Chapter 5

Responses from insurers and regulators

5.1 The main responses in submissions by insurers and regulators were:

- privatised last resort insurance has delivered consumer protection at an economical, and still declining cost;
- complaints that the market is not competitive, and insurance is too hard to get, may have had substance in 2001-02, after the collapse of HIH, but this is no longer the case;
- financial assessment by insurers imposes a worthwhile discipline on builders and has improved builders' capital adequacy, to the benefit of consumers.

The value of the insurance to consumers

5.2 A number of consumer submissions made complaints against insurers - mainly for denying claims, or (in the submitter's belief) offering insufficient payment or drawing out legal proceedings in a tactical way. Where these complaints named Vero, the committee invited Vero's reply and Vero responded in detail. For example, in one case, according to Vero:

> Most of the delays were caused by the fact that Ms xxxxxxx’s claim appeared to be substantially higher than could be justified by the facts of the case and her failure, despite being represented, to comply with orders and directions made by the CTTT…. Neither she nor the other homeowners would have been better off under an alternative scheme. In an optional scheme it is likely they would have recovered nothing. In the first resort scheme the same outcome would have occurred. There would still be the potential for disagreement and the need for resolution of issues of quantum.[1]

5.3 On the claim, occasionally made, that insurers use court proceedings to wear applicants down, Vero commented:

> Less than 10% of claims Vero handle involve a tribunal or court. Sometimes that is the only way to resolve the detailed technical issues that arise. But to suggest that Vero adopts this as a deliberate strategy to wear claimants down (irrespective of the merits or complexity of the claim) is preposterous and denies the indisputable fact that valid claims settled early and effectively always cost an insurer less than claims involving lawyers and courts.[2]

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1 Vero Insurance Ltd, correspondence 24 July 2008, p.13

2 Vero Insurance Ltd, correspondence 16 August 2008

Committee comment

5.4 Some submissions seemed to imply that complaints of this sort arise from the toughness of the profit-motivated private insurer, and would not arise in a government scheme. This is not necessarily so. The possibility of disagreement about whether work is defective, or about the cost of rectification, exists in either case. A government insurer also has a duty not to pay more than is fair on claims.

The cost of home warranty insurance

5.5 The builder buys the insurance and passes on the cost to the consumer; so if price was a cause of complaint it would be for the consumer to complain. In fact the price of the insurance was not a significant issue in consumer complaints. Price comparisons between NSW/Victoria and Queensland were argued by those who support or oppose the two systems primarily for other reasons, each trying to use arguments about price as another string to their bow.

5.6 The Housing Industry Association provided this comparison of premiums, showing that for a median value new house in NSW and Victoria premiums are around $3 per thousand dollars of project; in Queensland, $7.57:

Home Owners Warranty Insurance as percentage of new home price

		2002	2003	2004	2005	2006	2007
Sydney	median new house construction price[1]	$179,067	$192,167	$240,423	$240,125	$246,041	$265,433
	HOWI premium inc. govt charges[2]	$1,136	$1,496	$1,491	$1,385	$953	$796
	HOWI % of new house price	0.634	0.778	0.620	0.577	0.387	0.3
	HOWI % increase over the period		24.06	-0.34	-7.65	-45.33	-19.72
Melbourne	median new house construction price[1]	$165,969	$184,070	$200,987	$203,431	$219,671	$232,649
	HOWI premium inc. govt charges[2]	$837	$894	$973	$918	$779	$661
	HOWI % of new house price	0.504	0.486	0.484	0.451	0.355	0.284
	HOWI % increase over the period		6	8	-6	-18	-18
Brisbane	median new house construction price[1]	$146,340	$168,435	$199,255	$209,931	$222,873	$236,365
	HOWI premium BSA[3]				$1,240	$1,692	$1,789
	HOWI % of new house price				0.591	0.759	0.757
	HOWI % increase over the period					26.71	5.42

1. Based on unpublished ABS building approvals data
2. Premiums taken from industry insurer
3. Taken from warranty premiums charged by the QBSA

source: Housing Industry Association, submission 60, p.5

5.7 The NSW Office of Fair Trading (OFT) publishes reports on its HWI scheme including premium and claims information supplied by insurers. According to the latest report, in NSW in the March 2008 quarter average premium per project certificate including charges was $723, and average premium per thousand dollars of project value was $3.60 for new single dwellings and $5.27 altogether. These figures have declined steadily since 2006.[3]

5.8 The Victorian government apparently does not know what premiums are in Victoria, which is regrettable. It said 'it is understood that Victorian premiums are on average less than those in Queensland.'[4]

5.9 Vero said that 'Queensland average premium financial year 2006/07 was $688 (a 22 per cent increase on the previous year) and trending up; compare NSW calendar year 2007 of $639 (premium including charges) and trending down'.[5]

5.10 Vero is the largest HWI insurer.[6] Vero gave the committee confidential information about its own average premiums in recent years. Its figures are not the same as but are broadly consistent with the figures above.[7]

5.11 Against this, the Builders Collective of Australia provided Vero 2007 rate cards which appear to show much higher premiums: for example, a 'standard premium' of $2,029 for contract value $250-300,000 (single dwelling, category 1 (least risky) builder).[8]

5.12 These rate cards do demonstrate some inconsistency in the comparative cost of premiums by state as provided in evidence to the committee. It may be that the cards are intended as a guide rather than a firm quote, and are subject to negotiation in the individual case. These rate cards are contradicted by the weight of other evidence which the committee has no reason to doubt.

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3 'Charges' includes all commissions, government and other charges reported by the insurer. It does not include charges by brokers to the customer. The 'including charges' premium is about 30% more than the 'excluding charges' premium: p.10. The higher figure for all projects, compared with single dwellings, arises because the rate per thousand dollars is higher for things like multi-unit buildings ($5.52), additions ($7.56) and renovations ($8.51). NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - information on the scheme as at 31 March 2008,* p.9-12.

4 Victorian Government, submission 38 p.3

5 Vero Insurance Ltd, correspondence 24 July 2008 p.8.

6 Although the home warranty portfolio is less than 1 per cent of Suncorp's commercial insurance business: *Committee Hansard* 20 June 2008 (in camera), p.1

7 Vero Insurance Ltd, confidential additional information 23 June 2008, p.7.

8 Builders Collective of Australia, additional information 8 September 2008, p.13

5.13 The Builders Collective also claimed that 97 per cent builders are in category 3 (more risky, higher premiums). Vero advised that about 30 per cent of its builders are in category 1 and 30 per cent in category 2.[9]

Availability of insurance

5.14 Five insurers now offer home warranty insurance, and all insurance is mediated by brokers. Those supporting the last resort system argue that falling prices demonstrate the increasing competitiveness of the market.

5.15 Dr Silberberg of the HIA said that home warranty insurance has 'fallen off the radar' as an issue for most builders:

> We survey our members regularly and we have in excess of 40,000. We ask them what are the issues that occupy their minds, that keep them awake at night. Home warranty has dropped off the radar. For many builders it is a past issue….[10]

5.16 In response to criticisms that the demand for deeds of indemnity or bank guarantees prevents builders from entering the market, Vero advised that its use of formal security 'has never exceeded 10% of builders with HWI eligibility and the current proportion is closer to 5%':

> The Builders Collective suggest that, after the collapse of HIH and withdrawal of Dexta, Vero "took advantage" of the situation by applying a general policy that all builders must provide guarantees. This is not true. Guarantees and securities have always been used as a selective tool to underpin the eligibility requirements of builders and are often required of builders who have chosen to hold assets outside of the building entity by using trusts. At no stage has Vero's use of formal security ever exceeded 10% of builders with HWI eligibility and the current proportion is closer to 5%....[11]

5.17 Vero said in 2005 that 'security is only required if a builder does not meet the minimum financial tests of soundness such as holding net assets of 10 per cent of annual turnover.'[12] Vero told this committee it 'does not support the underwriting of trust structures without formal security from the beneficiaries as the structures are primarily designed to protect assets from attachment by creditors, including homeowners.'

> Our ability to pursue the builder [personally] is a vital aspect of all HWI schemes, including first resort schemes. Without it, builders are more likely

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9 Mr R. Joseph (Builders Collective of Australia), *Committee Hansard* 10 April 2008, p.11. Vero Insurance Ltd, correspondence 13 October 2008, p.2

10 Dr R. Silberberg (HIA), *Committee Hansard* 17 September 2008, p.7

11 Vero Insurance Ltd, correspondence 24 July p.10

12 Vero Insurance Ltd, submission 171 to VCEC Housing Regulation inquiry 2005, p.16

> to hide behind “phoenix" companies or simply walk away from their contractual responsibilities.[13]

5.18 Vero advised that recoveries from builders have never exceeded 5-6 per cent of claims paid.[14]

5.19 On the cost of a bank guarantee to the builder, Vero said: 'Many builders prefer this option rather than face the tax/trust complications associated with boosting their balance sheets/ changing their business structure.'[15]

> To use an example: If a builder’s turnover is $2million p.a., the bank guarantee is for 10% of turnover or $200,000, and the fee is 2.0% of the security or $4,000. At an average contract value of $160,000, the number of contracts in a year would be approximately 12.5 and the cost of the bank facility, spread across these contracts, would be $320 each. Set against the opportunity cost of tying up $200,000 in net assets, the price is not onerous. It is often the reason why builders choose to use securities.[16]

Financial assessment by insurers is of benefit to consumers

5.20 The Insurance Council of Australia argued that the insurer's role in scrutinising builder applicants is beneficial for the consumer:

> A key benefit for consumers of privatised home warranty schemes is that the initial eligibility assessment process aims to allow only technically competent and financially sound builders to operate.[17]

5.21 Vero argued that it is not unreasonable for insurers to have this role:

> Licensing [by government] concentrates on technical ability, transferring the assessment of financial and business risk to those better placed, ie insurers.[18]

Claims that insurers are making excessive profits

5.22 It was sometimes suggested that insurers are making excessive profits from home warranty insurance.[19] This would presumably be because of lack of competition. It was sometimes implied that this is enabled because (allegedly) home warranty

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13 Vero Insurance Ltd, correspondence 24 July p.3,10

14 Vero Insurance Ltd, confidential additional information 23 June 2008, p.61

15 Vero Insurance Ltd, confidential additional information, 23 June 2008, p.13

16 Vero Insurance Ltd, submission 171 to VCEC Housing Regulation inquiry 2005, p.16

17 Insurance Council of Australia, submission 44, p.2

18 Vero Insurance Ltd, confidential additional information 23 June 2008, p.19

19 For example, Mr R. Joseph (Builders Collective of Australia), *Committee Hansard* 10 April 2008, p.2-3

insurance is exempt from some APRA oversight that applies to other insurances (in fact this is not true, as discussed in chapter 7).[20]

5.23 In reply supporters of current last resort arrangements argued that with five insurers currently selling home warranty insurance the market is competitive, and this has led to declining prices and better value for homeowners.[21]

5.24 According to the reports of the NSW Office of Fair Trading (OFT), in recent years average premium including charges per thousand dollars of project value has been declining (for a new single dwelling, from $4.97 in June 2006 to $3.60 in March 2008.[22] On the state of competition the latest OFT report says:

> As at 31 March 2008 there were five groups of licensed insurers providing home warranty insurance in New South Wales. There appears to be competition among insurers with no one group having more than a 40% market share in providing cover for builders (in terms of reported total written premium including charges) and with each of the other groups holding between 10% and 20% of the market.[23]

5.25 The OFT reports do not show the full history of premium revenue since the present scheme started on 1 July 2002. Since June 2006 the premium written per quarter has trended down from $13.9 million to under $9.7 million including charges; from $11.1 million to $7.3 million excluding charges (the latter figure is the amount retained by the insurer for claims, expenses and profit).[24]

5.26 In relation to project certificates issued since 1 July 2002, the total claims payment to the end of 2007 has been $16 million, and insurers estimate a further $7 million payments in respect of claims already accepted.[25]

5.27 These figures do not include claims yet to be made. The NSW OFT stressed that because of the long-tail nature of the insurance (cover lasts for six years after

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20 For example, Mr G. Renouf (CHOICE), *Committee Hansard* 13 June 2008, p.22

21 For example, Insurance Council of Australia, submission 44, p.3. Housing Industry Association, submission 60, p.4,13.

22 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 March 2008*, table D2.2

23 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 March 2008*, p.9

24 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 March 2008*, p.10. Premium including charges: $13,899,000 in June 2006 quarter; $9,767,000 in March 2008 quarter. Premium excluding charges: $11,090,000 in June 2006 quarter; $7,337,000 in March 2008 quarter. 'Including charges' includes all commissions, government and other charges reported by the insurer. It does not include charges by brokers to the customer: p.9. Does not include owner builders.

25 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 December 2007*, p.15. Mr G. McCarthy (NSW Home Warranty Insurance Scheme Board), *Committee Hansard* 13 June 2008, p.74.

completion, and claims may be on foot for up to ten years) it is not possible to draw conclusions about profitability from the information to date:

> Premium collected in 2002 could still be drawn down by claims made this year. As a result of this characteristic of the scheme, the fact is that we do not know the true profitability of the written premium in 2002 and will not until at least the end of 2009 or possibly 2010.[26]

5.28 While the profile of claims development over time in the past may be a guide, it is not a reliable one, as claims vary with the business cycle: insolvencies will be more common when there is a slow down in the building industry. The long period of cover exacerbates the uncertainty:

> One of the main consequences of long tail lines of business is that deteriorations in claims experience can take some years to materialise and, if they are not properly monitored, can have a sizeable impact on the feasibility of the scheme. For example, if reserves were built up at a 60% loss ratio for 4 years and it was then discovered that the underlying loss ratio was 85%, then the best part of a full year's premium would be required to be added to the reserves. This could have a devastating impact on the capital base supporting the business.[27]

5.29 Vero gave the committee confidential information about its loss ratio on home warranty insurance business over the last ten years. The loss ratio is the ratio of claims expense to premium revenue, and is one of the key measures of the profitability of insurance. A lower figure is a better result for the insurer, with the proviso that in the case of long tail insurance the trend over a number of years must be considered. A better result in later years may be needed to pay for a worse result in earlier years.

5.30 Vero's pricing aims to achieve a predetermined loss ratio across the business cycle in order to derive the required return on capital. Vero commented that 'the 80 per cent figure that some have suggested is too high given the credit and surety nature of this product and the front-end load of resources needed to underwrite it.'[28]

5.31 Vero's results show very high loss ratios for claims from the 1997 to 2001 underwriting years (the year the policy was issued) - that is, comparing premium revenue and claims expense within the year, the insurance was very unprofitable. Loss ratios for the underwriting years 2002 onwards have been lower. Vero commented

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26 Mr G. McCarthy (NSW Home Warranty Insurance Scheme Board), *Committee Hansard* 13 June 2008, p.75

27 D. Smith, *Builders Warranty - first resort or last resort or does it really matter*, paper to Institute of Actuaries of Australia 15th general seminar, 16-19 October 2005, p.6

28 Mr P. Jameson (Vero Insurance Ltd), *Committee Hansard* 20 June 2008 (in camera), p.2. 'net loss ratio': ratio of claims to premium net of reinsurance expense and reinsurance recoveries. The different between net premiums and net claims is what the insurer retains to pay administrative expenses, commissions to brokers, and its own profit.

that a significant proportion of the premium collected during the underwriting years 2002 to 2006 was collected to pay for prior years' claims:

> Collecting premiums in later years to pay for losses from earlier years is a typical action for long-tail classes when original underwriting-year pricing proves insufficient. This is why the New South Wales scheme data for the current version of that scheme shows a gap between premiums generated and claims paid…. we are not really comparing applies with apples.[29]

5.32 Comparing with published APRA data on the public and product liability insurance classes as a whole, from 2005 to 2007 Vero's net loss ratio on home warranty insurance for those calendar (accident) years has been higher (worse for the insurer) than all insurers' results for public and product liability which, with HWI, forms part of the 'long tail' category of insurance.[30]

Committee comment

5.33 The information above does not suggest that there is overcharging or lack of competition in the market for home warranty insurance.

Claims that commissions are excessive

5.34 It was sometimes claimed that excessive commissions are charged for insurance:[31]

> There were incredible 60 or 70 per cent commissions on these policies which go back to various associations and agents.[32]

5.35 An example was given of a policy in Tasmania from 2003 which showed agents' fees of $918.80.[33]

5.36 Home warranty insurance has always been sold through brokers since it is 'a specialised commercial insurance product, with a relatively low national premium pool, which lends itself to an intermediated distribution model', according to the National Insurance Brokers Association (NIBA). About 250 brokers have business in HWI, and according to NIBA 'insurance brokers compete aggressively in the market to obtain the business of builders'.[34]

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29 Mr P. Jameson (Vero Insurance Ltd), *Committee Hansard* 20 June 2008 (in camera), p.5.

30 Vero Insurance Ltd, confidential additional information, 23 June 2008, p.7-9. APRA, *Half Yearly General Insurance Bulletins*, various years, table 7.

31 For example, Mr R. Joseph, *Committee Hansard* 10 April 2008, p.3

32 Mr R. Joseph (Builders Collective of Australia), *Committee Hansard* 10 April 2008, p.3.

33 Builders Collective of Australia, submission 20 p.2

34 National Insurance Brokers Association, submission 127 p.4-5

5.37 Vero advised that it pays commissions to brokers of 7½ to 15 per cent depending on the circumstances. Brokers perform the sales and policy issuance function, and 'commission is a substitute in the large part for management expenses…with some of the smaller brokers, where we have to do more of the work, we pay less.'[35] Vero advised that its average commission payment in the period 2003-2007 has been about 10 per cent, and commissions are generally lower in HWI than in other general insurance classes.[36]

5.38 HIA Insurance Services, the largest broker of home warranty insurance, said it receives 'an average of 15 per cent brokerage from insurance companies for this type of business.'[37]

5.39 The NSW Office of Fair Trading does not report commissions separately, but lists total premium revenue with and without charges. 'Charges' includes not only the commissions discussed above but also charges such as GST, stamp duty, government levies and credit card surcharge reported by insurers. Total premium in the March 2008 quarter was $7,337,000 excluding charges and $9,767,000 - about one third more - including charges.[38]

5.40 The figures above refer to commissions charged by brokers to insurers, which insurers pass on to the builders. Brokers may also may also charge a fee directly to the builder. In the case of the HIA Insurance Services:

> The 15 per cent commission, frankly, is not sufficient to allow us to make any profit—it costs us more to run the business than we get from commissions—so we do charge fees to clients. So our remuneration comprises two components: a commission of up to 15 per cent paid by insurance companies and a broker service charge that we charge directly to the builder.[39]

5.41 These fees are not included in the 'charges' reported by the NSW OFT, however 'based on information from insurers' the OFT believes that these fees 'are understood generally to be a flat dollar amount per certificate ranging from $50 to $400 depending on the volume of business of a particular broker with a particular builder.'[40]

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35 Vero Insurance Lt, confidential additional information 23 June 2008, p.4. Mr P. Jameson (Vero Insurance Ltd), *Committee Hansard* 20 June 2008 (in camera), p.8

36 Vero Insurance Ltd, correspondence 13 October 2008

37 Mr D. Farrell (HIA Insurance Services Ltd), *Committee Hansard* 11 August 2008 (in camera), p.5

38 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 March 2008*, p.10

39 Mr D. Farrell (HIA Insurance Services Ltd), *Committee Hansard* 11 August 2008 (in camera), p.5

40 NSW Office of Fair Trading, *NSW Home Warranty Insurance Scheme - Information on the Scheme as at 31 March 2008*, p.9

5.42 HIA Insurance Services' broker service charge to the builder varies depending on the costs associated with handling the business of the particular builder. HIAIS gave the committee confidentially figures on its highest, lowest and average charge. Both the highest and lowest figures are significantly lower than those suggested in the NSW Office of Fair Trading reports. The average figure does not support claims that commissions are excessive.[41]

5.43 On the case of the $918 agent's fee, Vero commented:

> Tasmania's owner-builder HWI regime is and always has been a first resort scheme. The nature of this insurance is retrospective in that the homes are already built and probably have been for some years. As a result, owner-builder HWI in Tasmania requires a pre-insurance inspection; which is a cost not normally needed for licensed builder HWI. The pre-insurance inspection is in all probability reflected in the $900 fee that was characterised in the evidence to the Committee as a commission.[42]

Committee comment

5.44 The committee accepts the evidence that commissions to brokers are generally within normal industry margins.

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41 Mr D. Farrell (HIA Insurance Services Ltd), *Committee Hansard* 11 August 2008 (in camera), p.5. HIA Insurance Services, correspondence 27 October 2008.

42 Vero Insurance Ltd, correspondence 24 July 2008, p8