21 January 2016

Mr Anthony Lean
Chief Executive
State Insurance Regulatory Authority
Department of Finance, Services and Innovation
2-24 Rawson Place
Sydney NSW 2000

Dear Mr Lean

Supplement to Quarterly Reports: Observations on Scheme Progress to 30 June 2015

The State Insurance Regulatory Authority (**SIRA**)'s quarterly report presents a number of key indicators for the home building compensation scheme in NSW, based on data supplied by the insurers licensed to write this business.

The purposes of this letter are to comment on a number of additional matters, based on further analysis of the quarterly data together with additional information, and to draw some conclusions about the scheme's performance to date. This letter is intended to be published as a supplement to the June 2015 Scheme data report, for the information of consumers, builders and other interested parties. References to tables are to those in the quarterly report to June 2015.

This further analysis is based on data to 30 June 2015. The regulatory framework for Home Building Compensation in NSW has changed significantly since 2009, specifically the legislative amendments in 2009, 2011 and 2014. These changes have extended the claim indemnity period and have increased claim liabilities under the scheme.

Following structural changes on 1 September 2015 to the NSW insurance and care schemes, **SIRA**, which is part of the Department of Finance, Services and Innovation, has assumed the regulatory functions previously undertaken by NSW Fair Trading relating to Home Building Compensation. The NSW Self Insurance Corporation (**SICorp**) has become part of icare (Insurance & Care NSW) and changed its branding to **icare hbcf**.

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This analysis relates to data for the insurance period since 1 July 2002 when the current scheme commenced offering protection in the event of the death, disappearance or insolvency of a builder. For policies issued from 19 May 2009, cover extends to situations where a builder's licence is suspended for a failure to comply with a monetary order of the Consumer, Trader and Tenancy Tribunal or a court in favour of the homeowner. The analysis is for licensed builders only, excluding data for owner-builder insurance, unless otherwise noted.

Provision of Home Building Compensation cover

Lumley and CGU withdrew from the market in the December 2009 quarter, after which the Government announced structural changes to the scheme. Insurance under the Home Building Compensation Scheme continued to be provided by the remaining insurers (Calliden, QBE, Vero) until 30 June 2010. Calliden (from 1 October 2015, Residential Builders Underwriting Agency Pty Ltd as agent of Great Lakes Reinsurance (UK)) and QBE continue to act as agents of the new scheme insurer, **icare hbcf**. This report covers business written by all insurers between 1 July 2002 and 30 June 2015.

Ability to Claim and Value for Money

At 30 June 2015 more than 5,300 claims had been accepted by insurers since commencement of the current insurance scheme in July 2002 (Table E1).

Of the claims which have been finalised, an average of $67,250 was paid to the claimant with a further $5,600 on average paid to third parties (Table E3). Such a cost would be a considerable amount for most consumers to meet from their own resources, and represents close to fifty times the average premium paid per certificate in the June 2015 quarter.

The function of the insurance is to protect consumers in the event of the insolvency of their builder, or the builder's death, disappearance or suspension of licence. More than 90% of the claims accepted to date arose from builder insolvency, representing nearly 95% of the total claims cost to date (Tables E3 and E4).

Over 80% of builder insolvencies generate three or fewer insurance claims. At the other extreme, a small number of insolvencies have generated more than 100 claims each. Insolvencies generate claims of all types: failure to commence, failure to complete and defects claims.

Of the claims where liability has been assessed, about 20% (1,327 claims) have been declined by the insurers. Of these declined claims, most are due to no defect being found (55%), the builder being found to be solvent (24%), the claim being outside the coverage period (12%) or a missing builder being located (7%) (Table E1 and E2).

Insurer Profitability

As most claims arise from the insolvency of a builder, home building compensation claims activity is strongly influenced by the economic cycle. In addition to higher numbers of insolvencies during 2007 and 2008 because of the global financial crisis, there have been insolvencies of several large building groups involving hundreds of clients with unstarted, incomplete or recently completed homes, notably Beechwood, Westminster, Cosmopolitan and Holmwood.

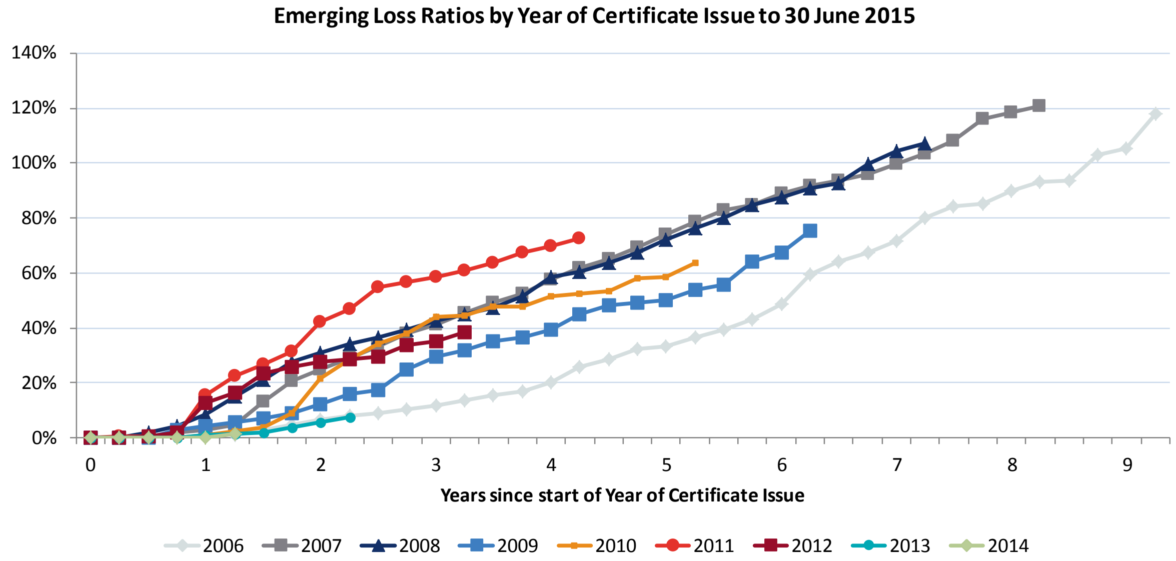
The insolvency of a builder can trigger claims on insurance policies for construction contracts which were issued several years earlier. The average time lag for defects claims to be notified is more than three years after policy issue, but there are still claims being reported more than seven years after policy issue. These time lags create the 'long tail' nature of home building compensation insurance. Insurers sell the policies but don't know until many years later whether the premiums were sufficient or excessive.

Profitability is also likely to be very cyclical, with the profits from the 'good' years subsidising the losses in the years when unpredictable downturns cause high claim costs.

Combining these factors – the exposure to the economic cycle and the time lags in the insurance cover – means that the 'value for money' or return on insurer capital implied by the premium rates for the period since 2005 is still not fully known. Insolvencies that are yet to occur will impact the profitability of these policies for a number of years to come. Even the earliest periods covered by the scheme have seen the emergence of a number of large claims in recent financial years which have significantly impacted scheme performance. However, our analysis indicates that no underwriting year since 2006 will have been profitable, and those losses are estimated to result in private sector insurers losing in excess of $40 million from this business between 2002 and 2010. **icare hbcf** is estimated to lose in excess of $200 million from 2010 to 2015.

One way to measure the emerging profitability of premiums is to compare the claims cost to date for all claims with liability accepted (Table E9) with the premiums for the corresponding policies (Tables D1.2 & OB.D1.2). Dividing the claims by the premiums gives a 'loss ratio', which is the proportion of premiums which is payable in claims costs – based on claims known to date.

This analysis is shown in the following graph. It includes licensed builders and owner-builder data. The premium used in these loss ratio calculations in this report includes charges. The claims cost data from Table E9 has been adjusted approximately to remove the GST recoverable by insurers.



While the final loss ratios for each year of certificate issue will not be known for many years, the graph shows that more recent years are emerging with much higher loss ratios than earlier years at the same stage of development. This is due to a combination of premium rate reductions, retrospective legislative changes, increasing numbers of builder insolvencies and large builder insolvencies with multiple claims (including Beechwood, Cosmopolitan, Westminster and Holmwood). The 2009 year is showing a somewhat lower development following premium rate increases, while the 2010 to 2012 years have been particularly impacted by the large builder failures. Projections which we have undertaken suggest that the ultimate loss ratio that will emerge for each year of certificate issue since 2008 will be at least double that which has emerged to date as considerable potential remains for the emergence of major defects claims. The two quarters' available experience of 2015 have not been included on the graph – they are both 0%.

Insurers' premiums must cover administration expenses and return on capital as well as claims costs. For such a class of insurance business, with variable experience over the economic cycle, we expect that insurers would seek to average around a 70% undiscounted loss ratio over time. Based on the pattern of claim emergence to date, none of the previous insurers is likely to have made a profit on this business written after 2006, and that trend continues to June 2015.

Affordability of Home Building Compensation Insurance

Average premium rates (per $1,000 of value of construction work) reduced considerably between 2006 and June 2008. From June 2008 there were increases in average premium rates across all types of building work until October 2010 when **icare hbcf** introduced its own premium rating structure. Since 2010, rates for alterations, renovations and swimming pool construction have reduced to levels below those of June 2008, while premiums for new single and multiple dwellings have generally increased.

Home building compensation premiums currently represent on average less than 1% of the cost (contract value) of construction work. If rates were lifted to levels that would provide a reasonable return on capital, we estimate home building compensation would cost between 2% and 5% of contract values. Alternatively, the underlying cost of the scheme would need to be reduced by an equivalent amount for it to be viable at current premium rates. Given that most scheme cost arises from claims for major defects particularly involving multi-units, the ability to materially reduce costs by reducing cover is limited. Reducing the risk of builder insolvency will reign in costs over a full economic cycle.

Members of the SIRA Board should not hesitate to contact us if you have any questions regarding the information in this letter.

Yours sincerely

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