

30 August 2011

Home Warranty Insurance Scheme Board
NSW Fair Trading
Department of Finance and Services
McKell Building, 2-24 Rawson Place
SYDNEY NSW 2000

Dear Members of the Board

Supplement to Quarterly Reports: Observations on Scheme Progress to 30 June 2010

The Board's quarterly report presents a number of key indicators for home warranty insurance business 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 on the Board's website as a supplement to the June 2010 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 2010 available on the Board's website at http://www.fairtrading.nsw.gov.au/pdfs/Tradespeople/HWI_data_jun2010.pdf.

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This further analysis is based on data to 30 June 2010. On 1 July 2010, major structural reforms to the Home Warranty Insurance Scheme in NSW took place: this is likely to affect the emergence and settlement of claims under the existing scheme.

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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.

Availability of Home Warranty Insurance

Lumley and CGU withdrew from the market in the December 2009 quarter, after which the Government announced structural changes to the scheme. Home Warranty Insurance continued to be provided by the remaining insurers (Calliden, QBE, Vero) until 30 June 2010. Calliden and QBE continue to act as agents of the new scheme insurer, the NSW Self Insurance Corporation trading as the NSW Home Warranty Insurance Fund.

Affordability of Home Warranty Insurance

Average premium rates (per \$1,000 of value of construction work) reduced considerably between 2006 and June 2008. Since June 2008 there have been increases in average premium rates across all types of building work. Average premium rates increased by about 13% between the withdrawal of Lumley and CGU in December 2009 and June 2010.

Home warranty insurance premiums represent on average less than 1% of the cost (contract value) of construction work except in the case of swimming pool construction where it is between 1% and 2%. The cost of this insurance therefore should not have any material impact on the capacity of consumers to construct or alter residential buildings.

Ability to Claim

At 30 June 2010 more than 2,000 claims had been accepted by insurers since commencement of the current insurance scheme in July 2002 (Table E1).

Additional data with which we were supplied showed around 60% of accepted claims were finalised within a year of being reported to the insurer, and a further 28% within two years.

Of the claims which have been finalised, an average of \$40,800 was paid to the claimant with a further \$3,000 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 over 38 times the average premium paid per certificate in the June 2010 quarter.

The function of the insurance is to protect consumers in the event of the insolvency of their builder, or the builder's death or disappearance. More than 94% of the claims accepted to date arose from builder insolvency (Tables E3 and E4).

Three-quarters 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/or defects claims.

Of the claims where liability has been assessed, 21% (563 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%) or a “disappeared” builder being located (12%) (Table E2).

Value for Money and Insurer Profitability

As most claims arise from the insolvency of a builder, home warranty claims activity is strongly influenced by the economic cycle. The data shows that in the nine months from January to September 2008, the number of builder insolvencies doubled compared to the preceding nine months, which in turn was twice the level of the preceding three years. In the following months to June 2010, insolvencies returned to the lower levels of 2007.

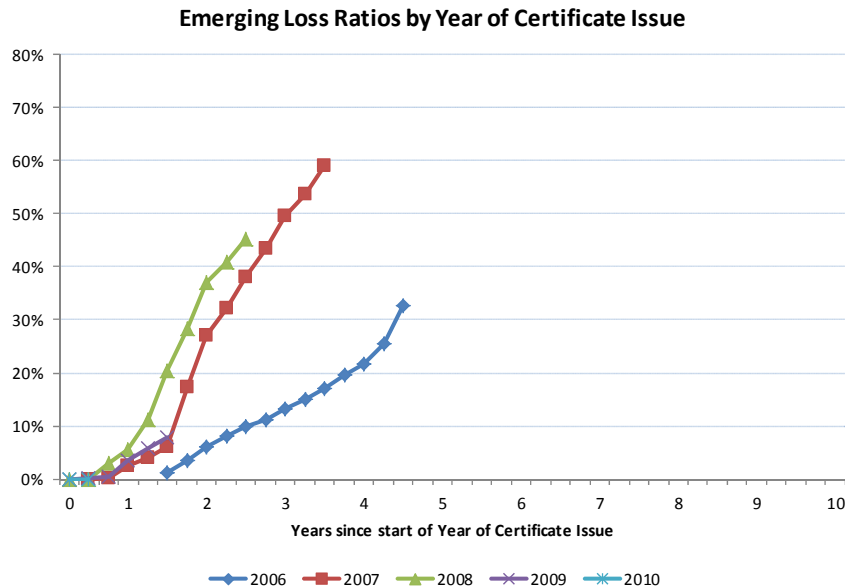
The insolvency of a builder can trigger claims on insurance policies for construction contracts which were issued several years earlier: the *average* time lag for defects claims to be notified is more than three years after policy issue, but there are still claims being reported more than seven years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

Combining these two factors – the exposure to the economic cycle and the time lags in the insurance cover – means that it is still too early to measure with any confidence the ‘value for money’ or insurer profitability in the premium rates for the period since 2005. Insolvencies that are yet to occur will impact the profitability of these policies for a number of years to come.

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.

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 claims cost data from Table E9 has been adjusted to remove the GST recoverable by insurers.

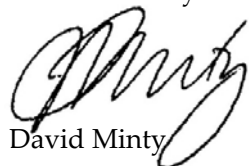


While the actual loss ratios for 2006-08 will not be known for several years yet, the graph shows that 2007 and 2008 are emerging with much higher loss ratios than 2006 at the same stage of development. This is due to a combination of premium rate reductions, increasing numbers of builder insolvencies and some large claims (including Beechwood). Both the 2009 and 2010 years are quite undeveloped at this stage. Projections which we have undertaken suggest that the ultimate loss ratio that will emerge for each year of certificate issue will be at least double that which has emerged to date as considerable potential remains for the emergence of structural claims.

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 75% 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 2005.

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

Yours sincerely



David Minty



Mark Hurst

Fellows of the Institute of Actuaries of Australia