DOMESTIC BUILDING INSURANCE PREMIUM VALIDATION REVIEW

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GLOSSARY

Actual premium	The premium charged to customers (excluding broker charges).
Book premium	The standard rates charged to customers, these are typically based on the technical premium/breakeven premium but may apply a factor (known as relativities) to differentiate policy characteristics.
Broker commission	The fee charged by a broker for facilitating the application of a project certificate.
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).
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, these companies 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.
Technical premium/Breakeven premium	The total expected cost of issuing a policy for the insurer (the VMIA), taking into account claim costs and all expenses (including the commission the distributor (QBE) charges the insurer to distribute the insurance product (DBI)).

ABBREVIATIONS

CEO	Chief Executive Officer
Commission	Essential Services Commission
DBI	Domestic Building Insurance
HGF	Housing Guarantee Fund
VMIA	Victorian Managed Insurance Authority

CONTENTS

SUMMARY

Domestic Building Insurance (DBI) is mandatory on all domestic construction contracts over $16 000 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. 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 referred to as ‘long-tail’ insurance since there can be a significant delay between when the premium is received and when a claim is made and finalised. Experience shows it is possible for claims to be made up to 11 years following issuing of a certificate. 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 claims come in.

Following the exit of five private insurers from the DBI market in 2010, the Victorian Managed Insurance Authority (VMIA) began offering DBI following an official mandate from the government. This mandate was renewed on 20 June 2013 and is due to expire on 30 June 2016. Arrangements were made with QBE to act as the distribution agent for the VMIA’s policies.[1]

[1] One private insurer, Calliden, continued to offer DBI until 31 December 2013. Since then, the VMIA has been the sole provider of DBI to registered builders. Nevertheless, the private insurers are still liable for any eligible claims against policies written before leaving the market.

THE COMMISSION'S TASK

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.

This is the second of the biennial reviews and covers the period from 1 July 2012 to 30 June 2014. It follows our first review which covered the period 1 June 2010 to 30 June 2012.

The Commission engaged Taylor Fry to provide independent, specialist actuarial advice on the VMIA's premium structure and underwriting standards. The VMIA provided Taylor Fry with actuarial and financial data, policy and premium information, which in conjunction with databases and manuals provided by the Commission, were utilised for its analysis. Taylor Fry's findings were compiled in a confidential report which, along with Commission's own experience in monitoring the DBI sector, has been used in the compilation of this report.

PREMIUM SUFFICIENCY

During the 1 July 2012 to 30 June 2014 period, premium levels were increased by 5 per cent above indexation for inflation (of 4 per cent per annum). The VMIA also changed its expense assumptions and negotiated a new agreement with QBE, which saw a reduction in the expected commissions paid.

The VMIA also made a significant increase to the capital charge component of DBI premiums. This component compensates the insurer for the capital (assets held in excess of liabilities) it requires to support the provision of this insurance product. The higher capital charge has reduced the VMIA's reliance on Government contributions but means capital is raised at a faster rate than before. This accelerated capital charge will continue until sufficient capital has been accumulated to manage the VMIA's risks associated with the DBI scheme. At this time, we would expect the capital charge to be reduced and premiums to decline to the level sufficient to cover the VMIA's ongoing expenses.

The accelerated capital charge represents a temporary pricing distortion arising from the indefinite length of time for which the VMIA will be the provider of DBI.

Overall, the VMIA's premiums are reasonable and sufficient to cover the VMIA's expenses, risks and long-term claim costs.

PREMIUM COVERAGE

Given the limited time the VMIA has been providing DBI, it has not been able to base the rating structure it uses to differentiate premiums (according to builder risk profiles) on its claims experience. The pragmatic approach adopted, was to initially use the QBE rating structure and then gradually adjust the structure based on emerging claims experience. In doing this, the VMIA has aimed to ensure that premium increases for builders are substantiated and that there is sufficient evidence to justify changes to the premium structure.

Taylor Fry's findings indicate the rating structure and assumptions the VMIA adopted at the time premiums for 2012-13 and 2013-14 were set, were reasonable and reflected the best estimates of costs that were likely to be incurred. The Commission considers that the VMIA's premiums are not set above the level required by the VMIA to cover its expenses, risks and long-term claim costs.

UNDERWRITING STANDARDS

Underwriting standards outline the criteria an insurer takes into consideration when accepting a risk or issuing a certificate to a builder. The VMIA have established a set of underwriting guidelines for QBE to follow in acting as the distributor of the VMIA's DBI product. These guidelines instruct QBE on how to rate insurance risks and the premium rates to apply.

Based on Taylor Fry's findings, we consider the VMIA's underwriting standards to be robust and appropriate in determining the relative risk of builders and in deciding whether a risk should be declined. The processes it undertakes are broadly in line with those considered appropriate in a commercial market. Because of its unique position in providing DBI, the VMIA appears to be offering cover to builders that may otherwise be declined in a more commercial environment. In doing so, however, the VMIA is actively managing the additional risk associated with these builders.

1 INTRODUCTION

1.1 WHAT IS DOMESTIC BUILDING INSURANCE?

Domestic Building Insurance (DBI) is mandatory on all domestic construction contracts over $16 000 in value[1], 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. 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. A homeowner has six years from completion to make a claim, although experience shows it is possible for claims to be made up to 11 years following the issuing of a certificate.[2]

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 claims come in.

[1] Prior to 1 July 2014, DBI was compulsory on all domestic constructions over $12 000.

[2] An insurer is liable for a claim from the time a certificate is issued at the start of a project, until 6 years after the project has been completed. Therefore, the period for which the insurer is liable varies with the length of the project. In some circumstances, a home-owner can make a claim after the liability period has expired (s.54, *Insurance Contracts Act 1984* (Cth).

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. 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. This mandate was renewed on 20 June 2013 and is due to expire on 30 June 2016. Arrangements were made with QBE to act as the distribution agent for the VMIA's policies. One private insurer, Calliden, continued to offer DBI to registered builders until 31 December 2013. Since then, the VMIA has been the sole provider of DBI to registered builders (Calliden continues to provide DBI to owner builders). 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 s. 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 its 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.

This direction was effective from 31 March 2010 to 30 June 2013. A second direction was issued effective from 1 July 2013 to 30 June 2016.

Source: Victoria Government Gazette No. S 115 Wednesday 31 March 2010 and G 25 Thursday 20 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 second of the biennial reviews and covers the period from 1 July 2012 to 30 June 2014. It follows our first review which covered the period 1 June 2010 to 30 June 2012.

1.4 THE COMMISSION'S APPROACH

The Commission engaged Taylor Fry to provide independent, specialist actuarial advice on the VMIA's premium structure and underwriting standards. The VMIA provided Taylor Fry with various actuarial and financial data, policy and premium information, which in conjunction with databases and manuals provided by the Commission, were utilised for its analysis. Taylor Fry's findings were compiled in a confidential report which the Commission has used in the compilation of this report.

This report outlines the Commission's main conclusions about the adequacy and validity of the VMIA's DBI premiums, drawing on Taylor Fry'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 the performance of the DBI scheme since 2008, and has access to data from all Victorian DBI insurers as far back as 2003. 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 per $1 000 of project value ($)
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	44.95	10 917	4.12
2013	52.90	11 609	4.56
2014 (Jan-Jun)	31.07	6 493	4.79

[a] Excludes GST, stamp duty and brokerage.

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 rate has risen back above $4. The total premium revenue collected in 2013 exceeded $50 million. However, it will not be known categorically if this was sufficient to fully cover costs until 2021 at the earliest given the long-tail nature of DBI.

The Taylor Fry advice illustrates the methodology and processes the VMIA employs to monitor its premium and claims positions. In the early years of a long-tail insurance scheme, 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 PREMIUMS

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

- **Technical premium/Breakeven premium** — the total expected cost of issuing a policy for the insurer (the VMIA), taking into account claim costs and all expenses[1].
- **Book premium** — the standard rates charged to customers, these are typically based on the technical premium but may apply a factor (known as relativities) to differentiate policy characteristics (such as a builder rating, which differentiates builders according to the risk a claim will be made).
- **Actual premium** — the premium charged to customers (excluding broker charges). The VMIA does not allow discounting so this should be the same as the book premium.

[1] The distributor (QBE) charges the Insurer (the VMIA) a commission which is included in the technical premium/breakeven premium.

Builders will also incur additional fees from brokers or building agencies which are added to the actual premium 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. The VMIA's actuarial consultants — Finity — first undertook an estimation of the required technical premium/breakeven premium in November 2010, shortly after the VMIA began writing DBI business. Its estimate was based on policy and claims information provided by Vero and QBE (who had recently exited the DBI market), Commission reports and public information about DBI markets from other jurisdictions. Finity also relied on expense projections from the VMIA in order to arrive at a breakeven premium.

In the years since the initial estimation, Finity has updated its models and estimations in regular reviews. Its updates have been based on the experience of both the VMIA, in writing DBI and on Vero and QBE for which DBI has moved into run-off (that is, where no new policies are written but the insurer is still responsible for claims on existing policies). Finity's reviews have compared the claims that were expected against those that occurred and made recommendations on changes to premiums where appropriate. Its reviews have, for the most part, made recommendations on changes to the risk premium component of the total premium. That is, the expected average claims cost per policy, excluding expenses and other loadings associated with the policy. This has left the VMIA to make changes to the expense components of the total premium.

In setting DBI premiums each year the VMIA:

- commissions advice from its actuarial consultants — Finity — in relation to the required average risk premium (the expected average claims cost per policy)
- determines the administrative and claims handling expenses to be allocated to DBI based on budgeted expenses
- determines the loading required to meet a required return on capital
- applies a loading to allow for commissions to QBE to provide underwriting service
- reviews the premium relativities (as noted above a premium relativity is a factor used to differentiate characteristics of builders according to the risk a claim will be made).

2.3 PREMIUM SUFFICIENCY

The first of Finity's reviews that are relevant to the 1 July 2012 to 30 June 2014 period was conducted in March 2012. Although there was limited claims experience for the VMIA to draw upon (19 months of data[2]), it was able to draw upon the claims experience of Vero and QBE which had moved into run-off. This data showed slightly fewer new claims reported for the period than expected (335 claims reported, compared to 348 expected), but substantially higher costs incurred than expected ($21.4 million incurred, compared to $14.5 million expected). Finity attributed this to more 'major events' triggering claims (that is, large builder insolvencies). As a result, Finity increased average claim size assumptions (around 12 per cent in excess of inflationary increases), partially offset by lower claim frequency assumptions (of 5 per cent). These changes resulted in an estimate of the cost of claims being around 7 per cent higher than previously projected.

Finity concluded that the higher than expected claims cost was closer to external benchmarks and that a 15 per cent uncertainty loading could be lowered[3]. It recommended no material change to premium levels, other than inflationary increases and changes to expense loading.

The second of Finity's reviews relevant to the 2012-2014 period, was conducted in February 2013. It found that claims experience to 30 June 2012 had been more favourable than expected. Yet claim costs in the six months to 31 December 2012 had substantially exceeded expectations (claim payments of $2.2 million had been expected, with $6 million actually paid), driven primarily by a number of medium to large sized insolvencies. Finity attributed this to a 'bringing forward' of losses that had been already allowed for. That is, claim payments were being paid earlier than expected, rather than being legitimately greater than expected. Nevertheless, the high claims costs led Finity to recommend a 5 per cent increase in the risk premium, above

[2] From 1 June 2010 to 31 December 2011

[3] The uncertainty loading was to allow for the possibility that claim costs might be higher than expected. At the point, Victoria had experienced relatively mild claim costs compared to elsewhere in Australia (especially New South Wales). Given DBI can be particularly cyclical, Finity was uncertain as to whether Victoria might experience higher claim costs in the future. Taylor Fry advised that such a loading was reasonable in this case and within the range of previous HGF claims experience.

indexation for inflation (of 4 per cent per annum[4]). In Taylor Fry's view, this recommendation was reasonable.

In addition to the risk premium increase, the VMIA also substantially changed its expense assumptions. Claims handling expenses were increased from 6 per cent to 8 per cent, based on the VMIA increasing its own management of DBI, effectively reducing QBE's role. At the same time, under a new agreement, the expected commissions to QBE were reduced. The new agreement involves a lower base commission rate, but allows for substantial performance bonuses which appear to have been below initial expectations.

At this time, the VMIA also made a significant increase to the capital charge component of DBI premiums — an amount which compensates the insurer for the 'capital' (assets held in excess of liabilities) required to support the insurance business. The VMIA targets holding assets to cover liabilities with a 75 per cent probability that actual claims costs will not exceed capital. The increase in capital charge has reduced this reliance on Government contributions to achieve this target. This was relevant as the VMIA was uncertain as to how long the Government would mandate that it provide DBI.

The higher capital charge has reduced the VMIA's reliance on Government contributions but means capital is raised at a faster rate than before. This accelerated capital charge will continue until sufficient capital has been accumulated to manage the VMIA's risks associated with the DBI scheme. At this time, we would expect the capital charge to be reduced and premiums to decline to the level sufficient to cover the VMIA's ongoing expenses.

The accelerated capital charge represents a temporary pricing distortion arising from the indefinite length of time for which the VMIA will be the provider of DBI.

Overall, the VMIA's premiums are reasonable and appropriate in meeting the VMIA's expenses, risks and long term costs.

[4] Taylor Fry advised that an assumption of 4% for the long term rate of inflation is typical for long tail classes of insurance.

CONCLUSION

Based on the actuarial advice provided by Taylor Fry, the Commission considers that the VMIA's premiums are sufficient to cover the VMIA's expenses, risks and long-term claim costs.

2.4 PREMIUM COVERAGE

Taylor Fry's findings indicate the VMIA's premiums are generally reasonable and not set above the level required to meet expenses and long-term claims costs. The assumptions the VMIA adopted at the time premiums for 2012-13 and 2013-14 were set, reflected best estimates of costs that were likely to be incurred.

It should be noted that cross-subsidies may exist between DBI policies. However, the VMIA is taking an active role in addressing these, so that over time, premiums are more closely aligned with risks.

The same premium is not charged to all builders for all types and values of works. The VMIA charges differential premiums based on the type of work (for example, structural, non-structural, multi-unit, swimming pool), the value of the work and the risk categorisation of the builder (for example, financial soundness, historical complaint experience). A rating structure of A, B and C is used to determine the premium relativities for the various risk profiles. A builder with an A rating is determined to have a lower insurance risk than a builder with a B rating, who in turn is considered to have a lower risk than a builder with a C rating.

Given the limited time the VMIA has been providing DBI, it has not been able to base the rating structure on its claims experience. The pragmatic approach adopted, was to initially use the A, B and C rating structure developed by QBE and then gradually adjust the structure based on emerging claims experience. In doing this, the VMIA has aimed to ensure that premium increases for builders are substantiated and that there is sufficient evidence to justify changes to the premium structure.

For example, changes to premium relativities in the 2012-13 to 2013-14 period have reduced the differential between the A, B and C risk rating of builders. This was based on analysis by Finity that indicated that rating C builders appeared to have lower claims than those builders of a lower risk profile — rating B. The analysis undertaken by Finity also recommended a material loading for multi-dwelling work of 50 per cent or greater, as this type of work had a higher claims frequency and higher average costs. As a result, the VMIA introduced a 25 per cent loading in 2013-14 across the entire DBI premium structure for multi-dwelling work. It held off applying a loading of a higher percentage, on the basis that premium increases needed to be fully supported by observed claims experience and that there was insufficient evidence to justify a greater increase at the time.

CONCLUSION

Based on the actuarial advice provided by Taylor Fry, the Commission considers that the VMIA's premiums are not set above the level required by the VMIA to cover its expenses, risks and long-term claim costs.

2.5 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. 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 that prices its risks inappropriately and/or accepts risks it should not, may find that it has not collected sufficient premiums to make claim payments.

The VMIA have established a set of underwriting guidelines for QBE to follow in acting as the distributor of the VMIA's DBI product. These guidelines instruct QBE on how to rate insurance risks and the premium rates to apply. QBE staff do not have any discretion to adjust or discount premiums for customers and the VMIA monitor actual premiums charged. Metrics for the correct charging of premiums were built into QBE's remuneration performance bonuses introduced in 2013-14.

Taylor Fry's findings indicate the VMIA's underwriting standards are robust and appropriate in determining the relative risk of builders and to decide whether a risk should be declined. The process it undertakes is broadly in line with that which would be considered appropriate in a commercial market.

It is a statutory requirement for registered builders to acquire DBI. By rejecting a builder's application for insurance, the VMIA effectively prevents the builder from operating. The VMIA is aware of this and has developed underwriting guidelines which minimise the likelihood of insurance being rejected. It is possible the VMIA's underwriting standards may differ, if it was not the only DBI insurer. However, the VMIA is able to manage the additional risk of accepting builders that may otherwise be declined, by placing conditions on their eligibility for DBI.[5] For example, the VMIA may impose annual turnover limits (the maximum value of building works a particular builder can undertake) based on its assessment of the value of works that a builder can prudently undertake given their financial position.

The VMIA's willingness to provide DBI cover is evidenced by the number of builders it has declined DBI. Up to the end of 2014, the VMIA had declined 102 builders. This compares to policies that have been offered to around 18 500 builders — meaning a declination rate of around 0.5 per cent. Taylor Fry advises this rate would be considered low in a commercial context, at least in the absence of material premium increases.

In summary, the VMIA's underwriting standards conform to commercial standards. While the VMIA appear to offer cover to builders that may otherwise be declined, it is aware of its role as the only DBI insurer and has the means to manage the additional risk associated with these builders.

CONCLUSION

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

[5] Taylor Fry advised that the additional risk of these builders is unlikely to have a significant impact on average premiums.

2.6 INFORMATION, METHODOLOGY AND ASSUMPTIONS USED BY THE VMIA

The available information used to set premium levels for 2012-13 and 2013-14 includes a combination of both pre-2010 data Finity obtained from QBE and Vero[6] and the VMIA's own experience with the policies it provided since its entry into the DBI market. The VMIA's own experience is still limited in setting premiums due to the long-tailed nature of DBI. The detailed policy and claims information produced by the VMIA will become more useful as it gains experience in this market.

The specific methodologies for setting premiums adopted by the VMIA (and Finity on the VMIA's behalf) are summarised as follows:

- The risk premium is estimated by Finity via selected average claims frequencies, average claim sizes, and projected expected future claims costs. Assumptions have been adjusted over time to account for new information and claims experience.
- The VMIA estimate expenses based on an allocation of budgeted expenses for DBI. The practice of allocating expenses within the organisation is standard industry practice and allows expenses to most appropriately be passed on to consumers.

We consider the assumptions adopted to be genuine best estimate assumptions without evidence of any bias to over- or under-estimation.

[6] Vero and QBE exited the Victorian DBI market in 2010