STRATA COMMUNITY INSURANCE

Section 11
- Loss of Lot Market Value

The Strength of **Experience.**

Problem	Solution
Inability to reinstate	New product
Financial loss for owners	Cover for market value

What happens if your scheme cannot be reinstated?

If you're like millions of other Australians, you will have a large amount of your net worth invested in your primary residence. As owners, we tend to always be optimistic on the value of this asset, and of course its true worth is only realised upon sale. For owners of detached housing, this asset represents your title to the land and physical improvements such as your home, garage and other fixtures. For owners of strata, this represents your title to occupy the space designated within the strata plan. The value is underpinned by your share (generally represented by unit entitlement) of the land and physical assets owned by the Body Corporate, less all of its liabilities.

In every State and Territory there is a legal requirement for the Body Corporate to reinstate your strata scheme following loss. This requirement is essential in retaining the value of your equity invested in your strata apartment (your asset). That is, if your scheme suffers a total loss, or constructive total loss, you cannot recover the value of your asset until the scheme is totally reinstated. Only then do you have an apartment to market and sell to potential buyers to realise a sale price.

But, what if your Body Corporate is prevented from reinstating? There are many strata schemes around Australia where the right to rebuild is limited or restricted under an ordinance or regulation issued by a public or statutory authority. What would happen if your 15 storey scheme could not be reinstated beyond 8 storeys? What are the potential financial implications for owners?

The process:

Our research suggests that in all States save for NSW, it is not possible to vary a strata plan. Therefore, to give force to any ordinance (building restriction) the strata scheme would need to be terminated. To generalise, this means the scheme would need to be wound up, with the land being liquidated and the proceeds being added to the insurance payout, plus any other cash assets of the scheme. After all liabilities have been met, and following a Supreme Court ratification, the net assets would be paid out to owners on a unit entitlement basis. It is highly probable that the liquidation proceeds will not equal expectations, given:

(a) the insurance proceeds reflect replacement value of the scheme; and

(b) a developer's interest in the site will be reflective of the economic value of the new restricted use of the land.

In NSW, it is possible to alter an existing strata scheme without termination, however the process would necessarily involve a process of terminating select individual lots (for example the lots in storeys 9-15 in the example above). Such adjustments could only take place following adequate compensation arrangements for the aggrieved lot owners and ratification by the Supreme Court.

The issue:

If a scheme or part of a scheme is terminated under the circumstances described above, it is highly unlikely that the value of the settlement that owners will receive as a part of the termination will reflect the market value of their lots. Many owners will face a loss in equity, and for those who have their lots mortgaged, the proceeds may not cover the outstanding value of their mortgage debt.

Our solution:

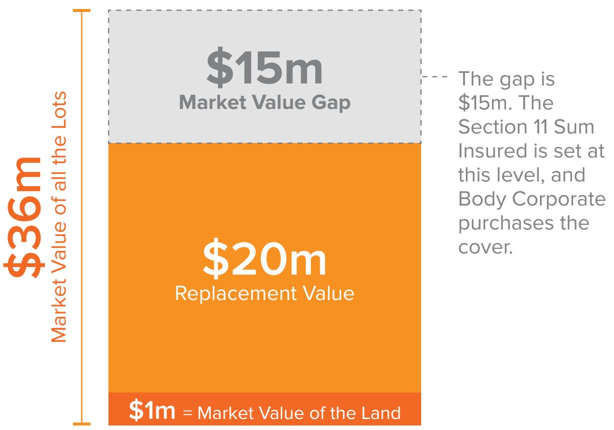
For the first time ever in the Australian strata market, we give Bodies Corporate the opportunity to insure the difference between the market value of all of the lots within a scheme, and the proceeds they will receive from the insurance funds (replacement value), together with the proceeds from the liquidation of the land. In the unfortunate circumstances of a total loss, and enforcement of an ordinance preventing the reinstatement of the scheme to its previous size, the Body Corporate would receive additional funds. They would then, having settled all liabilities, be in a position to distribute these as a part of the liquidation process.

How does it work?

Let's use the example of the 15 storey strata scheme that has an ordinance restricting reinstatement to 8 storeys. For simplicity, we will assume that there are 15 lots (one per storey) with equal unit entitlements. The Body Corporate would instruct a suitably qualified valuer to obtain three valuations:

1. the market value of all the individual lots;
2. the replacement value of the scheme as insured under Section 1 of the policy; and
3. the market value of the land following the imposition of the ordinance.

The valuations come back as $36m for market value of all the lots combined, $20m for replacement value, and $1m for the market value of the land, as represented in the following chart. Having been satisfied of the valuation process, we offer up to $15m Sum Insured for Section 11 – loss of lot market value, representing the difference between $36m market value of all the lots and $21m total for the replacement and land values.



A loss scenario:

A total loss occurs and the ordinance is enforced. The scheme needs to be terminated and the land liquidated. The Sum Insured for Section 1 automatically converts to an agreed value, and $20m is paid out to the Body Corporate. A post loss valuation is completed to assess the current market value at the time of the loss for the total of the individual lots and the land value. The market value of all lots is reassessed at $37m and the market value of the land at $800k. Deducting the $20m already paid and the $800k land value from the market value of $37m, the Body Corporate now has a gap of $16.2m. Section 11 will respond to the difference of $16.2m by paying out the full Sum Insured under that Section 11 – in this case $15m. This example is illustrated below:

In a situation where there is termination of some but not all lots in the scheme, in this case 7 lots – storeys 9 to 15 inclusive, Section 11 will respond in a similar way. The Sum Insured for Section 1 automatically converts to an agreed value, and $20m is paid out to the Body Corporate. However, in this case they must use the funds to reinstate the scheme to its new reduced height of 8 storeys, and apply the balance of the funds towards compensating the owners whose lots are terminated. A valuation is conducted and the market value of the 7 lots terminated is assessed at $14m. From this amount, the 7 lots' share of the Section 1 agreed value payout (7/15 x $20m = $9.3m) and the land value (7/15 x $800k = $0.373m) would be deducted, and the balance of the funds would be recoverable by the Body Corporate under Section 11 ($14m - $9.3m - $0.373m = $4.327m). They would use these funds towards compensating the owner's impacted by the termination.

Summary:

If you are an owner of a scheme, or a Strata Manager with schemes under your management, that has some form of ordinance or regulation impacting reinstatement, please call us to discuss this exposure and how we may be able to help. Our new Section 11 – Loss of lot market value may be exactly what you or your clients need under these circumstances.

*Paul Keating is founder and Managing Director of Strata Community Insurance, and a leading authority on risk and insurance related matters within the strata and community titles sector.