7 February 2013

Home Warranty Insurance Scheme Board
NSW Fair Trading
Department of Finance and Services
1 Fitzwilliam Street
Parramatta NSW 2150

Dear Members of the Board

Supplement to Quarterly Reports: Observations on Scheme Progress to 30 June 2012

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 2012 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 2012 available on the Board's website at http://www.fairtrading.nsw.gov.au/pdfs/Tradespeople/HWI_scheme_information_at_jun2012.pdf .

This supplement is provided as general information only and does not constitute actuarial advice. While Finity has taken reasonable care in compiling the information presented, Finity does not warrant that the information provided is relevant to a particular reader's situation, specific objectives or needs. You should not rely on the information in this supplement or disclose it or refer to it in any other document. Finity accepts no duty of care or liability to you or anyone else regarding this supplement and we are not responsible to you or anyone else for any loss suffered in connection with the use of this supplement or any of its content. Any questions regarding the information in this supplement should be directed in the first instance to the Secretary to the Board, on 13 32 20.

This further analysis is based on data to 30 June 2012. On 1 July 2010, major structural reforms to the Home Warranty Insurance Scheme in NSW took place, which are likely to affect the emergence and settlement of claims under the existing scheme.

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

Finity Consulting Pty Limited
ABN: 89 111 470 270

www.finity.com.au
www.finityconsulting.co.nz

Sydney
Level 7, 155 George Street
The Rocks NSW 2000
Ph: + 61 2 8252 3300
Fax: + 61 2 8252 3399

Melbourne
Level 3, 30 Collins Street
Melbourne VIC 3000
Ph: + 61 3 8080 0900
Fax: + 61 3 8080 0999

Auckland
Level 27, 188 Quay Street
Auckland 1010
Ph: + 64 9 363 2894
Fax: + 64 9 363 2895

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 (HWIF). This report covers business written by all insurers between 1 July 2002 and 30 June 2012.

Ability to Claim and Value for Money

At 30 June 2012 more than 3,400 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 $49,300 was paid to the claimant with a further $3,700 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 forty times the average premium paid per certificate in the June 2012 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 94% of the claims accepted to date arose from builder insolvency (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/or defects claims.

Of the claims where liability has been assessed, 21% (928 claims) have been declined by the insurers. Of these declined claims, most are due to no defect being found (56%), the builder being found to be solvent (26%) or a missing builder being located (9%) (Table E2).

Insurer Profitability

As most claims arise from the insolvency of a builder, home warranty 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 and Cosmopolitan.

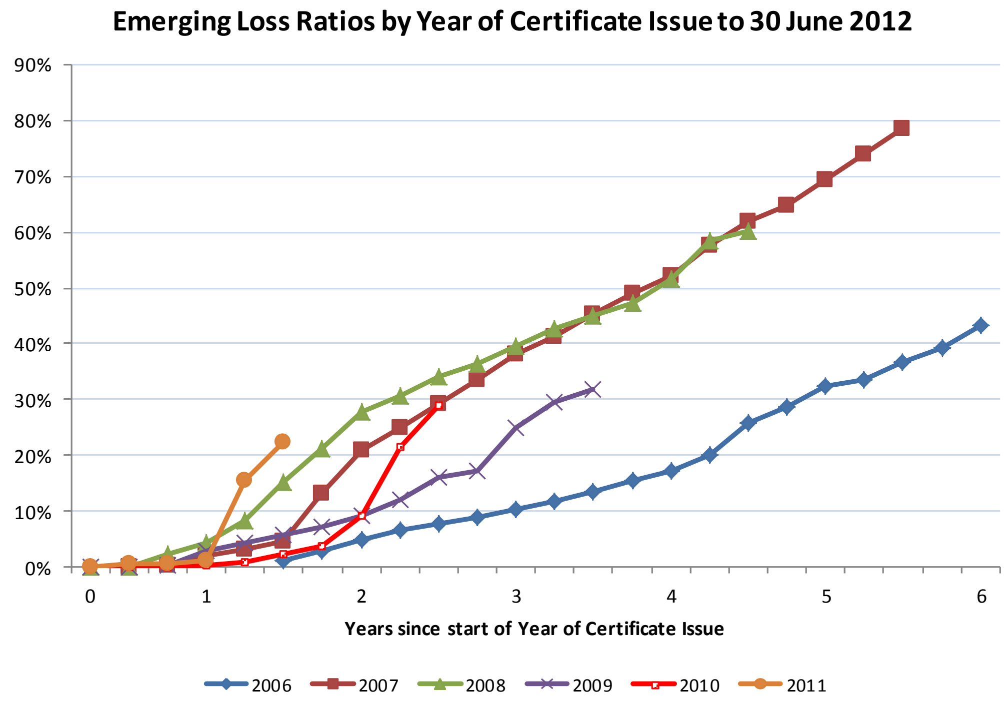
The insolvency of a builder can trigger claims on insurance policies for construction contracts which were issued several years earlier: the *average* time lag for defects claims to be notified is more than three years after policy issue, but there are still claims being reported more than seven years 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 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 2006-08 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, increasing numbers of builder insolvencies and some multiple claims (including Beechwood). The 2009 year is showing a somewhat lower development following premium rate increases, although there has been a trend upward in the latest three quarters. Both the 2010 and 2011 years have been particularly impacted by the Westminster and Cosmopolitan collapses. 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 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 2005, and that trend continues to June 2012.

Affordability of Home Warranty 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 the HWIF introduced its own premium rating structure. Since then 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 warranty insurance 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 insurers with a reasonable return on capital, we estimate home warranty insurance would cost between 2% and 4% 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.

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