15 September 2009

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

Dear Members of the Board

Supplement to quarterly reports: Observations on scheme progress

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 March 2009 Scheme data report, for the information of builders, consumers and other interested parties.

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This further analysis is based mainly on data to 30 June 2008, with some updates using data to 31 March 2009. The conclusions may be impacted by the subsequent withdrawal of Lumley and CGU from the market. References to tables and figures are from the March 2009 information on the scheme which can be found on the Department's website at http://www.fairtrading.nsw.gov.au/pdfs/Tradespeople/HWI_data_mar2009.pdf .

This analysis relates to data for the insurance period since 1 July 2002, from which date the current scheme offering protection only in the event of the death, disappearance or

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insolvency of a builder has applied. The analysis is for licensed builders only, excluding data for owner-builder insurance, unless otherwise noted.

Availability of home warranty insurance

As at 31 March 2009, the number of builders with eligibility to obtain home warranty insurance has increased by 24% since June 2006 (refer Figure A1 of the March 2009 information on the scheme). Comparison with data on the numbers of licensed builders shows an increasing proportion of licensed builders hold eligibility.

The proportion of eligibilities which are subject to the builder having provided some form of financial security – an indemnity, guarantee or other security – has fallen steadily since June 2007 (Table B1). At March 2009 only 7.5% of eligibilities were subject to provision of any security.

Overall the data suggests access for builders to insurance has improved over the period this information has been collected.

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 some increases in average premium rates, although at March 2009 they remain well below the levels of mid-2006 (Table D2.2).

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 should not be having any material impact on the capacity of consumers to construct or alter residential buildings.

Ability to claim

At 31 March 2009 more than 1,300 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 30% of claims were finalised within a year of being reported to the insurer, and 44% within two years.

Of the claims which have been finalised, an average of $35,000 was paid to the claimant with a further $3,400 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 about 50 times the average premium paid per certificate.

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 95% of the claims accepted to date arose from builder insolvency (Tables E3 & 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, 20% (333 claims) have been declined by the insurers. Of these declined claims, most are due to no defect being found (41%), the builder being found to be solvent (34%) or a "disappeared" builder being located (15%) (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 by June 2008, the current 'GFC' economic downturn was already producing two to three times the number of builder insolvencies than during the preceding three years.

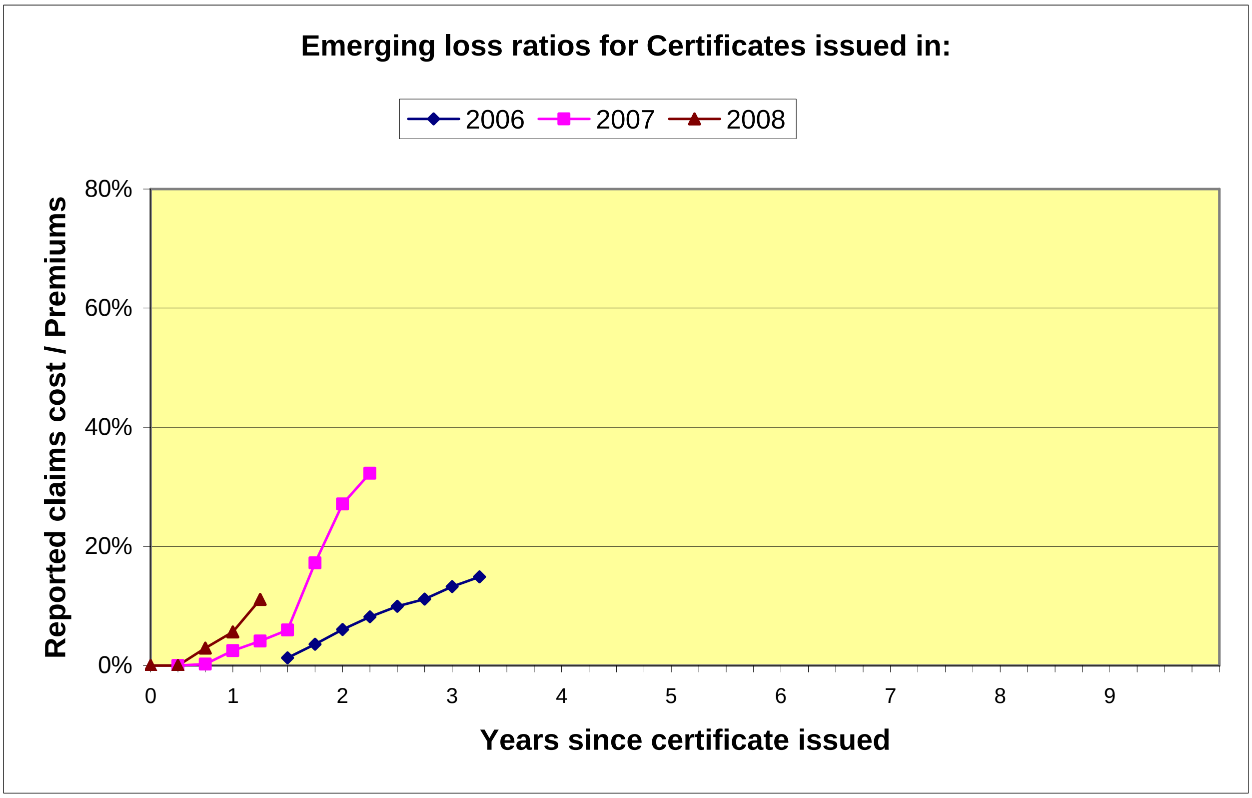
The insolvency of a builder can trigger claims on insurance policies for construction contracts which were issued several years earlier: the *average* time lag for defects claims to be notified is three years after policy issue. These time lags create the 'long tail' nature of home warranty insurance. 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 much too early to measure with any confidence the 'value for money' or insurer profitability in the premium rates for the period since 2006 for which data is available. 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 premiums by the claims 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 graph below. 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 as less profitable 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).

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 60% loss ratio over time.

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

Yours sincerely

Bruce Watson

David Minty

Fellows of the Institute of Actuaries of Australia