has the most comprehensive cover and best wording.

There is nothing to stop you from sourcing insurance yourself by approaching the various insurance providers directly and making your own comparisons. Remember, though, that cheapest is not always best. Some house and contents insurers won't deal with brokers (e.g. Tower and AA at the time of writing), so doing your own research could be worthwhile. Bear in mind, however, that research can be time consuming, so use a fire and general insurance broker to advise you if you don't want to do it yourself.

Managing your insurance

It only takes a small amount of effort to manage your insurance effectively, and as a result you will have continued cover and lower premiums.

- It is a great idea to cycle your insurance annually on the same day for all policies.
  - You can 'shop' the business around asking for tenders.
  - It makes less work – you write only one cheque.

- By having your home, contents and car insurance with one company, you will generally qualify for a discount.

- If you have a large property portfolio, you should be able to negotiate a bulk discount.

- Make sure you have the correct named policy holder for each property, i.e. the legal owner. For example, if your property is in a trust, the trustees for that trust are the legal owners and therefore their name(s) must be on the policy (not the namE of the trust itself).

- Paying premiums in one lump sum annually is cheaper than paying by instalments. Interest payments funding monthly instalments are charged by some companies.

- If you are involved with the sale or purchase of a property, confirm with your insurance provider that the house and contents will be fully insured at all times during the process. Usually the house and chattels are the seller's responsibility until the buyer takes legal possession.

CONCLUSION

- It is important to have the right kind of cover for your home and the properties in your investment portfolio.
- Be careful setting the value for 'fixed sum insured' properties – don't underinsure.
- All insurance policies contain conditions and obligations which you must fulfil in order for your cover to remain valid.
- House insurance is essential for any property, and covers the building itself and anything permanently attached to it. If the property is tenanted, house insurance may also cover landlord's chattels (up to a certaiN amount), depending on the policy.
- Contents insurance covers chattels and belongings that are not affixed to the building.
- Landlord insurance provides extra cover for loss of rent due to certain defined events.
- Income protection or trauma insurance might be worth considering for salaried homeowners, or investors with negatively geared portfolios.
- The easiest option is to use an insurance broker to find the right package for you. Otherwise undertake thorough due diligence before deciding on an insurer.
- Manage your insurance well by paying premiums on time, informing your insurer of any changes of circumstances, and doing what you can to reduce premiums (e.g. paying annually). Tender for business annually.

About the author

Matthew Gilligan is a chartered accountant, and has been practising since 1992. He is the managing director of Gilligan Rowe and Associates where he works alongside John Rowe, Janet Xuccoa and Salesh Chand (his partners) to assist the firm's clients.

In particular, Matthew heads GRA's specialist asset planning division, helping clients protect their assets, implement their estate plans and develop optimal taxation structures through a process called asset planning.

Matthew has extensive knowledge of the property market, with a focus on Auckland investment. He has been involved in this area for over 20 years and has developed and invested in property in Australia, the United States and New Zealand over that time.

A great believer in education and sharing knowledge, Matthew is a well-known speaker on asset planning and property matters. Matthew regularly presents at seminars, and also speaks to various groups, including working with banks and their clients, property investor associations, and various organisations around New Zealand that are interested in property.

As part of his commitment to education and helping people prosper, Matthew writes a regular blog to keep readers up to date with a range of topical issues affecting all New Zealanders who have a goal to be financially successful.

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