DOMESTIC BUILDING INSURANCE PREMIUM VALIDATION REVIEW

April 2017

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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 a 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.
Run-off period	The time after an insurer has stopped issuing insurance, but is still responsible for claims on existing project certificates/policies.
Technical premium/Breakeven premium	The total expected cost of issuing a project certificate or 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
IT	Information technology
VMIA	Victorian Managed Insurance Authority

CONTENTS

SUMMARY

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 home-owner 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.

Following the exit of five private insurers from the DBI market in 2010, the Victorian Managed Insurance Authority (VMIA)[2] began offering DBI following an official mandate from the Victorian government. Arrangements were made with QBE to act as the distribution agent for the VMIA's policies.

The VMIA is the main provider of DBI. A new private insurer, AssetInsure, began offering DBI to owner-builders in late 2015 and registered builders in late 2016. Aside from this insurer, no private insurers provide DBI although the insurers who exited the market are still responsible for claims made against the DBI they issued before leaving the market.

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

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

2 The VMIA is a statutory authority established by the Victorian Government and is the successor to the former State Insurance Office.

sufficient to cover claims when they are lodged. When this occurs, insurers must use other funds to cover the cost of claims.

THE COMMISSION'S TASK

The Essential Services Commission ('the Commission') was asked by the Minister for Finance in 2010, 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 (which we have termed 'premium sufficiency')
- premiums are not set above the level required by the VMIA to cover its expenses and the risks and the long-term claim costs (which we have termed 'premium coverage')
- 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.

This is the third of the biennial reviews and covers the period from 1 July 2014 to 30 June 2016. It follows from our first review which covered the period 1 June 2010 to 30 June 2012 and our second review which covered the period 1 July 2012 to 30 June 2014.

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

Premium sufficiency refers to whether premiums are sufficient to cover expenses, risks and long term claim costs. During the 1 July 2014 to 30 June 2016 period, the VMIA's DBI premiums appear to have been set at sufficient levels to cover expected expenses, risks and long-term claim costs.

The VMIA's expected average costs increased by 13.9 per cent in 2014-15 and 5.5 per cent in 2015-16. Much of these increases relate to the impact of inflation, a change in liability valuation assumptions and changes in claims costs. Also contributing to these increases was the Government mandated change in requirements for DBI on 1 July 2014[3] and the VMIA adding a fourth condition for making a DBI claim on 1 July 2015[4].

While claim costs increased, expenses — the costs associated with handling and administering claims — had ultimately decreased by the end of the review period. In 2014-15, this was driven largely by a reduction in 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. In 2015-16, much of the ultimate decrease in expenses was driven by a reduction in the commissions the VMIA paid to QBE (based on an agreement which was established in 2013-14).

[3] The amount at which DBI was compulsory on all domestic constructions, was increased from $12 000 to $16 000.

[4] The Victorian Managed Insurance Authority added a fourth condition by which a home-owner can make a DBI claim — failure to comply with a Tribunal or Court Order.

PREMIUM COVERAGE

The VMIA decided not to adjust its premiums in 2014-15 and 2015-16, even though its expenses and long terms claims costs changed during this period. The basis for this decision was to:

- Maintain premium consistency, by not adjusting premiums for small changes in expenses and claims costs. The aim was to provide builders with clarity regarding the premiums they are ultimately charged.
- Meet the anticipated future costs of developing information technology (IT) infrastructure to administer DBI, by retaining a premium surplus. While this might mean premiums were slightly higher than they would otherwise have been in 2015-16, it should reduce the need for the VMIA to raise premiums in the future.

On this basis, we consider the decision not to adjust premiums to be pragmatic and reasonable.

Given the limited time the VMIA has been providing DBI, it has not been able to base the ratings it uses to differentiate premiums (according to builder risk profiles) on its claims experience. Instead, it initially used the QBE ratings and has then gradually adjusted the ratings based on emerging claims experience. In doing this, the VMIA has aimed to substantiate premium adjustments based on sufficient evidence. While it is likely the VMIA's most recent adjustments (which occurred in the previous 2012-13 to 2013-14 review period) have been justified, this is yet to be confirmed by way of review. The Commission understands adjustments such as these will be assessed during 2017, as part of the VMIA's plans for a wider review of premiums and changes to the VMIA's distribution arrangements for DBI.

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 process it undertakes is broadly in line with that of a commercial insurer in the DBI market.

The VMIA provides DBI to some builders that could be regarded as 'higher-risk'. It manages the additional risk associated with such builders, by placing conditions on their eligibility for DBI (as commercial insurers that were prepared to accept such builders might do).

The VMIA's acceptance and management of 'higher-risk' builders is possible and appears reasonable because of its position as the main provider of DBI. It is possible another insurer that was prepared to accept higher-risk builders could enter the DBI market. In which case, the VMIA could re-assess whether it was prepared to continue accepting 'higher-risk' builders and revise its underwriting standards accordingly. If so, the impact would be observed in future premium validation reviews.

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 home-owner 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.[2] 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 project certificate which is issued to an eligible builder[3] for each building project. A home-owner 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 project certificate.[4]

A home-owner who is legally allowed to undertake building work over $16 000 in value on their property (defined as an 'owner-builder'), must also take out DBI, if they sell the property within six and a half years of completion. DBI cover for owner-builders is referred to as a policy rather than a project certificate.

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

2 Since 1 July 2015, the Victorian Managed Insurance Authority has added a fourth condition by which a home-owner can make a DBI claim — failure to comply with a Tribunal or Court Order.

3 Eligibility is a pre-approval from an insurer to take out DBI project certificates/policies. All builders are required to obtain eligibility with a DBI insurer in order to maintain their registration as a builder with the Victorian Building Authority.

4 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)).

DBI is often referred to as a 'long-tail' scheme, 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' schemes. 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 are lodged. Where this occurs, insurers must use other funds to cover the cost of claims.

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 scheme offering the same level of cover. This 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 Insurance Limited — reduced insurers' appetite for the scheme. Without a suitable form of insurance being offered, activity in the domestic building sector had the potential to be constrained.

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 the builder 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 except 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 Victorian government (see box 1.1). Arrangements were made with QBE to act as the distribution agent for the VMIA.

One private insurer, Calliden, continued to offer DBI to registered builders until 31 December 2013 and owner-builders until 31 December 2015. Since these dates, the VMIA has been the main provider of DBI to registered builders and owner-builders. However, a new private insurer, AssetInsure, began offering DBI to owner-builders in late 2015 and to registered builders in late 2016. Aside from this insurer, no private insurers provide DBI to either registered builders or owner-builders, although they are still liable for any eligible claims made against DBI project certificate/policies they issued 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. A third direction was issued effective from 1 July 2016 to 30 June 2021.

Source: Victoria Government Gazette No. S 115 Wednesday 31 March 2010, G 25 Thursday 20 June 2013 and G 50 Thursday 17 December 2015.

1.3 WHAT THE COMMISSION HAS BEEN ASKED TO DO

The Essential Services Commission ('the Commission') was asked by the Minister for Finance in 2010, 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 third of the biennial reviews and covers the period from 1 July 2014 to 30 June 2016. It follows our first review which covered the period 1 June 2010 to 30 June 2012 and our second review which covered the period 1 July 2012 to 30 June 2014.

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	27.4	6 839	4.00
2006	28.3	8 035	3.52
2007	27.3	8 779	3.11
2008	25.2	8 954	2.81
2009	32.0	10 718	2.98
2010	39.7	12 195	3.25
2011	42.3	12 059	3.51
2012	44.9	10 917	4.12
2013	52.9	11 609	4.56
2014	65.9	13 828	4.76
2015	73.9	15 750	4.69
2016 (Jan-Jun)	39.5	8 684	4.54

[a] Excludes GST, stamp duty and brokerage.

As table 2.1 shows, insurers were collecting $4.00 in premium for every $1000 in domestic construction in 2005. In the following years, this rate fell so that by 2008 and 2009, insurers were receiving less than $3.00 for every $1000. In 2010, all except one of the private insurers left the market, claiming it was unprofitable for them to continue offering DBI. The exit of insurers suggests the $3.25 per $1000 insurers were receiving in premiums at the time was insufficient to remain in the market. Since the VMIA started providing DBI, the premium rate has risen back above $4.00. The total premium revenue collected in 2015 exceeded $70 million. However, it will not be known categorically if this was sufficient to fully cover costs until 2023 at the earliest given the long-tail nature of DBI.

The Taylor Fry advice outlines 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, this advice is important in providing the Commission with assurance 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 concepts to consider in 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 for the insurer of issuing a project certificate or policy, 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 project certificate/policy characteristics (such as a builder rating, which differentiates builders according to the risk a claim will be made).

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

- **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.

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 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 (previous private providers of DBI who exited the DBI market by 2010), 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 project certificates/policies are written but the insurer is still responsible for claims on existing project certificates/policies). Finity's reviews have compared the claims that were expected against those that occurred and made recommendations on changes to premiums where appropriate.

Prior to 2014-15, Finity's reviews made recommendations on changes to the claims cost component of the breakeven premium. That is, the expected average claims cost per project certificate/policy, excluding expenses and other loadings associated with the project certificate/policy. However, for 2014-15 and 2015-16, Finity also recommended changes to the expense components of the breakeven premium.

In setting DBI premiums, the VMIA uses Finity's advice to:

- determine the administrative and claims handling expenses to be allocated to DBI based on budgeted expenses
- determine the loading required to meet a required return on capital
- apply a loading to allow for commissions to QBE to provide underwriting service

- review 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 VMIA's DBI premiums appear to have been set at sufficient levels to cover expected expenses, risks and long-term claim costs from 2014-15 to 2015-16. This is indicated by Taylor Fry's assessment of the VMIA's average breakeven premium during this period, as being reasonable and in line with previous costings.

In terms of the claim costs component of the breakeven premium, that is the amount insurers pay-out in claims, Finity estimated the VMIA's expected average costs to have increased by 13.9 per cent in 2014-15 from the previous financial year. This increase relates to:

- the impact of Government mandated changes to the requirements for DBI that increased the maximum claim cap from $200 000 to $300 000 and raised the threshold on which DBI is mandatory for construction contracts from $12 000 to $16 000
- a change in liability valuation assumptions
- the impact of inflation.

Finity then estimated the VMIA's expected average costs to have increased by 5.5 per cent from 2014-15 to 2015-16, which relates to:

- the impact of the VMIA adding a fourth condition by which a home-owner can make a DBI claim — failure to comply with a Tribunal or Court Order
- a change in estimates of undiscounted cost of claims
- the faster than expected settling of claims, which resulted in a small increase in discounted claims costs
- the impact of inflation.

While claim costs increased, expenses — the costs associated with handling and administering claims — had ultimately decreased by the end of the review period. In 2014-15, much of this was driven by a reduction in 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 was able to reduce the capital charge, as it had previously been accumulating capital to reduce its reliance on Government contributions. As the VMIA accumulates sufficient capital to manage the risks associated with the DBI scheme in the future, we would expect the capital charge to be reduced even further.

In 2015-16, much of the ultimate decrease in expenses was driven by a reduction in the commissions the VMIA paid to QBE, to distribute DBI on its behalf. The reduction is likely due to an agreement the VMIA established with QBE in 2013-14, which included a lower base commission rate and performance bonuses.

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

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

Overall, Taylor Fry's findings indicate the VMIA's premiums are reasonable and not set above the level required to meet expenses and long-term claims costs.

NO PREMIUM ADJUSTMENT DURING REVIEW PERIOD

The VMIA decided not to adjust its premiums in 2014-15 and 2015-16, even though its expenses and long terms claims costs changed during this period. There are two reasons for this decision. The first is the due to the VMIA's aim of maintaining premium consistency by not adjusting premiums for small changes in expenses and claims costs. This aim was to provide builders with clarity regarding the premiums they are ultimately charged.

The second reason for the VMIA's decision not to adjust premiums, relates to the anticipated future costs of developing information technology (IT) infrastructure to administer DBI, with the VMIA having received a longer, 5-year, mandate to provide DBI from the Government in late 2015. The VMIA plans to pay for these anticipated future costs using a surplus in premium revenue, which it will retain, should the amount it receives in revenue exceed its costs and expenses. Indeed, the VMIA is likely to have generated a surplus in 2015-16, although the actual surplus will not be known for some time (until it has paid out claims on project certificates/polices issued in 2015-16). On current estimates though, it appears the VMIA could have adjusted DBI premiums downwards by 8 per cent, had it not decided to retain a surplus. While this might mean premiums are slightly higher than they would otherwise have been, it should reduce the need for the VMIA to raise premiums in the future, depending on the extent to which any surplus generated in 2015-16, covers the anticipated costs of developing IT infrastructure.

Given the need for premium consistency and the anticipated future costs, we consider the decision not to adjust premiums in 2014-15 and 2015-16 to be pragmatic and reasonable.

PREMIUM RELATIVITIES

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 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.

Although the VMIA has been providing DBI since 2010, it has not been able to fully base ratings on its claims experience. The pragmatic approach adopted, was to initially use the A, B and C ratings developed by QBE and then gradually adjust the ratings based on emerging claims experience. In doing this, the VMIA aimed to ensure that premium increases for builders were substantiated and that there was sufficient evidence to justify changes to premiums.

The most recent changes relevant to the 2014-15 to 2015-16 review period, occurred during the previous 2012-13 to 2013-14 review period, in which the Commission noted possible cross-subsidies between DBI project certificates/policies. During the previous period, the VMIA made changes to the premium structure, so that over time, premiums would be more closely aligned with risks. For example, changes to premium relativities 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 for multi-dwelling work. While it might have applied a loading of a higher percentage, it chose not to 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.

While it is likely the VMIA has reduced cross subsidies as a result of changes in the 2012-13 to 2013-14 period, this is yet to be confirmed by way of review. However, VMIA staff informed Taylor Fry of the VMIA’s plans for premium relativities to be assessed during 2017, as part of a wider review of premiums and changes to its distribution arrangements for DBI. In which case, the VMIA could use this opportunity to identify and address any cross subsidies that remain within their DBI premium structure.

CONCLUSION

While there may have been scope for the VMIA to have reduced premiums during the review period, the Commission agrees with Taylor Fry's observations about the need for premium consistency and the anticipated future costs of developing IT infrastructure to be a pragmatic and reasonable basis to have left DBI premiums unchanged. As such, the Commission is satisfied 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 of a commercial insurer in the DBI market.

In commercial insurance markets, there is often a difference between insurers, in terms of the level of risk they are willing to accept from prospective insurance applicants. While most insurers will accept low-risk applicants, some may not be prepared to accept 'higher-risk' applicants. Other insurers, however, might be prepared to do so. In return for accepting the additional risk associated with 'higher-risk' applicants, these insurers may place stricter conditions on the applicants and/or charge a higher premium.

The VMIA provides DBI to some builders that could be regarded as 'higher-risk'. By providing cover to these builders, the VMIA's underwriting standards could be considered to be in line with that of commercial insurer that was prepared to accept the additional risk associated with 'higher-risk' builders (rather than in line with that of a commercial insurer that was not prepared to accept the additional risk).

The VMIA manages ‘higher-risk’ builders, by placing conditions on their eligibility for DBI.[2] 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 acceptance and management of ‘higher-risk’ builders is possible and appears reasonable because of its position as the main provider of DBI. It is also a statutory requirement for registered builders to acquire DBI, so rejection by the VMIA, AssetInsure and Calliden notwithstanding, effectively prevents builders from operating. The VMIA is aware of this and has developed underwriting guidelines which allow for ‘higher-risk’ builders to be accepted, where it is feasible.

It is possible another insurer that is prepared to accept higher-risk builders, may enter the DBI market at some point in the future.[3] If this were to occur, the VMIA could re-assess whether it was prepared to continue accepting ‘higher-risk’ builders and revise its underwriting standards accordingly. The impact of such changes would be observed in future premium validation reviews.

It should also be noted that even though the VMIA is the main provider of DBI, it may decline to insure, if it determines the additional risk associated with ‘higher-risk’ builders is too high. Up to February 2017, the VMIA had declined 314 builders. This compares to approximately 15 700 eligible builders and around 50 000 to 60 000 project certificates/policies written per year. While Taylor Fry advises this declination rate could be considered low in a commercial context, they advise it is not inconsistent with their overall findings of the VMIA’s underwriting standards being robust and appropriate.

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

[3] AssetInsure could be just such an insurer, although this will remain to be seen as it has only recently entered the DBI market.

CONCLUSION

Based on the actuarial advice provided by Taylor Fry, the Commission considers the VMIA's approach to underwriting appropriate and broadly in line with that of a commercial insurer in the DBI market.

2.6 INFORMATION, METHODOLOGY AND ASSUMPTIONS USED BY THE VMIA

The available information used to set premium levels for 2014-15 and 2015-16 includes a combination of both pre-2010 data Finity obtained from QBE and Vero[4] 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 continues to gain direct experience in this market.

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

- The claims costs are estimated 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.
- Expenses estimates are 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.

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