THE FACTS CONCERNING BUILDERS WARRANTY INSURANCE

Recent sensational claims in some media that Victorian consumers have been 'fleeced on insurance' premiums and payouts and that home building insurance is 'an outright scam' are wrong. They are based on figures selectively taken out of context.

The Government's own insurance underwriter, the Victorian Managed Insurance Authority (VMIA) found that the expected combined operating result for 2011/12 will be that $0.94 in every $1.00 of insurance premium will eventually be taken up in payments to homeowners and associated operating costs. See http://www.vmia.vic.gov.au/Insurance/Domestic-Building-Insurance/Statistics.aspx>

Since 2002 the insurance claims incurred, including associated costs, total nearly $61 million. As the nature of the product has not changed since the new scheme commenced in 2010 there is no basis to suggest the rate of claims paid can diminish. On that basis, claims of the scheme's being an unmitigated failure, with a 'vanishingly low rate of payout', are clearly contradicted by the Victorian Government's own publicly available figures.

To put the matter in its proper perspective, the amount of insurance written and claims made annually over the last 10 years has not greatly varied. The average annual number of claims 2002-2010 was 417. The suggestion that the 19 claims made to date under the new scheme (which only commenced in 2010) is representative is wrong and highly misleading. It does not account for claims to be incurred over the period of cover which is up to six years and have historically averaged 417 annually. Claims will continue to come in for insurance cover written in the last year until well after 2016.

The true facts are set out below. They can be easily substantiated by reading the Victorian Government's Essential Services Commission report Performance of Victoria's Domestic Building Insurance Scheme 2008-2010.

Background

In March 2010, following the withdrawal of insurers from the warranty business the Government announced that a new warranty scheme would be introduced to Victoria. The new scheme was designed to be funded by builder premiums and operated by the VMIA.

As part of VMIA's charter and reinforced by the Government announcement that the new scheme must be self-funding, the VMIA commissioned actuaries to develop a sustainable pricing model that would ensure adequate reserves to cover operational and claims outlays.

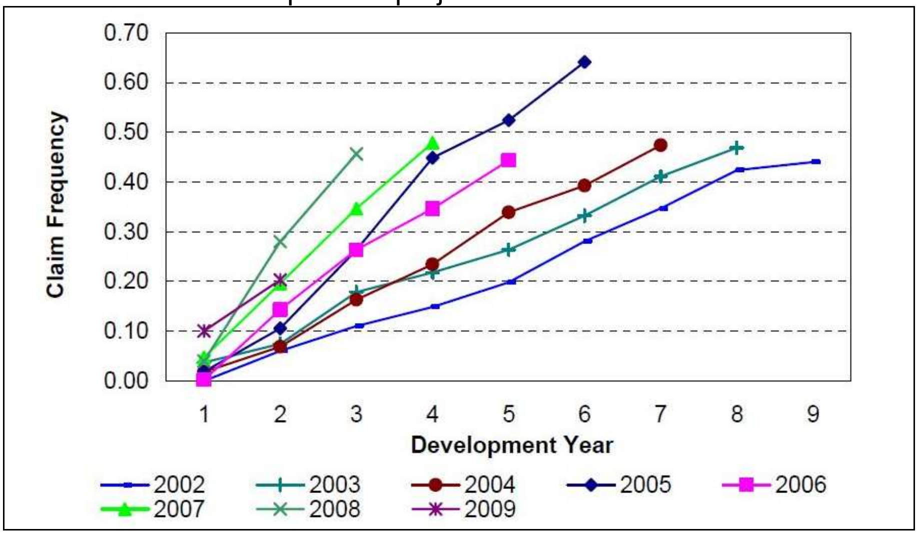
Domestic building insurance is considered to be a 'long-tail' insurance class as claims can be made:

- up to two years for non-structural claims; and
- up to six years for structural claims,

after completion of the building works or termination of the building contract.

Claims against policies issued in year one continue to develop until such time as the policy expires and beyond in some cases to 10 years after the policy has been issued. This means that claims in the first year of the policy are usually minimal, but grow over a period of years. The graph below clearly shows that all of the policy years from 2002 through to 2009 commenced in the first year with low claims activity/frequency (less than one claim for every 100 policies issued). However, once they mature the claims frequency increases on average to five claims in every 100 policies issued. Over the last five years the number of certificates issued on average is 54,000 per year. This means for each of these five years, 540 claims could eventuate with the whole five years of policies producing 2,700 claims.

Claim frequency by underwriting year – registered builder
per 100 project certificates

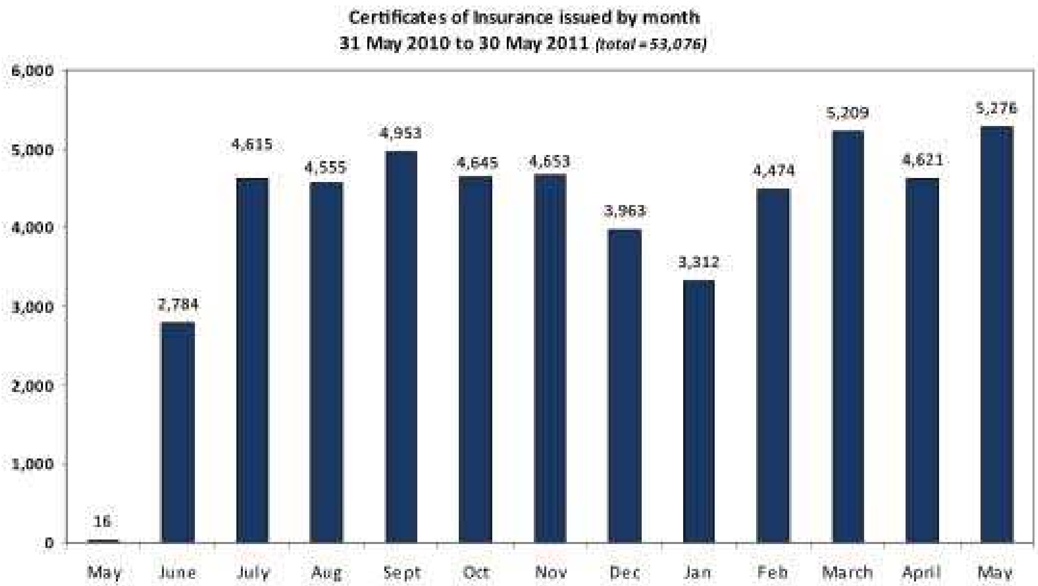


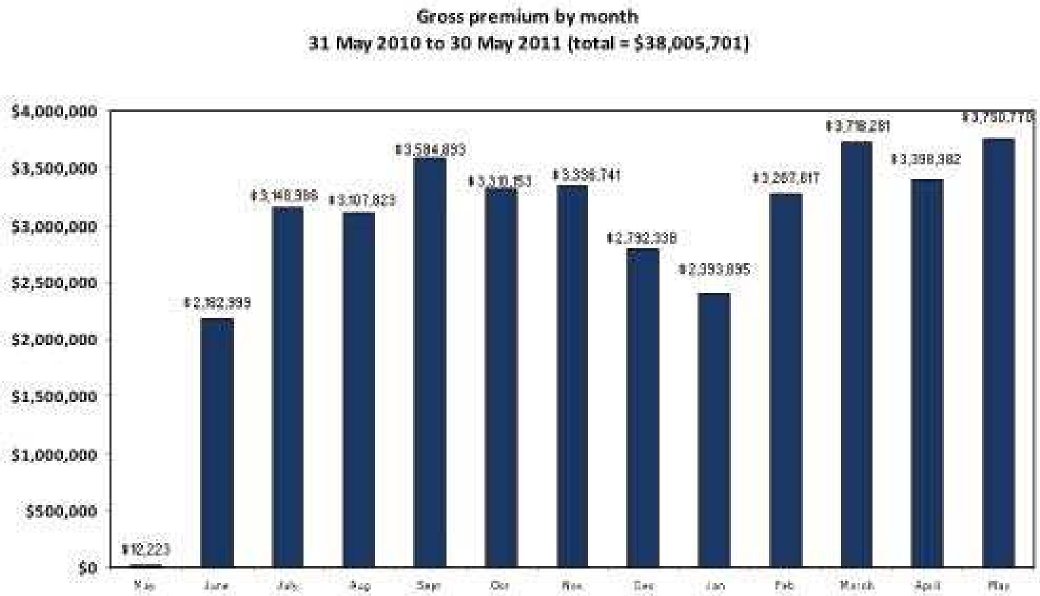
This means that the VMIA must ensure there are adequate reserves to cover anticipated future claims, which may be made years after the premium has been paid by the builder.

The VMIA aims to provide domestic building insurance on a ‘break-even’ basis; that is, to charge premiums that are adequate to cover claims, operating expenses and capital charges.

Below is a snapshot of the VMIA’s experience for the 12 months to 30 May 2011 and a brief explanation of some key underwriting and claim statistics.

Month-by-month data





Operating Ratio

The expected combined operating ratio for 2011/12 is 94%, this represents all operating expenses, claims costs and payments to beneficiaries. This figure is based on an actuarial projection of anticipated claims and operational costs, divided by the premium pool. It also includes a discount for projected premium investment returns.

This is equivalent to 156% when applying APRA's reporting approach, which uses a different method to calculate claims and does not include a discount for investment returns. The **Australian Prudential Regulation Authority (APRA)** is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

In June 2011, the Essential Services Commission released a report into the Performance of Victoria's Domestic Building Insurance Scheme 2008-2010 which reports on industry-wide data.

Key Findings

The Essential Services Commission found that since 2002 there have been 1,635 successful claims in Victoria which have resulted in payments and associated costs (GST, Claim investigation costs) to insured parties of almost $61 million, just over $33 million of this has been incurred in the last three years. Of the above claims, 1,415 were a direct result of Builder insolvency, 887 of which occurred in the last three years.

When actuaries determine the cost of premiums on long tail risk products they do so by using historical data. Based on the findings it is easy to understand why the VMIA is projecting a 94% operating ratio and 156% when applying APRA's reporting approach.

This essentially means that the best case scenario is that for every dollar of premium collected the VMIA will have six cents over and above that reserved for future claims. Four per cent of the remaining revenue will be used to repay the start-up capital loaned to the VMIA by the Government and a further two per cent represents the capital charge (or the opportunity cost borne by Government in not investing the funds elsewhere).

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