ESSENTIAL SERVICES COMMISSION

Level 37, 2 Lonsdale St
Melbourne 3000, Australia
Telephone +61 3 9032 1300
+61 1300 664 969
Facsimile +61 3 9032 1303

DOMESTIC BUILDING INSURANCE PREMIUM VALIDATION REVIEW

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ABBREVIATIONS

APRA	Australian Prudential Regulation Authority
BCV	Building Commission Victoria
CEO	Chief Executive Officer
Commission	Essential Services Commission
COO	Chief Operating Officer
DBI	Domestic Building Insurance
DTF	Department of Treasury and Finance
E&Y	Ernst & Young
HGF	Housing Guarantee Fund
VMIA	Victorian Managed Insurance Authority

GLOSSARY

Actual Price	This is the actual price charged or the premium the insurer receives.
Book Price	The book price is the standard rates that are charged to customers and are typically based on the technical cost but will contain a market overlay.
Broker Commission	Is the fee charged by a broker for their service in facilitating the application for a project certificate.
Building Commission Victoria	A statutory authority that oversees the building control system in Victoria.
Cross-subsidies	A cross-subsidy occurs when a particular cohort of builders are overpriced relative to their risk compared to another cohort which are under-priced. This results in the overpriced cohort effectively subsidising the under-priced segment. This can either be a deliberate pricing decision to ensure affordability or may be the result of an inefficient book pricing structure.
Eligibility	Pre-approval from an insurer for a builder to be issued project certificates.
First Resort	An insurance scheme that provides compensation regardless of the builder's circumstances (as opposed to the last resort scheme).
Investment Returns	The revenue earned by an insurer by investing premium revenue.
Last Resort	An insurance scheme where compensation is only available where all other avenues for resolution have been exhausted.

Long-tail insurance	Insurance products where the full cost of claims is not known for a long time after the premium is charged.
Owner Builder	A person who constructs or renovates a domestic building on his or her own land, who is not in the business of building.
Policy	For Owner Builders, DBI coverage is issued in the form of a policy. Owner Builders are only required to take out a policy if they sell the property within six and a half years of completion of building works.
Private Insurers	Independently trading insurance companies that compete in the market. Generally, they are publically listed entities, trading for profit.
Project Certificate	For registered builders, DBI coverage is issued in the form of a project certificate that is specific to the domestic building work undertaken in a domestic building contract.
Reinsurance	Reinsurance is the transfer of risk from an insurer to another party. The reinsurer takes on the risk in exchange for a premium. Essentially, it's an insurance company taking out an insurance policy of its own for large claim payments. The purpose of reinsurance is to reduce the variability of claims and minimise insolvency risks.
Technical Cost	This represents the true underlying risk of a policy, taking into account claim costs, expenses, reinsurance costs and required profit margins.
Turnover Limit	An insurer's calculation of a builder's capacity to undertake work. This is the total value of construction work that an insurer will issue certificates for in a 12 month period.

EXECUTIVE SUMMARY

What is domestic building insurance?

Domestic Building Insurance (DBI) is mandatory on all domestic construction contracts over $12,000 in value, such as new dwellings, renovations and swimming pools. It allows the homeowner to make a claim up to six years from completion if the work is not completed or is defective, but the builder has died, disappeared or become insolvent and therefore cannot be pursued personally.

DBI is often referred to as a 'long-tail' form of insurance since there can be a significant delay between receipt of the premium and payment of claims. While insurers make their best estimate of future costs when setting premiums, the uncertainty and delay in claims with long-tail insurance means there is a risk that the pool of insurance funds may not be sufficient to cover claims as they arise.

Why has the Commission been asked to look at the VMIA's premiums?

Five private sector insurers offered DBI policies until early 2010, when all but one of the private insurers announced they would not be issuing any new policies. In response, following an official mandate issued by the Victorian Government in March 2010, the Victorian Managed Insurance Authority (VMIA) began offering DBI. Arrangements were made with QBE to act as the distribution agent for the VMIA's policies (this current mandate is due to expire on 30 June 2013).

While one private insurer, Calliden, continues to offer DBI, the VMIA is now responsible for providing a large majority of the DBI market. Given the VMIA's market power, the Essential Services Commission ('the Commission') has been asked to examine the adequacy and validity of the DBI premiums set by the VMIA. This review covers the period from 1 June 2010 to 30 June 2012.

In undertaking this review, the Commission engaged Ernst and Young (E&Y) to provide independent, specialist actuarial advice on the VMIA's premium structure and underwriting standards. The Commission also drew on its experience in providing regular performance monitoring of the DBI sector.

The long-tail nature of DBI means that it will be many years before claims costs emerge to a point where it can be concluded that the premiums collected were adequate. The E&Y advice reviewed the methodology and processes that the VMIA employs to monitor its premium and claims positions. In the early years of a long-tail insurance before many claims have been lodged, these procedural observations are important to give assurance to the Commission and the broader community that the VMIA is managing its information, and has the capacity to make appropriate adjustments to premiums as more claims data comes in.

Are the VMIA's premiums over the reporting period reasonable?

The VMIA outsources the determination of its DBI technical cost[1] to Finity, who are actuarial consultants, and who have conducted annual reviews (in November 2010 and March 2011) of the premium pool, and calculated the required premium to break-even.

Based on the actuarial advice provided by E&Y, the Commission has concluded that the VMIA's premiums:

- are sufficient to cover its expenses, risks and long-term claim costs
- are not set above the level required by the VMIA to cover its expenses and the risks and the long-term claim costs.

In making these conclusions, the Commission noted E&Y's analysis which found that:

- The assumptions used by Finity to project claims costs are within a reasonable range based on the information available at the time. In addition, the variations in actual claims cost from that assumed are reasonable given the long-tail nature of DBI.
- The loadings applied to projected claims costs to take into account the probability of a large builder[2] becoming insolvent and differences in business mix and scheme performance are reasonable.[3]
- The assumed claims handling expense is within the range of assumptions made by other insurers.
- The agent commission paid to QBE was validated by independent parties to the VMIA as being in a reasonable range at the time the agreement with QBE was entered into.
- The methodology used to calculate the capital charge[4] is line with industry practice, and the assumptions used are reasonable.

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1 In the pricing of insurance products, technical cost represents the underlying risk of a policy, taking into account claims costs, the cost of reinsurance (where appropriate), all expenses and required profit margins. It is often referred to as the 'break-even premium'.

2 The large builder loading reflects the probability of a large builder becoming insolvent which could result in high claim numbers due to the volume of business undertaken.

3 The historic claims data used by Finity to project future claim costs was based largely on Vero's and QBE's experience of the DBI market (about 50 per cent). The loading for difference in business mix and scheme performance reflects the probability that the VMIA's experience (with the majority of the market) may be different to QBE and Vero.

4 The VMIA's pricing policy includes a margin (or 'capital charge') in the form of a return on capital that is to be generated in order to support the underlying liabilities (i.e. claims costs).

Do the VMIA's underwriting standards conform to commercial standards?

The Commission has also considered whether the VMIA's underwriting standards conform to commercial standards. Underwriting standards outline the criteria taken into account when accepting risk or issuing a project certificate (i.e. the DBI policy) to a builder.

Based on the advice provided by E&Y, the Commission has concluded that the VMIA's underwriting standards do conform to commercial standards.

The three major criteria taken into account when issuing a certificate to a builder are:

- builder capabilities
- financial backing of the builder, and
- ability to obtain restitution from the builder.

E&Y found that the VMIA's underwriting fundamentals include all of the factors that a commercial insurer would take into consideration. The VMIA's preferred position is to negotiate terms with respect to risk management, as opposed to a straight decline. In doing so, E&Y suggested that the VMIA appears to go to greater lengths than a commercial insurer to offer eligibility to any individual builder. However, the process it undertakes, and the conditions it places on builders (such as turnover limits), assists in managing the risk the VMIA takes on. These conditions are in line with those used in a commercial market place.

Does the VMIA's provision of DBI result in a net cost to taxpayers?

One of the Government's objectives is that the VMIA's provision of DBI should result in no net cost to the taxpayer over time. In E&Y's view, there is no net cost to taxpayers from the scheme in a given year, as the VMIA's current approach is to set premiums that are designed to cover all costs projected at the time.

However, over time, net costs to taxpayers could arise if the cost of claims increases significantly from that assumed when premiums were set.

The Commission is satisfied that the VMIA has robust processes in place to mitigate the risks of premiums and/or its reserves being insufficient to meet the Scheme's costs, if there is a significant difference between assumed and actual claims experience. For example:

- The VMIA has a robust monitoring regime that regularly examines premiums collected; conducts spot checks to ensure underwriting guidelines are being followed; and reviews break-even premiums. This monitoring allows the VMIA to make changes to premiums to ensure that they are still appropriate given the risks being faced by the Scheme.
- If an underwriting surplus is achieved, the surplus is retained as an asset (after any loan repayments to the DTF) in order to pay future DBI claims costs.[5] This

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[5] When the VMIA entered the DBI market it received a loan from DTF to meet a shortfall in premium revenue.

allows the VMIA to accumulate reserves which can be called upon if claims experience deteriorates significantly from that assumed.

How sufficient is the information used by the VMIA in setting premiums?

In E&Y's view the information used by the VMIA in setting premiums is the minimum required to conduct a meaningful analysis. Finity primarily utilised the historical claims data of private insurers QBE and Vero (who both withdrew from the DBI market in 2010). The claims data was summarised by type of claim, underwriting year, and development year from the 2002-03 financial year onwards. Finity also considered publicly available information on the performance of DBI more generally.

Best practice would typically see the actuary using historical transactional level claims information in order to better identify emerging trends that may not be apparent from summarised information. Furthermore, while QBE and Vero represent approximately 50 per cent of the full DBI market that transferred to the VMIA, access to full industry data would also have enhanced Finity's analysis.

While the provision of transactional level claim information and full industry data could have enhanced the analysis, the Commission recognises that this additional data would likely have added considerable time and expense to the valuation process. Moreover, it is by no means certain that other insurers would be forthcoming with the information in the required form.

How robust is the VMIA's premium-setting methodology?

In E&Y's view, the methodology adopted by Finity (on behalf of the VMIA) to determine premiums is in line with standard industry practice. Its assumptions in setting technical costs (which determine the level of the 'break-even' premium) are considered reasonable, given the information available for analysis.

The extent to which the VMIA is able to determine appropriate premiums and allow emerging experience to be incorporated is dependent on its pricing governance — that is, the rules, supporting policies and documentation which are used to determine premiums. It also includes the lines of communication, forums and avenues which are used to raise issues and the different levels of authority to make decisions.

While the VMIA has no formal pricing committee is in place — which would represent best practice pricing governance — E&Y's view is that the necessary communication is nevertheless occurring within the VMIA, with monthly meetings between the Chief Executive Officer, the Chief Operating Officer and the internal actuary. Based on this advice, the Commission concludes that the VMIA has a robust process in place to approve and monitor pricing actions.

1 INTRODUCTION

1.1 What is domestic building insurance?

Domestic Building Insurance (DBI) is mandatory on all domestic construction contracts over $12,000 in value, such as new dwellings, renovations and swimming pools. It is purchased by the builder and allows the homeowner to make a claim up to six years from completion if the work is defective or uncompleted, but only if the builder has died, disappeared or become insolvent, and therefore cannot be pursued personally. Hence, DBI is considered to be a last resort scheme, as it is only available where all other avenues for resolution have been exhausted.

DBI is provided in the form of a certificate which is issued to an eligible builder for each building project. Once a certificate is issued, it is assumed the construction is completed within 12 months of this date unless the insurer is notified otherwise. A homeowner then has a further six years from completion in which they can make a claim, although experience shows it is possible for claims to be reported up to 11 years following issuing of a certificate.

DBI is often referred to as 'long-tail' since there can be a significant delay between when the premium is received and when a claim is made and finalised. In contrast, insurance such as home and contents policies, where claims are submitted and paid out within 12 months, are known as 'short-tail'. While insurers make their best estimate of future costs when setting premiums, the delay in claims with long-tail insurance means there is a risk that the pool of premium funds may not be sufficient to cover claims when they come in.

1.2 History of domestic building insurance in Victoria

In Australia, domestic building (construction and renovation of private homes) is subject to various protections to safeguard consumers from sub-standard and defective work. Prior to 1996, all domestic building contracts in Victoria required the builder to make a contribution toward the Housing Guarantee Fund (HGF) which held the funds to be paid out to rectify any faults in construction. Home owners could claim from the HGF to cover any structural faults in construction for six years after completion of a project.

In 1996, the HGF was replaced by a mandatory Builders Warranty Insurance offering the same level of cover, but was provided by competing private sector insurers. A building contract could not proceed without a warranty insurance policy, and builders needed to show eligibility for insurance to maintain registration with the licensing body.

In 2002, upheavals in the insurance market — notably the collapse of HIH — reduced insurers' appetite for the scheme. The absence of insurance had the potential to constrain activity in the domestic building sector.

In response, the Government mandated a new style of insurance for domestic building. Still to be provided by the private insurance market, the new DBI would now cover home owners against defects only in the event that the builder had died, disappeared or become insolvent. If a builder was still trading, home owners would need to pursue them directly to rectify faults. This represented a move from 'first resort' to 'last resort' cover for domestic building.

Five private insurers offered last resort DBI policies until early 2010, when all bar one of the insurers announced that they would not be issuing any more policies. At this point, the Victorian Managed Insurance Authority (VMIA) began offering DBI, following an official mandate from the government (which is due to expire on 30 June 2013 — see box 1.1). Arrangements were made with QBE to act as the distribution agent for the VMIA's policies. While one private insurer, Calliden, continues to offer DBI, the VMIA is responsible for a large majority of the market. Nevertheless, the other private insurers are still liable for any eligible claims against policies they wrote before leaving the market.

Box 1.1 The Government mandate for the VMIA to provide DBI

In March 2010, the Government directed the VMIA to provide DBI to domestic builders (and owner-builders), as per section 25A of the *Victorian Managed Insurance Authority Act 1996*.

Builders are provided DBI where they can demonstrate to the VMIA that:

a) the DBI required is of the type specified by the Domestic Building Insurance Ministerial Order published in the Government Gazette No. S 98, dated 23 May 2003; and

b) they comply with the underwriting terms and conditions as determined by the VMIA. In setting these terms, the VMIA should have regard to current commercial criteria.

At the date of the Government's direction, builders who held DBI within the previous 15 months (effectively from the start of 2009), were to be provided comparable terms and conditions as their previous insurer, for at least 12 months, until they could be commercially assessed.

The VMIA is to determine underwriting terms and conditions as to premium and security and any other conditions it might reasonably require to provide DBI.

The VMIA is permitted to charge builders a percentage loading, in addition to their commercial premium, to recoup taxpayer funded costs for the provision of DBI and associated services. The design of this loading is to be developed in consultation with the Department of Treasury and Finance.

The Government's direction is effective from 31 March 2010 to 30 June 2013.

1.3 What the Commission has been asked to do

The Essential Services Commission ('the Commission') has been asked to examine the adequacy and validity of the VMIA's DBI premiums on a biennial basis.

Specifically, the terms of reference require the Commission to report on whether the VMIA's:

- premiums are sufficient to cover its expenses, risks and long-term claim costs
- premiums are not set above the level required by the VMIA to cover its expenses and the risks and the long-term claim costs
- underwriting standards conform to commercial standards.

The Commission is to have regard to:

- the Government's objective that there is no net cost to taxpayers over time from the Scheme
- the information used by the VMIA in setting premiums
- the methodology and assumptions used by the VMIA in setting premiums.

The objective of this work is to inform the Government, builders and consumers of the validity of the VMIA's DBI premiums.

This is the first of the biennial reviews, and covers the period from 1 June 2010 to 30 June 2012.

1.4 The Commission's approach

The Commission engaged Ernst & Young (E&Y) to provide independent, specialist actuarial advice on the VMIA's premium structure and underwriting standards. The VMIA provided E&Y with various actuarial and financial data, policy and premium information, which in conjunction with databases and manuals provided by the Commission, were utilised for their analysis. E&Y's findings were compiled in a confidential report which the Commission has used as the basis of this report.

This report outlines the Commission's main conclusions about the adequacy and validity of the VMIA's DBI premiums, drawing on E&Y's advice and the Commission's own experience in monitoring the DBI sector.

2 PRICING

2.1 Introduction

The Commission has been reporting annually on DBI since 2008, and has access to data from all Victorian DBI insurers as far back as 2003.[6] The aggregate premium data collected provides a history of DBI premium setting.

Premiums are calculated per project, taking into account the total value of the construction and the characteristics of the builder. As shown in Table 2.1, the total premium collected can be viewed in relation to the total value of building work being undertaken.

Table 2.1 DBI premium revenue

Year	*Total premium collected*[a] *($m)*	*Project value ($m)*	*Premium $1000 of project value ($)*
2005	27.36	6 839	4.00
2006	28.32	8 035	3.52
2007	27.29	8 779	3.11
2008	25.18	8 954	2.81
2009	31.95	10 718	2.98
2010	29.68	12 195	2.43
2011	42.34	12 059	3.51
2012 (Jan-Jun)	22.02	5 359	4.11

[a] Excludes stamp duty and GST.

As the table shows, insurers were collecting $4.00 in premium for every $1000 in domestic construction in 2005. Between 2008 and 2010, insurers were receiving less than $3 for every $1000. In 2010, all bar one of the private insurers left the market, claiming DBI was unprofitable. The exit of insurers would suggest that the $2.43 per $1000 they were receiving in premiums at the time was an insufficient level to remain in the market. Since the VMIA started providing DBI, the premium

6 The insurers that have left the market are still liable for claims against the certificates they issued before leaving the market, and continue to supply data to the Commission.

rate has risen back to above $4. Meanwhile, the total premium revenue collected in 2011 exceeded $40 million. However, it will not be known categorically if this was sufficient to fully cover costs until 2019 at the earliest given the long-tail nature of DBI.

The E&Y advice illustrates the methodology and processes that the VMIA employs to monitor its premium and claims positions. In the early years of a long-tail insurance before many claims have been lodged, these procedural observations are important to give assurance to the Commission that the VMIA is managing its information, and has the capacity to make appropriate adjustments to premiums as more claims data comes in.

2.2 Overview of the VMIA's pricing

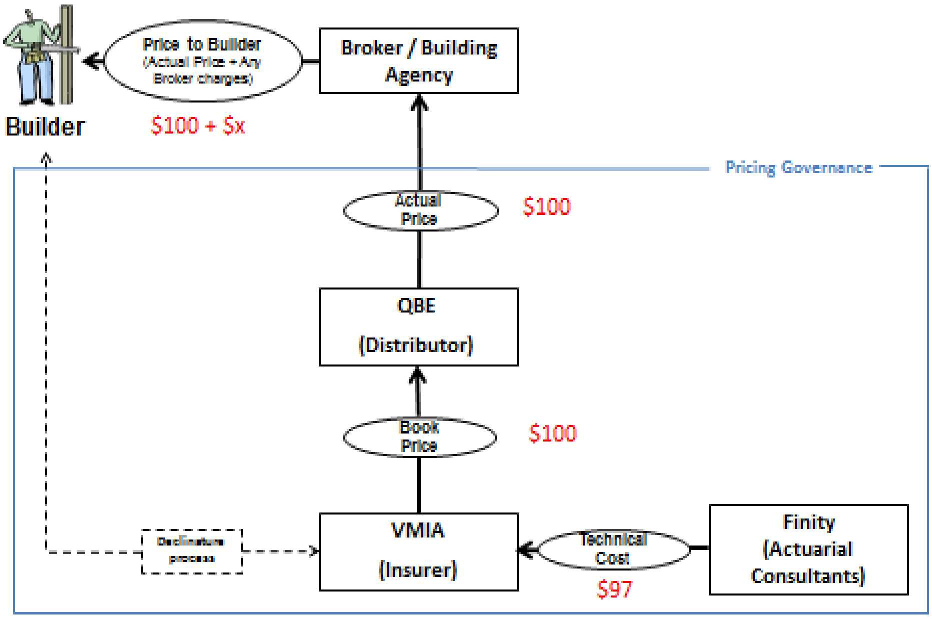
There are three key components of pricing when setting the premium of an insurance product, which provides the context for understanding how DBI premiums are set by the VMIA. These are:

- **Technical cost** — referred to as the break-even premium by the VMIA, represents the true underlying risk of a policy, taking into account claim costs, expenses, reinsurance costs (where available) and required profit margins.
- **Book price** — the standard rates charged to customers, they are typically based on the technical cost but will contain a market overlay, which allows for market segmentation and specific goals.
- **Actual price** — the actual price charged to the insurer (excluding broker charges) which may differ if the insurance company allows loading or discounts. The VMIA does not allow discounting or loading, so the actual price should be the same as the book price.

The relationship between these three pricing components in terms of setting the VMIA's premiums for DBI is illustrated in figure 2.1.

Ultimately, builders will also incur additional fees from brokers or building agencies which are added to the actual price charged by the VMIA. These additional fees are not available to the VMIA to cover expenses and claim costs, and are therefore outside the scope of the Commission's review.

Figure 2.1 **Interaction of DBI pricing components**

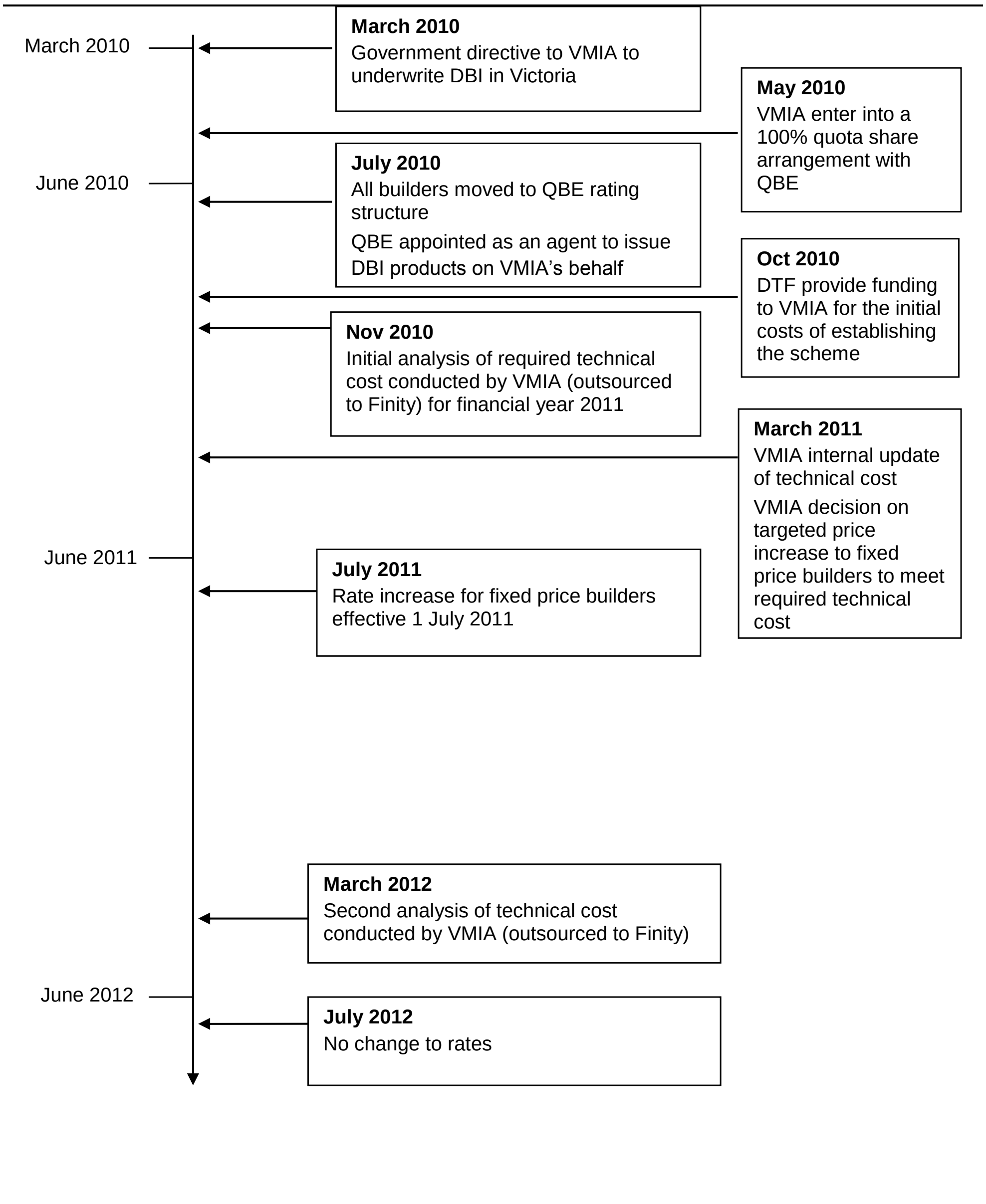


Note: The dollar amounts in this diagram are for illustration purposes only.

When the VMIA entered the market, it adopted QBE's rating structure and book prices. Following a review of its technical cost, the VMIA adjusted its book prices (published on its website) in July 2011 (see figure 2.2). There have been no subsequent changes to the VMIA's book prices.

The VMIA outsources the determination of its DBI technical cost to Finity, who are actuarial consultants, and who have conducted annual reviews (in November 2010 and March 2011) of the premium pool, and calculated the required premium to break-even.

Figure 2.2 **Timeline of events following the VMIA's entry into the DBI market**



2.3 Premium sufficiency and coverage

Given the long-tail nature of DBI, it can take many years for the full costs for any premium year to emerge. Therefore in setting appropriate premiums it is necessary to make assumptions about the costs that premiums will need to cover. These assumptions are typically based on past and emerging claims experience.

Setting premiums

In assessing premium sufficiency and coverage, E&Y considered:

- the information used to set the technical cost
- the suitability of the methodology and assumptions used to calculate the technical cost
- how book prices were originally determined by the VMIA
- how book prices have shifted over time, how the technical cost influences the price taken to market and whether there are significant variations between the prices taken to market and the technical cost that would mean that the claim costs, expenses and profit margin is not being achieved, and
- whether experience is emerging significantly different to expectations.

Initially, the VMIA's basic book pricing structure was set in line with that utilised by QBE on its exit from the market as a private underwriter. The book price varies with:

- whether the builder is a registered or owner builder
- the value of the project
- the type of work undertaken, i.e. structural, non-structural and swimming pools
- the assigned category of the (registered) builder into A, B or C — this assignment is based on a number of underlying factors including the building history, claims experience and financial position of the builder. An A rated builder is considered to have lower insurance risk than a C rated builder, and
- the policy term (for owner builders only), i.e. the length of time remaining until the legislated 6 year post completion term is finished.

The VMIA's initial approach

When the VMIA entered the market, it was receiving requests from builders transferring from all exiting insurers and so was required to shift builders from potentially five book pricing structures to one. To this end, the VMIA mapped the categorisations of other insurers into that adopted by the VMIA. This was completed in order to meet the government instructions with respect to 'comparable underwriting terms' (see chapter 1).

Builders who were unable to provide evidence of their former rating were commercially assessed to determine the appropriate categorisation. Large volume builders who had negotiated fixed rates were maintained on those rates without modification.[7] In addition, builders who were insured with QBE and receiving multi-policy discounts were also allowed to retain the same level of discount.

In E&Y's view, adopting QBE book prices on entry was a pragmatic solution given the limited time and information available to the VMIA. In addition, the continuation of existing discounts and the mapping of other insurers' builder categories into the QBE categories fulfilled the government mandate that the VMIA maintain comparable underwriting terms.

Finity's reviews of the VMIA's premiums

At the time the VMIA entered the market there was no comparison of book price to the **technical cost** (or **break-even premium)**. Subsequent analysis undertaken in November 2010 by Finity indicated book prices were not adequate to break-even. This shortfall was met through a loan from DTF to be repaid from underwriting profits in subsequent years. Finity calculated technical cost (the average cost per certificate) by estimating the present value of the expected costs associated with issuing DBI and adding on various fees and charges.

The components of the technical cost or break-even premium calculated by Finity include:

- **Claims costs** — an estimate of the projected claims costs for the various types of claims based on QBE's and Vero's past experience.[8] This component also includes an event loading to take into account the probability of a large builder becoming insolvent and a loading to reflect differences in the VMIA's business mix and scheme performance compared to QBE and Vero.
- **Claims handling expense** — the direct costs of managing claims (for example, salaries of claim management staff, legal costs and surveyor costs) based on the VMIA's projected costs.
- **Policy administration expense** — the general expenses incurred by the VMIA in managing its DBI operations based on the VMIA's budgets.
- **Agent commission** — the fee paid to QBE for selling the VMIA's DBI insurance product to builders.
- **Capital charge** — the margin to ensure that the required return on capital is generated in order to support the underlying liabilities (claims costs).

In assessing the calculation of technical cost, E&Y found that:

- The assumptions used by Finity to project claims costs are within a reasonable range based on the information that Finity had at the time (although, as discussed in Section 2.6, this information could have been better). In addition, the variations in actual claims cost from that assumed are reasonable given the long-tail nature of DBI.

7 Under a fixed rate arrangement, the 'rate' is agreed between the insurer and the builder and is then held constant for each certificate regardless of the specific characteristics of the project for which the certificate is being issued (i.e. irrespective of project size or type of work).

8 Vero and QBE held about 50 per cent of the DBI market.

- The loadings to take into account the probability of a large builder becoming insolvent and differences in business mix are reasonable.
- The assumed claims handling expense is within range of assumptions made by other insurers.
- The agent commission was validated by independent parties to the VMIA as being in a reasonable range.
- The methodology used to calculate the capital charge is line with industry practice and the assumptions used are reasonable.

Following its 2010 review, Finity recommended a 9 per cent increase to the average premium in order to break-even. On the basis of this recommendation, the VMIA decided to introduce new book prices from 1 July 2011. As a first step in determining an appropriate book price change, the VMIA updated the technical cost to allow for additional claims inflation and assumptions of 2011-12 DBI expenses. The result was an average increase of 12 per cent to the total premium pool in order to break-even. In order to achieve the required premium increase, the VMIA:

- removed QBE multi-policy discounts, and
- re-negotiated terms with builders on fixed rates to bring these into line with category A builders in the basic book prices. Fixed rate builders were also given the opportunity to move to the variable book rate structure.

Finity conducted a second review of technical costs in March 2012 using the same methodology. No further changes to premiums were made.

Sufficiency and coverage

The analysis undertaken by E&Y indicates that, based on the information available to Finity at the time, the VMIA's break-even premiums (thus technical costs) and book prices for 2010-11 and 2011-12 were set at sufficient levels to cover expected expenses, risks and long-term claim costs.

Claims experience for the 2010-11 and 2011-12 financial years (which covers 24 months of the 25 month period covered by this review) has not varied significantly from expectations. While still in its infancy, claims experience is in the bounds of what would be considered normal, given the inherent volatility in claims for this type of insurance.

The targeted book price increases effective 1 July 2011 were set to increase the average premium to slightly above the break-even level and thereby ensure premiums were sufficient to cover expenses, risks and long-term claim costs.

The average premium for 2011-12 was around six per cent higher than that required to break-even. The difference reflects the impact of changes in book prices and variations in business mix between 2010-11 and 2011-12. E&Y considers this difference to be normal and within a reasonable range given:

- the nature of the book rate changes implemented, and
- the non-recurring nature of building and construction work.

Conclusions

Based on the actuarial advice provided by E&Y, the Commission considers that the VMIA's premiums:

- are sufficient to cover the VMIA's expenses, risks and long-term claim costs
- are not set above the level required by the VMIA to cover its expenses, risks and long-term claim costs.

2.4 Commercial underwriting standards

Underwriting standards outline the criteria an insurer takes into consideration when accepting a risk or issuing a certificate to a builder. While each insurer will have similar criteria they take into consideration, they will have different limits or tolerance levels. In the case of DBI, one insurer may only issue certificates to builders whose projects are low value, while others may issue certificates to all builders regardless of the project value. The criteria are driven by an insurer's risk appetite and market strategy.

The underwriting standards adopted by an insurer will have a significant impact on the sustainability of their product. An insurer who prices its risks inappropriately and/or accepts risks it shouldn't may find that it has not collected sufficient premiums to make claim payments.

E&Y was not able to sight the VMIA's manual of underwriting standards in conducting its analysis, due to confidentiality concerns with the agency agreement. However, they were provided with the underwriting fundamentals which are the guiding principles of the manual. They noted three major criteria which the VMIA (or QBE on its behalf) takes into consideration when issuing a certificate to a builder:

- **Builder capabilities** — the VMIA considers the project type and project turnover the builder is applying for as well as what projects they have completed previously (i.e. experience). Technical and management skills are also considered.
- **Financial backing of the builder** — essentially, a builder's ability to undertake the projects and remain solvent in the foreseeable future. As such, financial performance, capital adequacy and financial viability are reviewed, as are the assets and liabilities of the company or builder.
- **Ability to obtain restitution from the builder** — the VMIA also considers the potential for restitution from the builder in the event of a claim. They examine the quality and liquidity of any securities which are provided, as well as the quality of any intercompany and Director loans, if there is a reliance on these in the Balance Sheet.

Other factors considered can include: whether a builder has ever been bankrupt before; claims history; moral and ethical risk; financial statements; and financial risk indicators. The underwriting standards manual would detail the explicit limits and how the quality of assets would be assessed.

All of these factors result in builders being assigned into a category from A to C, which influences both price and may place conditions on builders' eligibility for DBI. For example, in order to receive DBI a builder may be subject to limits on annual turnover or the number of jobs they may have underway at any given time.

E&Y also reviewed what happens where a builder falls outside of the risk criteria and QBE recommend their application be subject to the VMIA's process of declinature. The initial process is undertaken by the VMIA's Project and Procurement Manager of DBI, who then provides the Chief Operating Officer (COO) of DBI with their findings prior to sending a letter of intent to decline or issue a certificate to the builder on the agreed terms. Should the builder respond to a declined application and provides more information, a second review is conducted by the Chief Executive Officer (CEO) of DBI. Thus, there is a clear segregation of duties and decision making authority.

In E&Y's view, the VMIA has a robust process in place to decide whether a risk should be declined. Their preferred position is to negotiate terms with respect to risk management, as opposed to a straight decline. Calliden notwithstanding (whose risk appetite appears to be narrow and targeted towards specific risks), the VMIA is often the only choice for a builder to receive an insurance certificate. The VMIA has advised that, to date, it has only declined 25 builders.

E&Y found that the VMIA's underwriting fundamentals include all of the factors that a commercial insurer would take into consideration. The VMIA's preferred position is to negotiate terms with respect to risk management, as opposed to a straight decline. In doing so, E&Y, suggested that the VMIA appears to go to greater lengths than a commercial insurer to offer eligibility to any individual builder. However, the process it undertakes, and the conditions (such as turnover limits) it places on builders, assists in managing the risk the VMIA takes on. These conditions are in line with what would be considered in a commercial market place.

Conclusion

Based on the actuarial advice provided by E&Y, the Commission considers that the VMIA's underwriting standards conform to commercial standards.

2.5 Net cost to taxpayers

In assessing whether there is a likely to be a net cost to taxpayers, E&Y considered whether it would be necessary for an injection of capital to support the VMIA's DBI product. A capital injection would be required if the VMIA is in a position where its capital and premium pools have been exhausted. The capital injection could come from the VMIA's other operations or from the Victorian Government.

In E&Y's view, there is no net cost to taxpayers from the scheme in a given year, as the VMIA's current approach is to match premiums with the break-even premium pool. The premiums they set are designed to cover expected costs projected at the time. In line with this approach, no attempt is made to ‘claw-back’ historical losses in setting premiums.

E&Y noted that the requirement to operate in a commercial insurance environment is inconsistent with ensuring that there will be no net costs to the taxpayer. That is reducing the probability of losses to zero. The VMIA’s approach is consistent with normal practice in competitive private insurance markets where historical losses are generally unable to be recouped from inflating future prices due to competitive pressures.

Over time, the VMIA’s approach has the potential to result in a net cost to taxpayers, should claim costs increase significantly from that assumed when premiums are set. However, this risk could be mitigated by:

- **allowing historical losses to be recouped from future premiums**. This could more easily be achieved by the VMIA if it were in a weakly competitive market. Currently, the only other insurer in the market is Calliden, but there is no restriction on other insurers re-entering the market. Therefore, any attempt to claw-back past losses from higher premiums for future underwriting years would be unsustainable because builders could just choose to move to other insurers in the market. The VMIA would also need to have longevity in the scheme because utilising this approach means that there needs to be subsidisation of premiums between years.
- **the VMIA taking out reinsurance** protection on a 'stop-loss' basis which means that claims to the VMIA are capped at a certain amount each year. The reinsurer is liable for claims beyond the cap. The VMIA was unable to enter into an appropriate reinsurance arrangement (other than with DTF, which in effect would be a transfer of risk between government entities).[9]
- **the VMIA holding additional capital** to minimise the risk of a cost to taxpayers. Under this option it is unlikely that the risk will be reduced to zero (as the amount of capital required to be held would be prohibitive). Also, this would result in an opportunity cost to the taxpayer as capital is being tied up when it could be utilised for other activities.

The risk of a net loss to taxpayers over time largely comes from there being a significant difference between assumed and actual claims experience and the VMIA having insufficient premiums or reserves to meet the Scheme’s costs. In practice, this risk is partly mitigated through the monitoring of premiums undertaken by the VMIA. The VMIA monitors average premium revenue[10] on a monthly basis; conducts spot checks to ensure underwriting guidelines are being followed; and undertakes annual reviews of break-even premiums. This monitoring

[9] When the VMIA entered the market, it engaged Finity to conduct an analysis of the various scenarios that would threaten the solvency position of the DBI Scheme. The VMIA also engaged Aon Benifield to determine the reinsurers willing to enter into an arrangement with the VMIA with respect to DBI. Aon Benifield determined there was very limited appetite in the market for DBI reinsurance.

[10] Also known as ‘achieved premiums’ it is calculated as the total premium pool received divided by the number of certificates.

allows the VMIA to make changes to premiums to ensure that they are still appropriate given the risks being faced by the Scheme.

In addition, if an underwriting surplus is achieved, the surplus is retained as an asset (after any loan repayments to the DTF — as noted in section 2.3) in order to pay future DBI claims costs. This allows the VMIA to accumulate reserves which can be called upon if claims experience deteriorates significantly from that assumed.

Conclusions

Based on E&Ys findings and analysis, it is the Commission's view that there is no present net cost to taxpayers from the Scheme.

Over time, there is a risk of taxpayers incurring a net cost, should claim costs significantly exceed forecasts when premiums were set. However, this risk is being partly mitigated through the VMIA's process of monitoring premiums on a regular basis, and the ability to retain any underwriting surplus as an asset in order to pay for future DBI claims costs.

2.6 Information used by the VMIA

To calculate an appropriate break-even premium, Finity (on behalf of the VMIA) primarily used historical claims data of QBE and Vero (who withdrew from the DBI market in 2010). The claims data was summarised by type of claim, underwriting year, and development year from the 2002-03 financial year onwards. Finity also considered publicly available information on the performance of DBI more generally (including the Commission's annual performance reports and similar reports from other States).

In E&Y's view, the claims data provided to Finity was the minimum required to conduct a meaningful analysis. Best practice would typically see the actuary receiving transactional level claims information (i.e. one line per transaction) in order to better identify emerging trends that may not be apparent from summarised information. In addition, QBE and Vero represented approximately 50 per cent of the full DBI market transferred to the VMIA. Although access to full industry data would have enhanced Finity's analysis, E&Y noted that Finity utilised other information sources to compensate for the limitation.[11]

While the provision of transactional level claim information and full industry data could have enhanced the information used by Finity, E&Y also noted that using this additional data would have likely added considerable time and expense to the valuation process. Therefore, the trade-off between the benefits of obtaining additional data and the resulting extra workload would need to be evaluated.

[11] Finity has access to the Australian Prudential Regulation Authority's (APRA) National Claims and Policy Database, an independent repository of industry-wide insurance policy and claim information.

In addition to the extra workload, the VMIA would need to source the additional data from other insurers, most of which have been out of the market for a number of years. These insurers may be reluctant to provide the VMIA with detailed transactional data and may not have retained the required data in an appropriate form. In the meantime the VMIA is building up its own historical transactional claims database.

On balance, it is the Commission's view that the VMIA should consider approaching the other insurers to obtain transactional level claims information if it is available.

Conclusion

Based on the advice provided by E&Y, the Commission concludes that:

- Finity utilised the minimum amount of information required to conduct a meaningful analysis in calculating the VMIA's premiums.
- Consideration should be given to enhancing information sources by seeking transactional level claim information and full industry data from other insurers if available.

2.7 Methodology and assumptions used by the VMIA

In E&Y's view, the methodology adopted by Finity (on behalf of the VMIA) to determine technical premiums is in line with standard industry practice. Its assumptions in setting technical costs are considered reasonable, given the information available for analysis.

The extent to which the VMIA is able to determine appropriate premiums and allow emerging experience to be incorporated is dependent on its pricing governance — that is, the rules, supporting policies and documentation which are used to determine premiums. It also includes the lines of communication, forums and avenues which are used to raise issues and the different levels of authority to make decisions.

According to E&Y, an example of leading pricing governance is to have a committee with key stakeholders as members. Meetings occur at a frequency decided by the business and look at operational as well as strategic issues. A pricing committee provides both a forum to raise key issues with management and the opportunity to reassess the market from a strategic perspective.

The VMIA has no formal pricing committee in place. However, monthly monitoring is conducted and results discussed amongst the CEO, COO and the internal actuary for DBI. The primary purpose of the monthly monitoring is to determine whether the average break-even premium is being achieved and whether an adjustment to the book prices is necessary to ensure targets are met. The VMIA conducts 'spot checks' on QBE, where they check a number of policies to see if the underwriting guidelines and pricing have been performed appropriately. They also perform a 'temperature check' or more detailed analysis to check the performance of the portfolio at mid financial year. Finally, Finity conducts an annual review of emerging claims experience, revised break-even premiums and any additional items as requested by the VMIA.

E&Y found that, although there is no formal pricing committee is in place, that the VMIA has a robust process in place to approve and monitor pricing actions.

Conclusion

Based on E&Y's analysis and findings, the Commission considers that the VMIA has adopted the appropriate methodology and assumptions and has adequate premium monitoring processes in place.