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# PERFORMANCE OF VICTORIA'S DOMESTIC BUILDING INSURANCE SCHEME 2010-2011

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# EXECUTIVE SUMMARY

Domestic building insurance (DBI), also known as builders' warranty insurance, is a mandatory insurance for all domestic construction contracts over $12 000 in value. DBI compensates a home-owner for losses resulting from non-completion or defects in domestic building work where the builder cannot be pursued directly for redress because they have died, disappeared, or become insolvent.

The ESC has Terms of Reference to monitor and report annually on the pricing and claims management of this insurance. Insurers provide the ESC with quarterly data on claims, premiums and builder eligibility to enable analysis of their performance. This data is not audited and the Commission relies on insurers providing accurate data.

The current scheme was introduced in 2002, with the insurance provided by five competing private insurers. In the last two years, all but one of the private insurers has left the DBI market, and since May 2010, the State Government has been supplying the majority of policies through the Victorian Managed Insurance Authority (VMIA).

Aside from the loss of competition, there have been no other significant changes to DBI, or the wider framework of consumer protection in the domestic building sector. Private insurers are still liable for claims against the policies they wrote before leaving the market.

The Commission's report on DBI examines performance from five different perspectives:

- DBI scheme performance (chapter 2) combines data on premium revenue and claim costs to give a picture of DBI profitability.
- Builder eligibility (chapter 3) discusses the processes required for registered builders to be able to access the product.
- Project certificates and premiums (chapter 4) studies the demand for DBI in terms of different types of building projects, and discusses the costs of DBI coverage.
- The frequency of claims and the costs faced by insurers to pay compensation are examined in chapter 5.
- DBI arrangements for owner builders are covered in chapter 6.

An increase in builder insolvencies — brought on in part by the Global Financial Crisis (GFC) — has resulted in an increase in DBI claims. This has affected the profitability of the scheme, and was cited by private insurers as a reason to stop offering the product.

Nevertheless, builders did not suffer from a lack of access to DBI after the exit of private insurers. The statistics on project certificates (individual DBI policies specific to a building contract) show that there has been no slow-down in the demand for DBI. Premium rates have risen since their lowest point in 2009. VMIA, which is committed to transparency, publishes its rates.

The Commission has not been able to assess the overall cost of the DBI scheme on the domestic building industry because of the absence of data about the cost of brokerage.

The Commission's analysis reveals that the rate of claims against DBI policies is rising, as is the cost of an average claim. However, the actual incidence of claims is very low in the context of the number of project certificates issued. For the first time, the report includes data on the average turnaround time for DBI claims, which is just under two years.

The majority of claims made against registered builders are for insolvency. Owner builders are not registered builders, yet are entitled to manage construction on their own property. A special class of building permit is issued to an owner builder, and DBI is only required if they sell the property they built or renovated within six and a half years of completion. Only about ten per cent of owner builder activity requires DBI. The rate of claims against owner builder policies is higher than registered builders, and the main reason for claims is disappearance. Premiums are higher for owner builders, reflecting the higher claims incidence.

# 1 INTRODUCTION

Most people are familiar with insurance. Generally it brings to mind a house and contents policy, or the experience of comparing car insurance products. Indeed, home and vehicle insurances make up nearly 50 per cent of the Australian market.[1] DBI is an obscure product, and the majority of the population will go through life without ever hearing of it.

This report was written assuming a certain base level of experience with Domestic Building Insurance (DBI). For someone new to this sector, this introduction aims to provide you with the basic background and vocabulary you will need to understand this report. Abbreviations and terms included in the glossary are in italic.

DBI compensates a home-owner for losses resulting from non-completion or defects in domestic building work where the builder cannot be pursued directly for redress because they have died, disappeared, or become insolvent. These three triggers are collectively abbreviated as ***DDI***. DBI is known as a ***last resort*** insurance scheme as it is only available where all other avenues for resolution have been exhausted. A ***first resort*** scheme provides compensation for defects even if the builder is still trading.

## 1.1 Eligibility

All builders are required to have ***eligibility*** with a DBI insurer in order to maintain their registration with the ***Building Practitioners Board*** (BPB). Eligibility is like pre-approval from an insurer to take out DBI policies. Insurers use the eligibility process to evaluate the financial position of the builder and impose an annual ***turnover limit*** which is their assessment of the maximum value of building projects the builder can take on without risking insolvency.

## 1.2 Project certificates and premium

In Victoria, DBI cover is compulsory for all domestic building works with a contract value over $12 000. When a contract for the work has been agreed, the builder takes out a DBI policy known as a ***project certificate*** on behalf of the customer. The ***project certificate*** is specific to the work in the associated contract. A ***premium*** is calculated by the insurer based on the contract value, and is paid by the builder.

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[1] As measured by net earned premium. APRA Statistics Quarterly, September 2011.

## 1.3 Owner builders

A home owner is legally allowed to manage building work on their property as an ***owner builder*** subject to certain regulatory requirements. Owner builders are not registered builders, and must obtain consent from the Building Commission to do any work with a value over $12 000. Owner builders do not require DBI to commence work, but must take out a policy to cover defects if they sell the property within six and a half years of completion. DBI cover for owner builders is called a 'policy' rather than a ***project certificate***.

## 1.4 History and background

Table 1.1 **Developments in DBI in Victoria**

| *Date* | *Event* |
|---|---|
| Jul 1984 | HIA & MBAV builders warranty schemes combine to create the Housing Guarantee Fund (HGF) |
| Jun 1996 | HGF replaced by mandatory first resort scheme provided by private insurers |
| Mar 2001 | HIH collapse |
| Sep 2001 | September 11 terrorist attacks unsettle insurance markets |
| Jul 2002 | New mandatory last-resort scheme introduced underwritten by competing private insurers |
| Oct 2005 | Final report — VCEC Inquiry into regulation of the housing construction sector and related issues |
| Jul 2009 | CGU and Lumley exit the DBI market |
| Feb 2010 | Vero — the market leading private insurer offering DBI — exits the market |
| Mar 2010 | Victorian Government announces underwriting of DBI scheme through the VMIA |
| May 2010 | Arrangements made with QBE to act as agent issuing DBI cover underwritten by VMIA |
| | One private insurer — Calliden — remains in the market |
| Oct 2010 | Final report — Parliamentary inquiry into Builders Warranty Insurance |

Each state in Australia has its own arrangements for DBI (see appendix). Victoria operated a ***first resort*** scheme — the Housing Guarantee Fund — between 1984 and 1996. This was replaced by a new first resort scheme underwritten by ***private insurers*** until 2002 when the arrangements were altered to a ***last resort*** scheme, still provided by the private insurance market.

Recently there has been significant uncertainty in the DBI market in Victoria with all but one of the ***private insurers*** ceasing to issue ***project certificates***. Since June 2010 the Victorian Government has been underwriting DBI through the Victorian Managed Insurance Authority (VMIA).

## 1.5 Claims

A home-owner can notify insurers of a DBI claim up to six years from the completion of the building project.[2] DBI is referred to as a ***long tail*** insurance because of the protracted period faced by insurers between charging a premium and knowing the cost of claims. This is distinct from home contents policies or car insurance where premiums are calculated annually and the ***claims liability*** is generally known within a few months of the year's end. Insurers earn ***investment returns*** on the premium pool while they wait to pay out claims. In a long tail insurance this revenue can be significant over the years it takes for claims to develop.

The period of time that insurers must consider claims against a policy is known as the ***liability period***. Home-owners have six years after the completion of domestic building work to notify insurers of a claim. For its analysis, the Commission assumes that construction is complete 12 months after the Certificate Issue date, but the construction of a domestic dwelling could take three years while a renovation could be completed in two or three months. Insurers do not collect completion times from builders.

There is no limit in legislation on the time that can elapse between notification of a claim and the submission of information required to open a claim. Over 90 per cent of claims to date have been received within 90 days of the first notification, but the potential exists for closed notifications to be re-opened for assessment years after being received by an insurer.

It is difficult to calculate the exact length of the liability period on a project certificate given that the construction period varies and notifications can be re-opened. The Commission considers seven years to be a reasonable assumption for analysis, accepting insurers' comments that the liability period could feasibly extend to ten years. To date, a very small percentage of claims have been lodged more than seven years beyond the certificate issue date.

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[2] Claims for 'failure to commence' or 'failure to complete' can be made if the builder is DDI before the project is completed.

The private insurers are still liable for claims on the project certificates they issued before they left the market. This is known as a ***run-off period***, and will continue for the next six or seven years as claims are made by home-owners against project certificates issued before the insurers left the market.

To understand DBI procedures described in the report there are several key dates used to track a claim's progress. Insurers provide this data to the Commission for all claims on a quarterly basis.

### Table 1.2 Key dates in the DBI claim process

| *Date* | *Description* |
|---|---|
| Certificate Issue Date | The date the project certificate is issued by the insurer. This is at the commencement of construction. This date is also known as the 'underwriting date' as it is the point where the premium is charged. |
| Loss Date | The date a claimant became aware of a defect or failure. This date is supplied by the claimant. |
| Notification Date | The date the insurer first receives notification in writing of a potential claim. These 'notification only claims' can be escalated into claims on provision of minimum information. If the notification has not been escalated within 90 days it is closed on the insurer's system, but can be re-opened at any time. |
| Claim Received Date | The date the insurer receives the minimum information required to open a DBI claim on their system. |
| Liability Decision Date | The date the insurer made the decision to accept or deny a claim. If no decision is made within 90 days, the claim is deemed to be accepted. |
| Claim Finalised Date | The date the claim was closed on the insurer's system with all costs paid out. |

## 1.6 Glossary

| | |
|---|---|
| ***Builders warranty insurance*** | This is another name for Domestic Building Insurance. |
| ***Building Commission*** | A statutory authority that oversees the building control system in Victoria. |
| ***Building Practitioners Board*** | The licensing arm of the Building Commission. |
| ***Claims liability*** | The cost of a claim to an insurer. This includes money paid out as well as estimates of future costs. |
| ***Domestic building insurance*** | A mandatory insurance that compensates home owners for structural faults where the builder is unable to rectify the works because they have died, disappeared or become insolvent (also referred to as Builders Warranty Insurance). |
| ***Eligibility*** | Pre-approval from an insurer for a builder to be issued project certificates. |
| ***First resort*** | An insurance scheme that covers all structural faults regardless of the builder's circumstances (as opposed to a last resort scheme). |
| ***Investment returns*** | The revenue earned by an insurer by investing premium revenue. |
| ***Liability period*** | The period time that an insurer is liable for claims on a policy. |
| ***Long tail insurance*** | Describes insurance products where the full cost of claims is not known for a long time after the premium is charged. |
| ***Owner builder*** | A home owner who is managing construction on their own property in place of a registered builder. |
| ***Premium*** | The charge for insurance coverage. |
| ***Private insurers*** | Independently trading insurance companies that compete in the market. Generally they are publicly listed entities, trading for profit. |
| ***Project certificate*** | For registered builders, DBI coverage is issued in the form of a project certificate which 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 policies. |
| ***Turnover limit*** | An insurer's calculation of a builder's capacity to undertake work. This is the total value of construction works that an insurer will issue certificates for in a twelve month period. |
| ***VMIA-Victorian Managed Insurance Authority*** | A statutory body which operates as the 'captive insurer' for the State of Victoria. |

# 2 OVERVIEW OF THE DBI SCHEME

**KEY POINTS**

There has been significant structural change in the DBI market in recent years. An increase in builder insolvencies — apparently brought on by the GFC — has resulted in an increase in claims. This has caused the withdrawal of all but one private sector insurer in the market. The Victorian Government now underwrites the majority of the market for this type of insurance.

The loss ratio is a leading indicator of the viability of the DBI scheme, and has risen to high levels in recent years. Claims costs already represent 43 per cent of premium for project certificates issued in 2008, with more than half the liability period remaining.

The Commission's analysis suggests that insurers are likely to face a peak in structural damage claims over the next three years, and the claims will become more costly.

The Domestic Builder's Insurance (DBI) scheme, like all insurances, can be understood as a pooling of the risk of uncertain future events. Builders pay a premium on behalf of property owners. These funds are held by an insurer and used to compensate the owner in the event that the construction is defective and the builder has died, disappeared or become insolvent (DDI).

Insurers have to predict the chances of a claim being made and the likely costs associated with claims in order to set a premium which will cover their risk. Insurers bear the commercial risk if they have underestimated the frequency and cost of claims. DBI claims can be lodged long after the policy has been taken out and paid. The insurance is compulsory by law. Insurers spread the risk across the entire domestic building sector. Claims are relatively infrequent, although rates are rising. Certificates written recently have long liability periods remaining. Since 2002, 1833 claims have been accepted by insurers.

The financial viability of the DBI scheme rests on several factors which affect the premium pool and the size and frequency of claims.

## 2.1 Victoria's DBI scheme

Between 2002 and 2010, DBI was offered by five competing, private sector insurers. DBI is mandatory and the terms of cover are governed by legislation. Insurers competed on premiums and service, and builders were free to choose their insurer. By April 2010, all but two of the insurers had withdrawn from the market. The Victorian Government intervened to underwrite the scheme through the Victorian Managed Insurance Authority (VMIA). QBE ceased writing DBI at this time but acts as the agent for VMIA. Calliden continues to offer DBI. Private insurers who withdrew from the market are still liable for claims against the certificates they issued.

## 2.2 Risks in DBI

Insurer risk in DBI derives from a combination of factors. To date, over 90 per cent of claims are the result of a builder becoming insolvent, making it by far the most important issue for insurers to consider. Before a builder can take out a DBI project certificate, they must have been granted 'eligibility' by an insurer which involves an assessment of the builder's finances. Insurers can use this process to mitigate against some of the specific risks of insolvency by an individual builder. Broader economic factors influence the rate of builder insolvency and consequently the costs faced by an insurer in paying claims. Examples of these factors are split into 'specific' and 'systemic' risks in table 2.1.

To address specific risks, insurers can classify builders and projects into grades, and charge higher or lower premiums depending on the builder's rating and the type of construction. This is described in more detail in chapter 4.

Systemic risks, which strike more broadly, are harder to manage through premium setting. Insurers cited economic factors as the main reason for their withdrawal from the DBI market. The impact of the GFC and uncertainty surrounding the domestic housing market prompted CGU, Lumley and Vero to cease writing DBI by early 2010. Insurers faced an unexpected increase in the rate of claims, and withdrew on the basis that the product was becoming unprofitable.

Table 2.1 **Risk factors facing DBI insurers**

| | |
|---|---|
| **SPECIFIC RISKS** | |
| Builder's financial position | A builder with a precarious financial position has a greater chance of becoming insolvent than a builder in a very healthy position. |
| Builder's financial history | A builder with a history of poor financial management is typically considered more likely to become insolvent. |
| Type of project | Some types of jobs have a history of higher claims costs. Eg. Swimming pool construction vs Non-structural renovations. |
| Quality of builder's work | A builder whose work is technically competent is less likely to generate claims costs for defects even if they are DDI. |
| **SYSTEMIC RISKS** | |
| Domestic real estate market | A downturn in domestic building activity could lead to a rise in the rate of builder insolvencies. |
| Availability of credit | Builders rely on credit to manage their cash flow and supply of materials. A tightening of creditor requirements could push some entities toward insolvency. |
| Cost of materials | Increases in the cost of materials can affect builders' finances and the costs to the insurer of paying out claims. |

## 2.3 Indicator of scheme performance

The most commonly used measure of an insurance scheme's viability is the loss ratio. This is calculated as claims losses[3] divided by the total earned premium. In a long-tail insurance like DBI, it is hard to calculate this figure until the full liability period has expired, which takes a minimum of six years.[4] Insurers set a premium based on an assumed loss ratio and build up reserves to satisfy this level of claims costs. If the assumption proves too low, additional funds need to be found either by increasing rates on future policies or drawing on capital reserves.

Table 2.2 shows the progressive loss ratios for the scheme since 2002. For the years after 2005 it is important to take into account that there are still several years remaining in which further claims will be paid out. The ratios

[3] Claims losses include monies paid out to date, plus estimates of future payments on any open claims.

[4] As explained in the introduction, the liability period can extend beyond the Commission's assumption of seven years.

between 2007 and 2009 are as high or higher than in earlier years, despite having more years of the liability period remaining. Coming into 2009, insurers would have recognised that the loss ratio was climbing compared to prior years, and chose to exit the market rather than raise premiums to the level required to cover the additional claim costs. The simple loss ratio in this table does not account for operational costs faced by the insurer, or investment returns earned on premium.

Table 2.2 **Simple loss ratio**
All insurers — registered builder and owner builder combined

| *Year* | *Project certs & policies issued* | *Premium (excl. charges) ($000)* | *No. of claims accepted*[a] | *Net Incurred costs*[b] *($000)* | *Years*[c] *of liability remaining* | *Loss ratio* |
|---|---|---|---|---|---|---|
| 2002 | 17 731 | 10 661 | 98 | 4 017 | 0 | 38 |
| 2003 | 40 305 | 27 521 | 242 | 8 287 | 0 | 30 |
| 2004 | 34 720 | 27 536 | 233 | 9 630 | 0 | 35 |
| 2005 | 46 975 | 31 986 | 338 | 13 989 | 1 | 44 |
| 2006 | 53 142 | 32 119 | 265 | 10 200 | 2 | 32 |
| 2007 | 54 690 | 30 574 | 326 | 10 337 | 3 | 34 |
| 2008 | 53 113 | 27 650 | 325 | 11 837 | 4 | 43 |
| 2009 | 61 555 | 34 251 | 225 | 12 972 | 5 | 38 |
| 2010 | 65 101 | 41 881 | 63 | 3 911 | 6 | 9 |
| 2011 Jan-Jun | 33 934 | 21 614 | 1 | 93 | 7 | 0 |

[a] Excludes notification only claims, and claims denied. Claims have been assigned to the year in which the project certificate was issued. [b] Includes payments made plus estimated future costs including costs of claims denied. [c] Assumes 12 month construction plus 6 year liability period.

At first glance, the current situation appears somewhat disquieting. Claims costs already represent 43 per cent of premium for 2008, with more than half the liability period remaining. Competition for DBI was strong at this time, and average premium rates were at their lowest (see chapter 4). If claims continue at the current rate, it suggests that the private insurers (most of whom have already left the market) will face costs greater than the value of the premium pool. The Commission will continue to monitor claims data for evidence that insurers are not minimising claims losses at the expense of claimants' rights (See chapter 5).

As shown in table 2.2, while claims rose after 2006, the number of certificates being issued did not slow down. This would indicate that it was not a slowdown in the domestic building industry driving the trend in claims.

Since the current scheme began in January 2002, over 400 different builders have had claims successfully lodged against them for insolvency. Between the middle of 2007 and the end of 2010 there were several large scale insolvencies in the domestic construction sector, generating hundreds of claims and millions of dollars in costs. Indeed, the ten most costly insolvencies to date represent 2.5 per cent of total builder insolvencies, but account for 20 per cent of total claims accepted and 29 per cent of the net incurred costs of the scheme (see table 2.3).

Table 2.3 **Builder insolvencies**
January 2002-June 2011

| *Ranking* | *No. of claims accepted* | *Amt paid to June 2011 ($000)* | *Outstanding estimate ($000)* | *Net incurred costs ($000)* |
|---|---|---|---|---|
| Top 10 | 417 | 15 856 | 8 334 | 24 190 |
| Other insolvencies[a] | 1 457 | 4 406 | 11 452 | 51 858 |
| All other causes [b] | 242 | 4 705 | 1 490 | 6 194 |
| TOTAL | 2 116 | 60 967 | 21 276 | 82 242 |

[a] Registered builder only. [b] Includes all owner builder claims.

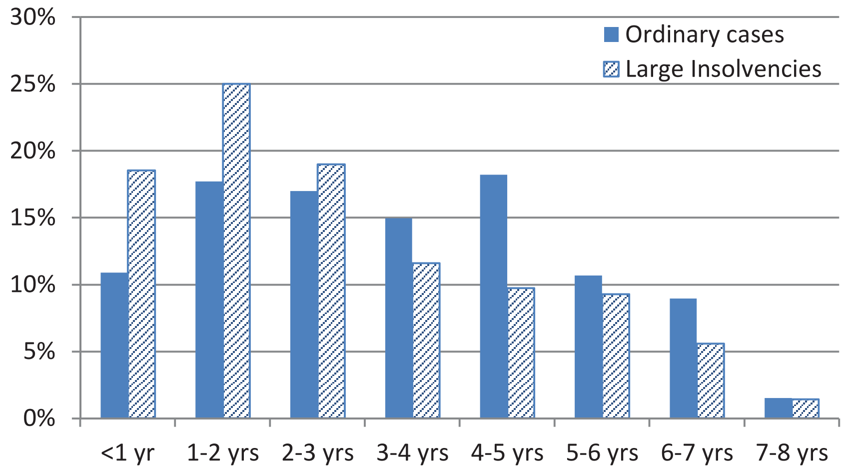
The run of large insolvencies between 2007 and 2010 are likely the result of a tightening of the credit market. The withdrawal of builders does not appear to have affected the rate of project certificates being issued. Building companies with robust finances were able to continue accessing credit under the more rigorous terms that were presented, and picked up the business from those who ceased trading.

Insurers that have withdrawn from the DBI market are no longer earning premium income, and thus have a finite source of funds to meet future claims costs before losing money.

## 2.4 Claim development over time

Insurers are liable for claims for six years after a project is completed. Analysis in past reports has suggested that, on average, claims peak three to five years after the issue of project certificates and taper off to almost nothing after seven years. Further Commission analysis for this report shows that the pattern of claim development over time is different in a large insolvency[5] than in other, ordinary, cases. In large insolvencies, 44 per cent of claims are notified within two years of the project certificate date. For smaller entities claims are slow in the first 12 months, but come in consistently for the next four years. After six years, more than 90 per cent of claims have been received in all cases.

Figure 2.4 **Claim development from certificate issue date**
Claims against certificates issued before 1 January 2007 [a]




[a] Certificates issued before 2007 are at least five years into their liability period which was considered sufficient for analysis.

There are several factors which help to explain this difference. Large insolvencies have a higher proportion of claims for 'failure to complete' or 'failure to commence' than ordinary cases which are made close to the certificate issue date. Some large builders have dozens of projects underway when they suddenly cease trading. In the case of smaller builders, it can take a long time for their status as DDI to be established, which can delay the development of claims. Construction entities of significant size which become insolvent are far more rapidly flagged by ASIC, the BPB, and creditors. With a small entity, claimants may have to instigate lengthy proceedings in VCAT to establish their builder is DDI which delays the development of claims.

[5] The Commission defines a 'large insolvency' as a case of a single builder that generates more than 15 claims, or over $1 million in net incurred costs.

## 2.5 Cost of claims over time

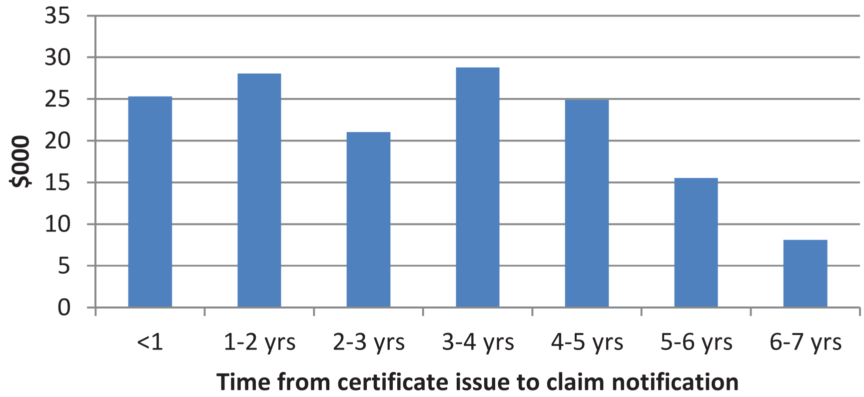
Based on the 1328 claims that have been accepted and finalised to date, the average cost of a DBI claim is $32 001, but the costs differ significantly by claim type.

Table 2.5 **Average claim cost by claim type**
Finalised claims 2002-2011

| *Category* | *No. of claims* | *Net Incurred costs ($000)* | *Average cost per claim ($)* |
|---|---|---|---|
| Failure to commence | 59 | 1 111 | 18 839 |
| Failure to complete | 435 | 21 212 | 48 763 |
| Structural defect | 461 | 9 503 | 20 615 |
| Other (non-structural) defect | 373 | 10 671 | 28 608 |
| **Total** | **1 328** | **42 498** | **32 001** |

Claims for 'failure to complete' are the most costly to insurers, but do not vary much over time and are paid and completed within two or three years of the certificate being issued. Structural and non-structural defect claims continue to be lodged long after a certificate's issue, and the cost changes over time. On average the cost of defect claims is highest three to four years after the certificate issue date. A fault may become more costly to repair the longer it is left before being rectified.

Figure 2.6 **Average cost of defect claims over time**
Finalised claims




Using the data on claim development and costs, insurers are likely to face a peak in defect claims over the next three years, and the claims will become more costly. The Commission's analysis (see section 2.3) suggests that insurers' loss ratios may exceed 100 per cent for the years after 2007. According to its website, VMIA projects a 94 per cent loss rate for 2011-12, based on projected claims costs, operational costs and returns from the investment of premium.

# 3 ELIGIBILITY

**KEY POINTS**

Proof of DBI eligibility is required for a builder to maintain their licence. Following the withdrawal of private sector insurers, the Victorian Government has underwritten the scheme since June 2010 through the VMIA (in arrangement with QBE). As a result, the withdrawal of insurers does not appear to have had an impact on the ability of builders to obtain DBI eligibility.

Because DBI insurers do not accept applications for eligibility directly from builders, insurance brokers need to be engaged, which charge a fee to the builder. While the Commission has no information on brokerage fees, submissions to a parliamentary inquiry suggest that some builders consider them to be excessive. Insurers decide an annual turnover limit for builders, which effectively caps the total value of contracts an eligible builder can make with customers in a year.

## 3.1 Builder registration with the BPB

In order to practice, a builder must be registered with the Building Practitioners Board (BPB). The BPB is an independent statutory body, established to oversee the quality and standard of professional services in the industry. Only a builder that is registered with the BPB can enter into a domestic building contract with a consumer or perform work for another builder.

Approval for BPB registration is based on an initial application and involves examinations and interviews with an assessor. The applicant must also provide proof of DBI eligibility with an insurer. The recommendation of the assessor is then made to a full meeting of the Board as to the suitability of the applicant for registration. Subsequent renewal of registration is based on the ability to provide proof of DBI eligibility and payment of an annual fee.

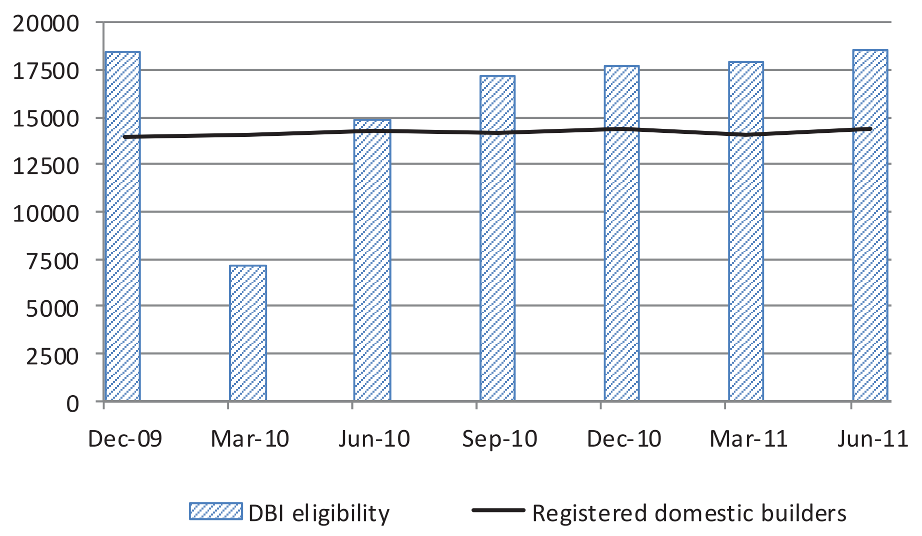
## 3.2 Access to DBI

Access to DBI is essential to a builder's ability to operate as they cannot maintain their registration without proof of eligibility. When several insurers left the market in 2009 and 2010, there was a risk that inability to access DBI could endanger the domestic building sector. Since June 2010 the

Government has underwritten the scheme through the VMIA in agreement with QBE. For at least the first 12 months of this arrangement, builders who previously held eligibility with any insurer automatically qualified for eligibility with the VMIA.

The Victorian eligibility data provided by insurers, shown in figure 3.1, indicates that the recent withdrawal of insurers from the market did not have a lasting impact on the ability of builders to obtain eligibility for DBI. The March 2010 quarter is low but Vero did not provide data for this period even though they were still issuing certificates until February 2010. At the conclusion of the transition period, overall builder eligibilities were rising.

Figure 3.1 **DBI eligibility and domestic builder registrations**




[a] Vero did not provide data for the March 2010 quarter, although they were active until February 2010. The Commission understands that many builders were eligible with Vero for part of this quarter.

*Data source:* Building Commission Pulse.

The number of builders eligible with Calliden insurance has decreased over this period; this may be a result of a higher standard of risk assessment being enforced by this insurer. As detailed on its website, Calliden tends to focus on small to medium residential builders with annual turnovers under $20 million and its policies restrict individual job limits to less than one million dollars.

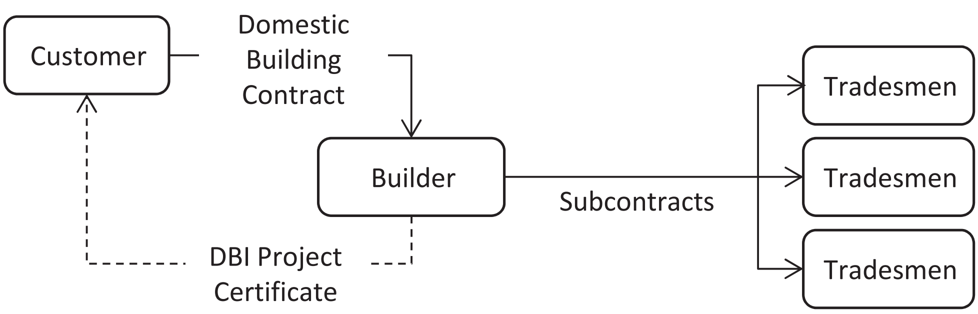
## 3.3 What exactly is DBI eligibility?

Eligibility with an insurer for DBI is a form of pre-approval for the issuance of project certificates. Under the *Domestic Building Contracts Act 1995*, each time a builder enters a domestic building contract over $12 000 with a customer, they must take out a project certificate specific to the works covered by the contract.

Before granting eligibility, an insurer reviews a builder's business history and finances to assess their risk. (Table 2.1 lists the major factors that insurers consider.) Insurers impose an annual turnover limit on builders based on their assessment of the value of works that a builder can prudently undertake given their financial position. In a year an eligible builder can take out project certificates up to the value of their turnover limit. DBI eligibility is reassessed annually by the insurer. Builders have the option of applying to reassess their turnover limit at any stage. An insurer may require a bank guarantee, or some kind of indemnity to extend the limit.

While DBI eligibility is compulsory for builders in order to maintain registration, not all registered builders would routinely enter domestic building contracts with customers. Figure 3.2 illustrates the parties and relationships in a standard domestic building contract.

Figure 3.2 **Participants in a domestic building contract**



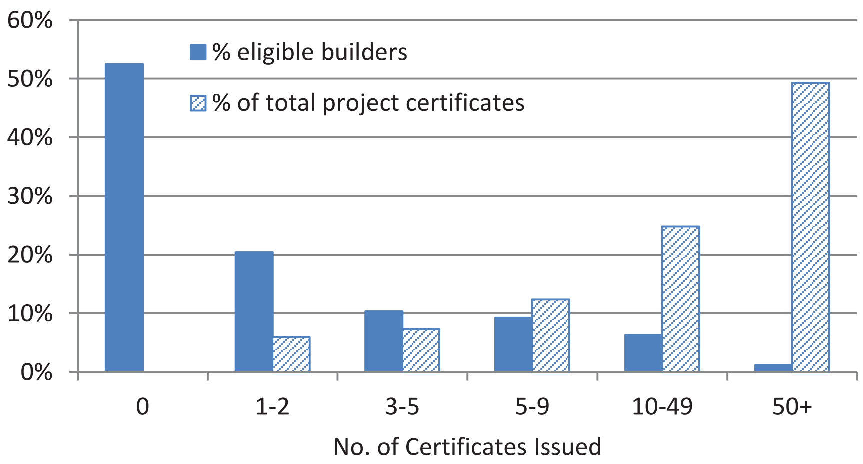

The 'builder' on the domestic building contract (who is required to take out a project certificate) can range from a sole trader undertaking the bulk of construction personally; to a large corporate entity employing registered builders and tradesmen to perform work on their behalf.

## 3.4 Certificates issued per eligible builder

Figure 3.3 uses data obtained from VMIA to show the number of DBI project certificates issued per eligible builder over the 18 months to November 2011. In this time 78 333 project certificates were issued to 7722 different eligible builders.

A large number of builders requested no project certificates over this period while a small group of less than 200 builders took out half of all the project certificates within the period. It would be reasonable to assume that most active domestic builders would enter into a contract (and therefore require a project certificate) within an 18 month period. This data would indicate that a large number of registered builders are gaining eligibility only to fulfil the requirement in order to maintain their registration.

Figure 3.3 **Certificates issued per builder — VMIA**
June 2010-November 2011




*Data source:* VMIA.

Builder registration with the BPB is made at the level of individuals, while eligibility for DBI and the ability to enter domestic building contracts is available to all legal entities — companies, trusts, etc — as long as a party in the entity is a registered builder.

A builder considered unsuitable by an insurer for DBI cannot maintain their registration. This requirement is a way to ensure consumer protection, and illustrates to the BPB that builders have shown adequate evidence of their financial competence to satisfy the insurer's requirements.

## 3.5 Issues in eligibility

### 3.5.1 Brokerage

DBI insurers do not accept applications for eligibility directly from builders, requiring them to engage an insurance broker. The broker acts as an intermediary with the insurer and charges a fee to the builder on successfully gaining eligibility. The broker receives a commission for each project certificate that is issued to the eligible builder. The Commission has no information on these fees, but submissions to the Parliamentary Inquiry into Builders Warranty Insurance[6] illustrated that some builders consider the fees excessive.

### 3.5.2 Turnover limits

As mentioned in section 3.3, insurers decide an annual turnover limit for eligible builders. This practice effectively caps the total value of contracts an eligible builder can make with customers in a year. From an insurer's perspective, the turnover limit is necessary to mitigate against a builder taking on more work than they can support financially, and becoming insolvent. Domestic building is capital intensive and cash flow is lumpy, and attempts to 'trade out of trouble' by taking on extra projects could be seen as risky by insurers who will be liable for the cost of unfinished work if the builder becomes insolvent. Whether the limit constrains the builder's opportunity to trade remains untested.

The Commission's analysis of aggregate turnover limit (see table 3.4) against the value of project certificates issued shows significant leeway, but is of limited use without individual project certificate data by builder registration which would allow the Commission to study how close to the limit builders are operating. The eligibility data from insurers includes individual limits which exceed the total annual value of domestic construction undertaken in the entire State, so there are clearly builders facing no limits from their DBI cover on the work they can take on. There are also over 750 builders with turnover limits set at one dollar. Builders with a one dollar limit can keep their registration, but would not be able to enter contracts requiring DBI.

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[6] Legislative Council Standing Committee on Finance and Public Administration, Inquiry into Builders Warranty Insurance, Final Report, 2010.

Table 3.4 **Project value against total turnover limit**

| | *Value of projects ($000)* | *Aggregate turnover limit at December ($000)* |
|---|---|---|
| 2009 | 492 269 | 59 810 |
| 2010 | 471 311 | 40 245 |
| 2011 (Jan-Jun) | 189 453 | 47 747[a] |

[a] As at 30 June 2011.

# 4 PROJECT CERTIFICATES AND PREMIUMS

**KEY POINTS**

A builder must take out a project certificate with their DBI insurer whenever they agree a contract for domestic building work with a value of more than $12 000. Premiums are calculated on the value of contracted works; the category of work; and the insurer’s rating of the builder’s individual risk.

The bulk of certificates are issued for new dwellings and structural renovations.

Average premium rates were lowest before June 2009.

The premium without fees and charges is useful for understanding the pool of money available for insurers for paying claims. However, without information about brokerage charges, the Commission cannot evaluate the total cost of the insurance to the building sector.

A builder must take out a project certificate with their DBI insurer whenever they agree a contract for domestic building work with a value of more than $12 000. Insurers calculate a premium for each certificate which is specific to the work specified in the contract. The premium for the project certificate is based on the value of the contract.

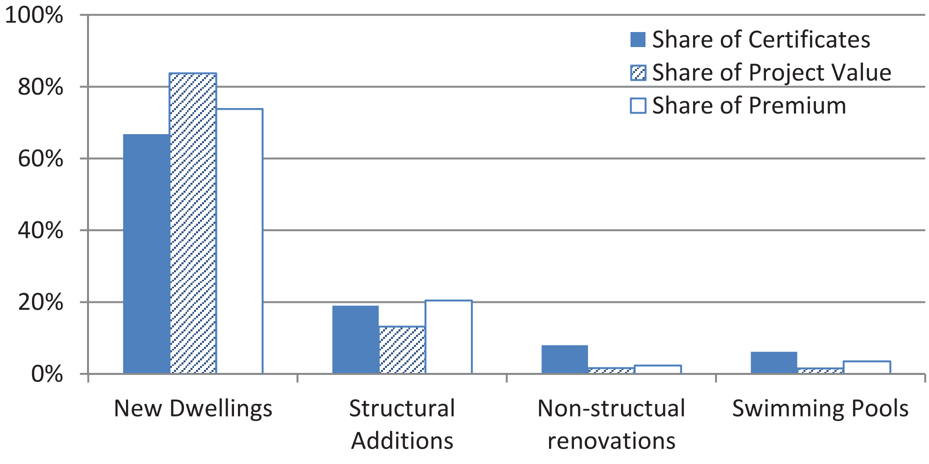
The total premium pool in any year is a combination of the rates being charged and the total amount of domestic construction that commences. Table 4.1 shows the total premium pool collected each year since 2005. Insurers have collected annual premiums between $25 and $40 million each year.

Table 4.1 **Total annual premium**
(excludes GST, stamp duty and brokerage)

| *Year* | *Project Certificates* | *Value of Projects ($m)* | *Premium ($m)* | *Average project value ($)* | *Average cost of a project certificate* |
|---|---|---|---|---|---|
| 2005 | 42 556 | 6 839.01 | 27.36 | 160 706 | 643 |
| 2006 | 47 337 | 8 034.60 | 28.32 | 169 732 | 598 |
| 2007 | 50 574 | 8 778.59 | 27.29 | 173 579 | 540 |
| 2008 | 49 946 | 8 953.82 | 25.18 | 179 270 | 504 |
| 2009 | 58 525 | 10 717.94 | 31.95 | 183 134 | 546 |
| 2010 | 62 414 | 12 195.22 | 39.68 | 195 392 | 636 |
| 2011 (Jan-Jun) | 32 888 | 6 828.28 | 20.64 | 207 622 | 627 |

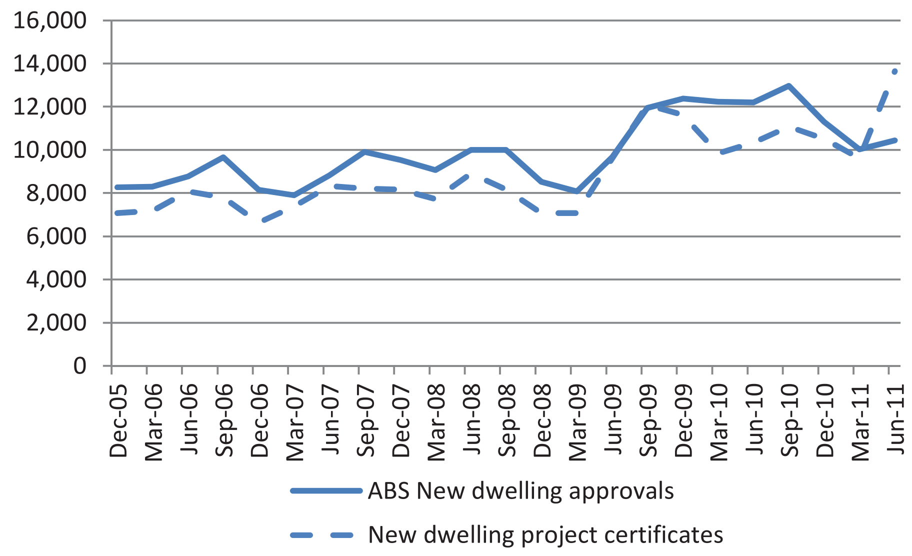
Certificates are issued in several categories depending on the type of building work undertaken. The Commission has aggregate quarterly premium and certificate data back to 2005.

Figure 4.2 **Share of project certificates by project type**
September 2005 to June 2011




The bulk of certificates are issued for new dwellings and structural renovations. Non-structural renovations (such as kitchen and bathroom remodelling) and swimming pools combined make up around 15 per cent of certificates issued, and between five and 10 per cent of total premium charges.

Figure 4.3 **New dwelling approvals in Victoria**




*Source:* ABS 8731.0 Building Approvals, Australia, Table 23. Dwelling Units Approved in New Residential Buildings, Number and Value, Original — Victoria. Includes houses, semi-detached dwellings, and units/apartments ≤ 3 storeys

Comparing the number of project certificates issued for new dwellings with ABS quarterly data on building approvals is a way to check that builders are taking out insurance as required. Figure 4.3 shows the two data sets tracking closely until September 2009, when the withdrawal of insurers from the market may have led to delays in processing of project certificates, creating a time lag between the issue of a permit and the issue of a DBI certificate. The Commission will continue to monitor these figures to check that the variance is temporary.

## 4.1 Premium rates

Before 2009 five insurers competed for DBI, but now VMIA (with QBE as its agent) provides the majority of project certificates, with Calliden the only private insurer remaining in the DBI market. VMIA publishes its rates on its website (see appendix). The premium is based on several parameters:

- the value of the contracted works (in bands)
- the category of work (structural, non-structural, swimming pools) and
- the insurer’s rating of the builder’s individual risk (A, B, or C).

The cost per $1000 of project value drops as projects grow in value. Rates for swimming pools are higher than work on dwellings. The rate for non-structural work is the lowest. Builders with a poorer risk rating pay more than twice as much for a certificate than builders on the ‘A rate’. For a $320 000 house construction project, a project certificate from VMIA would cost an A-rated builder $1262.03 and a C-rated builder $2438.15 plus GST, stamp duty and brokerage

Figure 4.4 **Average premium per $1000 project value** (excludes GST, stamp duty and brokerage)

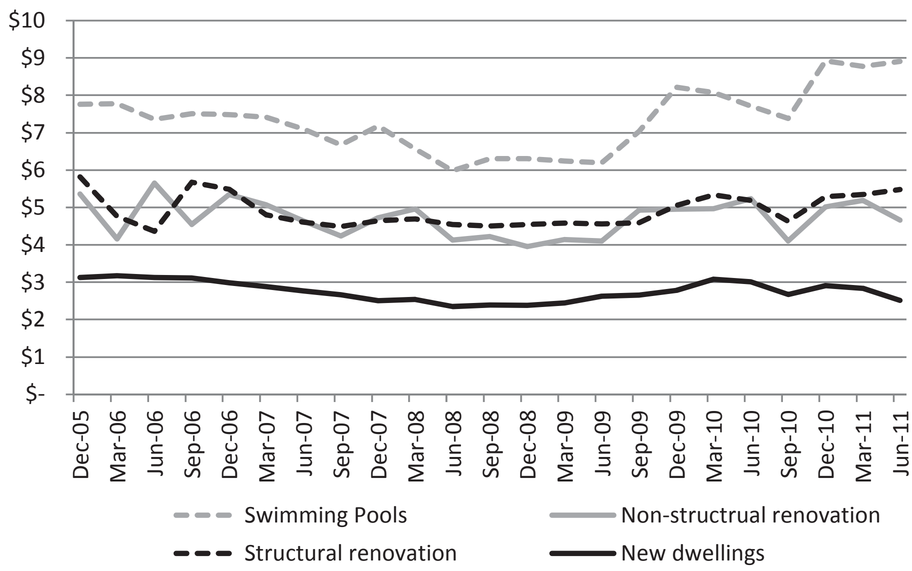



Figure 4.4 illustrates that average premium rates were at their lowest before June 2009. Competition between insurers was strong, but the market for DBI could still be characterised as immature, and a lack of information about costs could have driven premiums below an efficient price. The rates for renovations seem similar regardless of whether the project is structural or non-structural, despite the fact that non-structural claims can only be made for two years after completion while structural claims have a six year claim period. Swimming pool construction has the highest premium charges. Project certificates for new single dwelling construction make up more than 50 per cent of certificates issued, and over 60 per cent of total premium.

## 4.2 Brokerage

The Commission has no data, except for anecdotal reports, on the commission paid to brokers for DBI project certificates. In the absence of this information there are limits on the useful analysis that can be carried out. The premium without fees and charges is valuable for understanding the pool of money available to insurers for paying claims, but in the absence of brokerage estimates, the Commission cannot evaluate the total cost of the insurance to the building industry.

# 5 CLAIMS

**KEY POINTS**

Since 2002, some 2 750 claims under the DBI scheme have proceeded beyond the notification phase. While relatively infrequent in relation to the total number of project certificates issued, each claim nevertheless represents a major inconvenience for customers whose building project is incomplete or defective.

Claims are rising. The rate of claims after two years for project certificates issued in 2008 is already equivalent to the historical claim rate four years after the certificate issue date.

The average cost to an insurer of a DBI claim is $33 310, but costs vary significantly by type of claim, with claims for 'failure to complete' the most costly to insurers.

Claim turnaround times are an important measure of insurer performance. Since 2002, the average time from receiving a notification to a claim being finalised is just under two years. There is considerable variation between individual insurer's performances.

Most of the claims denied by insurers are on the basis that either the fault reported was not deemed a structural defect, or because the builder was not insolvent.

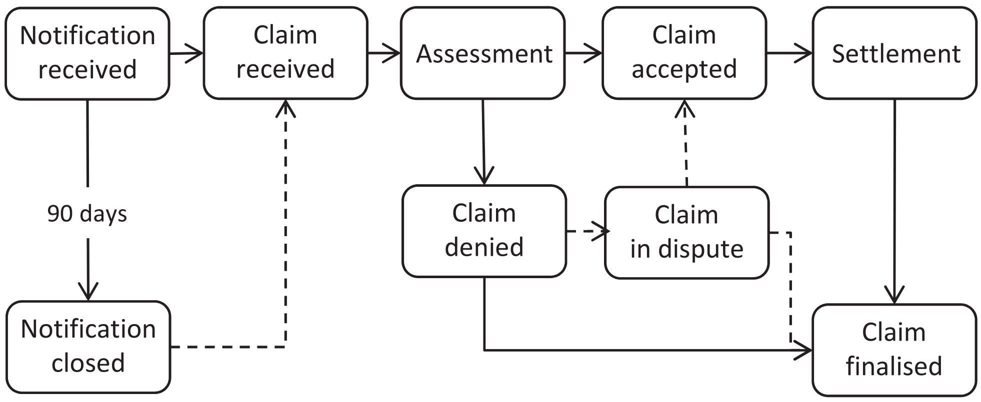
Claims under Victoria's DBI scheme can only be made under certain circumstances. The *Domestic Building Contracts Act 1995,* contains a number of implied warranties concerning a builder's work. DBI claims are only available where rights under these warranties cannot be pursued because the builder has died, disappeared or become insolvent. These three triggers are collectively abbreviated as DDI.

Chapter 2 analysed the costs and trends in terms of the overall profitability of the scheme. This chapter will present detailed data relating to claims frequency and costs since the current scheme began in 2002. As has been mentioned previously in the report, the long liability period for DBI means that it is difficult to present claim numbers in their true context until at least six years after the issue date of project certificates.

## 5.1 Claim process

A claim goes through multiple stages in its development, as illustrated in figure 5.1.

Figure 5.1 **Claim process**




A policy holder may notify an insurer of a fault at any time after a project certificate has been issued by providing very basic information. This notification escalates into a claim if the claimant provides minimum claims information within 90 days.[7] If the minimum information is not received within this time, the notification is closed, but remains on file. The notification may be re-opened at a later stage and escalated into a claim with provision of minimum information. The Commission's analysis concentrates on claims that have graduated beyond this 'notification' stage.

The insurer assesses a claim when minimum claims information has been provided. This involves investigating the builder to determine if they are DDI, and the defect reported to see if it qualifies for compensation. The assessment period may be a matter of days or months depending on the individual circumstances. The insurer then accepts or denies liability for the claim. If the claim is denied, the claimant has the opportunity to dispute the insurer's decision, otherwise the claim is finalised. If the insurer accepts the claim, a settlement period begins in which the compensation is calculated and paid. When the claim is fully settled with the claimant it is considered finalised, and closed.

## 5.2 Claims overview

Claims are relatively infrequent in relation to the number of project certificates issued, but each one represents a major inconvenience for the customer whose home building project is incomplete or defective and whose relationship with their building contractor has completely

[7] This is typically a standard claim form which requires details of the builder, property, etc.

deteriorated. This section provides the high level data on DBI claims since 2002.

Table 5.2 **Claim numbers by status**
January 2002 to June 2011
Registered builder only

| | *Open* | *Closed/Finalised* | *Total* |
|---|---|---|---|
| **CLAIMS** | | | |
| Accepted[a] | 583 | 1 250 | 1 833 |
| Pending[b] | 150 | | 150 |
| **Liability accepted or pending** | **733** | **1 250** | **1 983** |
| **Liability Denied** | **31** | **736** | **767** |
| **Total Claims** | **764** | **1 986** | **2 750** |
| **NOTIFICATIONS** | **328** | **742** | **1 070** |
| **GRAND TOTAL** | **1 092** | **2 728** | **3 820** |

[a] Includes deemed, full, and partial acceptance. [b] Includes claims being assessed and claims in dispute

Table 5.3 splits all claims received against registered builders, whether accepted or not, by the reported cause and claim type. As discussed in chapter 2, insolvency is by far the most common reason that claims on DBI are made for registered builders.

Table 5.3 **Claims received by type and cause**
Registered builder only

| | *Death* | *Disappearance* | *Insolvency* | *Total* |
|---|---|---|---|---|
| Failure to commence | 2 | 3 | 74 | 79 |
| Failure to complete | 17 | 31 | 755 | 803 |
| Structural defect | 20 | 67 | 1 008 | 1 095 |
| Non-structural defect | 14 | 24 | 735 | 773 |
| **TOTAL** | **53** | **125** | **2 572** | **2 750** |

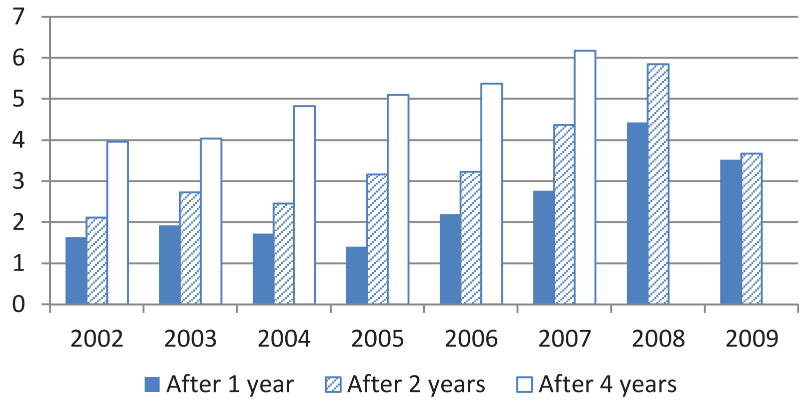
The matrix presented in table 5.4 illustrates the progressive build-up of claims since 2002 as the scheme matures. The annual total by the year of claim notification (running vertically down the right) shows more claims coming in every year. Along the horizontal total, the same claims have been distributed by the year in which the project certificate being claimed against was issued.

Table 5.4 **Claims received over time**
Registered builder only

| Notification year | *Project certificate issue year* 2002 | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *Total* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2002 | 3 | | | | | | | | | | **3** |
| 2003 | 22 | 20 | | | | | | | | | **42** |
| 2004 | 15 | 36 | 8 | | | | | | | | **59** |
| 2005 | 25 | 84 | 34 | 12 | | | | | | | **155** |
| 2006 | 21 | 41 | 60 | 60 | 3 | | | | | | **185** |
| 2007 | 20 | 40 | 44 | 97 | 90 | 26 | | | | | **317** |
| 2008 | 30 | 60 | 56 | 115 | 84 | 90 | 24 | | | | **459** |
| 2009 | 17 | 60 | 29 | 69 | 54 | 116 | 155 | 73 | | | **573** |
| 2010 | 4 | 34 | 48 | 69 | 82 | 124 | 112 | 121 | 26 | | **620** |
| 2011 (Jan-Jun) | 1 | 6 | 38 | 30 | 49 | 61 | 58 | 53 | 40 | 1 | **337** |
| | **159** | **381** | **317** | **452** | **362** | **417** | **349** | **247** | **66** | **1** | **2 750** |

Figure 5.5 normalises claims by the number of certificates issued in a particular year as a rate per 1000 certificates. As illustrated, the rate rises as the liability period extends. It is important to note that the rate of claims after two years for certificates issued in 2008 is already equivalent to the historical claim rate four years after the certificate issue date.

Figure 5.5 **Claim acceptance rate per 1000 project certificates**
By year of certificate issue
Registered builder only




## 5.3 Claim costs

Insurers record costs against each claim. Net Incurred Costs is the main measure of claim costs. This is made up of several categories and represents the insurer's total liability at any given point in time.

Table 5.6 **Calculation of net incurred costs**

| | | |
|---|---|---|
| | $ Paid to claimant | Payments made directly to the home owner to date |
| *Plus* | $ Paid to third party | Includes cost of investigation, structural assessments, legal fees |
| *Less* | Third party recoveries | Monies recovered from builders, suppliers, other insurances etc |
| *Plus* | Outstanding estimate | Insurer's estimate of the future costs relating to the claim. A finalised claim has no outstanding costs. |

Some claims will be accepted and finalised with no costs, and a claim may incur costs even if it is not accepted. Total cost is more significant to insurers than the number of claims received, as it is the test of their premium setting and risk assessment and drives their profitability.

Table 5.7 **Costs by claim status**
($000) Registered builder only

| | Open | | | Finalised | | |
|---|---|---|---|---|---|---|
| | *Pending* | *Accepted* | *Denied* | *Accepted* | *Denied* | *Total* |
| No. of claims | 150 | 583 | 32 | 1 250 | 736 | **2 751** |
| Paid to claimant | 188 | 14 633 | 3 | 38 808 | 1 003 | **54 635** |
| Paid to 3rd party | 258 | 1 989 | 50 | 5 307 | 793 | **8 397** |
| 3rd party recoveries | 58 | 330 | 0 | 2 478 | 59 | **2 925** |
| Outstanding estimate | 6 006 | 14 766 | 462 | 0 | 0 | **21 235** |
| Net incurred costs | 6 395 | 31 058 | 516 | 41 637 | 1 737 | **81 342** |
| Average Claim cost | 42.63 | 53.27 | 16.12 | 33.31 | 2.36 | **29.57** |

The Commission notes that average claim costs are much lower in finalised claims than where the insurer is estimating the cost of the outstanding liability. This could indicate that actual costs tend to come in under the insurer's estimate.

## 5.4 Claim turnaround times

The time it takes for a claim to go through each stage of the claim process is an important measure of insurer's performance. Looking at the claims that have been accepted and finalised since the scheme started in 2002, the average time from receiving a notification to a claim being finalised is 596 days, or just under two years (see table 5.8). The bulk of this time seems to be between the liability decision being made and the claim being finalised. On average the decision is made to accept liability 70 days from notification. It then takes a further 525 days on average to finalise the claim.

Table 5.8 **Average time from claim notification to finalisation**
Finalised, accepted claims January 2002-June 2011

| | *Claims (no.)* | *Notification to Claim receipt (days)* | *Claim receipt to liability decision (days)* | *Liability decision to finalisation (days)* | *Total (days)* |
|---|---|---|---|---|---|
| All Insurers | 1520 | 22 | 48 | 525 | 596 |

There is considerable variation in insurers' performance in this area with the average for individual insurers ranging from 200 to more than 750. The Commission will continue to monitor and report this aspect of claims handling in the run-off period. VMIA's internal procedures are based on a 56 day turnaround from liability decision to finalisation (28 days, plus a 28 day appeal period). Its average reflects this, although the Commission notes that this is based on a small number of claims.

## 5.5 Claims denied

Insurers can deny claims on the basis of several criteria. As highlighted in table 5.9, most claims are denied either because the fault reported was not deemed a structural defect, or because the builder was not insolvent.

Table 5.9 **Reasons for claims denied**
Registered builder only

| | *Claims (no.)* | *Proportion (%)* |
|---|---|---|
| Incorrect insurer | 8 | 1 |
| Out of time | 53 | 7 |
| Builder found | 53 | 7 |
| Builder not dead | 3 | 0 |
| Builder not insolvent | 281 | 37 |
| Not deemed a defect | 369 | 48 |
| Total | 767 | 100 |

There have been 281 claims denied because the builder is not insolvent. A significant "grey area" exists where a builder has ceased trading and is unable to be pursued to rectify structural defects in their work, but insurers can legitimately deny claims. If the builder is not technically insolvent under the definition in the Ministerial Order — which refers to the *Corporations Act 2001* — it falls on the home owner to pursue the builder through VCAT, and if that does not settle the matter, instigate bankruptcy proceedings against the builder through the courts before an insurer will accept their DBI claim. These cases can take a long time to resolve and impose a significant strain on the claimant. For claimants unwilling to go to VCAT, there is no avenue remaining to rectify their structural faults.

The Commission has undertaken analysis of claims denied on the basis of a builder not being insolvent, which revealed numerous cases where claims were denied, but the insurer subsequently accepted insolvency claims against the same builder from other parties. More than a quarter of the builders with claims denied for insolvency have also had insolvency claims accepted. A summary of findings is in table 5.10.

### Table 5.10 **Number of builders with claims lodged for insolvency**

| | *Builders* | *Claims* |
|---|---|---|
| Liability accepted on the basis of insolvency | 384 | 1 858 |
| Liability denied as 'not insolvent' | 174 | 281 |
| Builders on both lists | 46 | 110 |

Insurers are required to inform the BPB if a DBI claim is settled or paid. A potential claimant is likely to contact the BPB if they are having trouble tracking down their builder to rectify faults, and at this point would be advised that a claim on DBI was available. A claimant who has already been denied a DBI claim is unlikely to find out that their builder has been declared insolvent through this avenue.

# 6 OWNER BUILDERS

**KEY POINTS**

Owner builders require DBI if they sell the home they have constructed within six and a half years of completion. Insurers treat owner builders as a separate risk category from registered builders and have different premiums even though the insurance cover is similar.

Owner builders pay an average of $5 per $1000 of project value for DBI cover. There has been little volatility in this rate over the last five years, although it has risen slightly since the changes in the market in 2009.

The most common reason for claims against owner builders is disappearance. In the absence of a central licensing body, it is difficult for new owners of a property to track down the original owner builder to rectify faults.

An owner builder is defined as someone who carries out building on their own property. Owner builders are generally not in the building industry and must obtain a Certificate of Consent from the Building Practitioner's Board to obtain a building permit for domestic building work valued at more than $12 000. In doing so, owner builders take on all the risks and responsibilities of a registered building practitioner.

Owner builders require DBI if they sell the home they have constructed within six and a half years of completion. They are required to provide the purchaser with evidence of a DBI policy and a report on any building defects by a prescribed building practitioner. The insurance policy (an owner builder policy is not called a project certificate) is for the benefit of the purchaser and subsequent owners, in the event that the owner builder dies, disappears or is insolvent, and the building works are defective.

To obtain DBI they must provide details of the cost of works, building inspections and certificate of occupancy date and location of the property. They must also provide a current defects report and a copy of the building permit.

Table 6.1 compares the building permits issued to owner builders for new domestic buildings with the number of owner builder DBI policies issued. A significant proportion of domestic building permits issued to owner builders do not require DBI as the property is not sold.

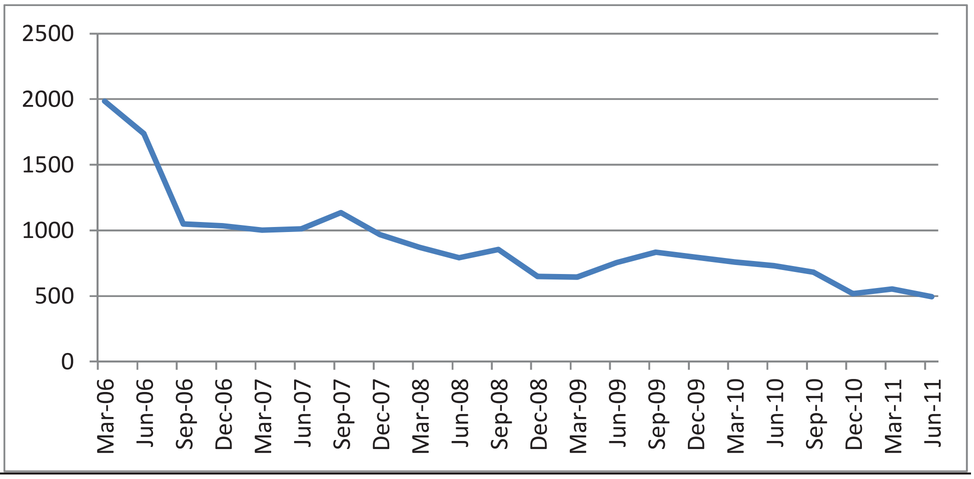
Table 6.1 **Owner builder activity**

| | *Building Permits*[a] | *Value ($000)* | *DBI Policies* | *Value ($000)* | *Premium ($000)* |
|---|---|---|---|---|---|
| 2002 | 28 600 | 1 761 732 | 3 068 | 363 702 | 645 |
| 2003 | 29 791 | 1 923 515 | 3 370 | 405 389 | 744 |
| 2004 | 29 545 | 1 982 845 | 3 388 | 457 190 | 3 714 |
| 2005 | 26 807 | 1 683 667 | 4 419 | 672 393 | 4 625 |
| 2006 | 24 714 | 1 438 931 | 5 805 | 952 246 | 3 804 |
| 2007 | 24 776 | 1 318 842 | 4 116 | 674 972 | 3 285 |
| 2008 | 24 396 | 1 374 818 | 3 167 | 549 536 | 2 470 |
| 2009 | 22 674 | 1 277 676 | 3 030 | 492 269 | 2 301 |
| 2010 | 24 107 | 1 478 535 | 2 687 | 471 310 | 2 196 |
| 2011 (Jan-Jun) | 9 784 | 651 656 | 1 046 | 189 453 | 978 |

[a] Includes permits for new dwellings and renovation/alterations

Source: Building Commission

Figure 6.2 **Owner builder policies issued by quarter**



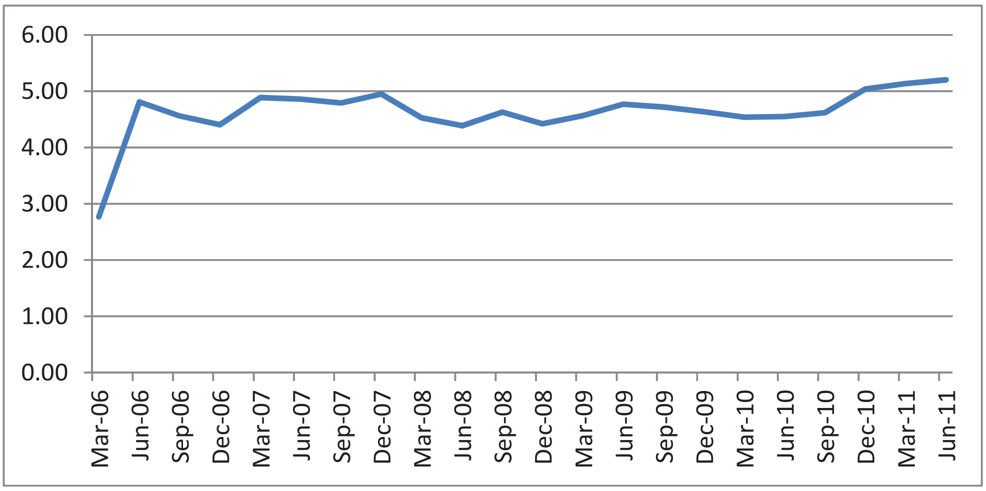

Insurers treat owner builders as a separate risk category from registered builders and have different premiums even though the insurance coverage is very similar. Owner builder policies cover structural and non-structural faults under the same rules as registered builder project certificates, but do not cover ‘failure to commence’ and ‘failure to complete’.

The number of owner builder policies being issued has been declining since 2006, but has remained fairly steady at about 11 per cent of total annual owner builder building permits.

## 6.1 Premiums

Owner builders pay an average premium of around $5 per $1000 of project value for DBI cover. There has been little volatility in this rate over the last five years, although it has risen since the changes to the market in 2009. In the earlier years of the scheme, there were insurers who specialised in DBI for owner builders. Both Calliden and VMIA will issue policies to owner builders.

Figure 6.3 **Average premium per $1000 of project value**
Owner builders




## 6.2 Claims

Owner builders have a higher rate of claims than registered builders even though the number of claims is very small. The most common reason for claims against owner builders is disappearance. In the absence of a central licensing body, as exists for registered builders, it is more difficult for new owners of a property to track down the original owner builder to rectify faults.

Table 6.4 **Claim development and costs**
Owner builders

| *Time from policy issue date* | *Claims* | *% of total claims* | *Net incurred cost ($000)* | *Average claim cost ($000)* |
|---|---|---|---|---|
| Within 12 months | 16 | 12 | 500.63 | 31.29 |
| 1-2 years | 20 | 15 | 370.04 | 18.50 |
| 2-3 years | 26 | 20 | 631.89 | 24.30 |
| 3-4 years | 28 | 21 | 569.95 | 20.36 |
| 4-5 years | 16 | 12 | 557.19 | 34.82 |
| 5-6 years | 22 | 17 | 305.99 | 13.91 |
| 6-7 years | 4 | 3 | 216.18 | 54.04 |
| Over 7 years | 1 | 1 | 1.00 | 1.00 |
| **Total** | **133** | **100** | **3 152.86** | **23.70** |

# APPENDIX A | TERMS OF REFERENCE

*Essential Services Commission Act* **2001**

**Essential Services Commission**

**Terms of Reference**

**Domestic Building Insurance – Data and Performance Monitoring**

I, Tim Holding MP, Minister for Finance, WorkCover and the Transport Accident Commission, request the Essential Services Commission (the Commission) to provide ongoing monitoring reports on the pricing and performance of the Victorian Managed Insurance Authority's (VMIA) provision of domestic building insurance (DBI). The reports will cover claims management, the pricing of private domestic building insurers during the transition period from 29 March 2010 to the establishment of the new arrangements, and the claims management of the private domestic building insurers during the run-off period of their insurance policies.

## Background

DBI has been compulsory in Victoria since 2002 for all residential building works in excess of $12,000 carried out by licensed builders.

DBI policies are taken out by the builder in favour of the homeowner and cover loss or damage resulting from non-completion of the work. This includes loss of deposit or breach of statutory warranty if the homeowner cannot recover compensation from the builder because of the death, disappearance or insolvency of the builder.

DBI was provided solely by private insurers. However, after a decrease in the number of private insurers and the associated levels of competition, the Government announced on 29 March 2010 that the VMIA would become a statutory monopoly provider of DBI after a transition period.

## Scope of the Advice – Data and Performance Monitoring

The Commission is to annually monitor and report on the pricing and performance of the VMIA and private insurer's provision of DBI on an ongoing basis. The scope of the monitoring is to cover the:

- pricing and claims management of the VMIA;
- pricing of private domestic building insurers during the transition period; and
- private domestic building insurers' claims management during the run-off period.

The ongoing reporting is to be delivered in the form of annual reports.

The purpose of the annual reports is to inform the public of the performance of DBI.

The Commission will be required to publish a monitoring report each year that will be made publicly available. Any confidential or commercially sensitive material should be included in a separate attachment.

The purpose of the annual reports with the attachment is to inform the Government's consideration of DBI developments.

The annual reports will analyse quarterly data, including the number of eligible builders, project certificates, premiums levels, the number and amounts of claims for both the VMIA and private domestic building insurers and any other metrics the Commission and the Department of Treasury and Finance consider relevant.

**Advice Process – Performance Monitoring**

The monitoring reports are to be prepared independently by the Commission, under subsection 10(g) of the *Essential Services Commission Act* 2001 (the ESC Act), which provides the Commission with a general function to provide advice to the Minister for Finance.

The first data monitoring report is to cover the period from 1 July 2008 to 30 June 2010. Subsequent reports are to cover data for each financial year from 2010-11 onwards. The reports are to be provided by 30 November each year.

In providing this advice, the Commission is to have regard to its statutory objectives in section 8 of the ESC Act.

**TIM HOLDING MP**
Minister for Finance, WorkCover
and the Transport Accident Commission

Date: 9/07/2010

# APPENDIX B JURISDICTIONAL COMPARISONS

Table B.1 **Summary of builders warranty insurance**

| *State authorities* | *Eligibility conditions for builders* | *Type of scheme*[a] | *Min value of works* | *Max value payable* | *Coverage period* | *Premiums* | *Underwriting and number of insurers* | *Owner builders* |
|---|---|---|---|---|---|---|---|---|
| **NSW**<br>*Home Building Act1989 (NSW)*<br>*Home Building Regulation 2004(NSW)*<br>*Home Building Amendment Act 2011(NSW)* | All licensed domestic builders must be eligible.<br>DBI must be purchased if contract price is greater than $20 000; exemptions granted under special license where contract price does not exceed $20 000. | Last resort | $20 000 | $340 000<br>or 20% of contract value | Non structural 2 years;<br>structural up to 7 years from completion, maximum of 10 years from issue of policy;<br>up to 12 months for incomplete work. | Premiums are set by insurers based on risk assessment and value of project. | NSW Home Warranty Insurance Fund, underwrites policies issued by QBE and Calliden insurance agents via approved brokers. | Required by law on sale of property if within 6 years of completion of building works. |

| *State authorities* | *Eligibility conditions for builders* | *Type of scheme*[a] | *Min value of works* | *Max value payable* | *Coverage period* | *Premiums* | *Underwriting and number of insurers* | *Owner builders* |
|---|---|---|---|---|---|---|---|---|
| **QLD**<br>*Queensland Building Services Authority (BSA) Act1991(QLD)* | All contractors must be licensed with BSA, for contract value greater than $3300. | First resort | $3300 | $400 000 | Non structural 6 months; structural 6 years and 6 months. | Contract price is the basis for determining premium, premiums set by BSA. | Queensland Home Warranty Scheme - Building Services Authority (BSA) | Exempt |
| **VIC**<br>*Building Act 1993(Vic.)* | All licensed domestic builders must be eligible.<br>DBI must be purchased where contract price exceeds $12 000. | Last resort | $12 000 | $200 000 or 20% of contract | Non structural 2 years; structural 6 years from the date of completion. | Premiums are set by insurers based on risk assessment and value of project. | VMIA and Calliden via approved brokers. | Required by law on sale of property if within 6 years of completion of building works. |
| **SA**<br>*Builders Licensing Act1986(SA)* | All licensed domestic builders must be eligible or provide evidence of at least $100 000 in tangible net assets and solvency. | Last resort | $12 000 | $80 000 | 3 months from handover until 5 years from completion. | Premiums are set by insurers based on risk assessment and value of project. | QBE and Calliden via approved brokers. | Required by law on sale of property if within 5 years of completion of building works. |

| *State authorities* | *Eligibility conditions for builders* | *Type of scheme*[a] | *Min value of works* | *Max value payable* | *Coverage period* | *Premiums* | *Underwriting and number of insurers* | *Owner builders* |
|---|---|---|---|---|---|---|---|---|
| **TAS**<br>*Building Act 2000(Tas.*<br><br>*Housing Indemnity Amendment Act 2008(Tas.)*<br><br>*Draft Residential Building Work Quality (Warranties and Disputes) Bill 2012 (Tas.)* | Public Liability insurance and Contract Works insurance is a requirement for accreditation as a Builder.<br>The *Housing Indemnity Amendment Act 2008* removed the mandatory requirement for domestic builders to purchase DBI.<br>Draft legislation is intended to set up consumer protection and dispute resolution framework, open for comment till March 16 2012. | Draft legislation enables dispute resolution process. | | | | | | Register is maintained by Director of Building Control.<br>Require details of workers compensation and<br>public liability insurance. |
| **WA**<br>*Home Building Contracts Act 1991(WA)* | All licensed domestic builders must be eligible. | Last resort | $20 000 | $100 000 | 6 years from date of completion. | Premiums are set by Insurers based on risk assessment and value of project. | QBE and Calliden via approved brokers. | Required by law on sale of property if within 6 years of completion of building works. |

| *State authorities* | *Eligibility conditions for builders* | *Type of scheme*[a] | *Min value of works* | *Max value payable* | *Coverage period* | *Premiums* | *Underwriting and number of insurers* | *Owner builders* |
|---|---|---|---|---|---|---|---|---|
| **NT** (Bills Pending)<br>Building Amendment (Registration and other matters) Bill 2011<br>Building Amendment (Residential Building Consumer Protection) Bill 2011 (NT) | Eligibility is required for registration.<br>Insurance Certificate is required before completion is approved by certifier.<br>Builder registration requires $50,000 in net assets be maintained as part of pending legislation. | Pending legislation introduces last resort scheme and includes dispute resolution to close gap between first and last resort. | $12 000 | $80 000 | Non structural 2 years; structural 6 years from the date of completion. | Premiums are set by Insurers based on risk assessment and value of project. | HIA – brokerage services (underwritten by QBE) and MBA (Fidelity Fund) are the proposed administrator. | |
| **ACT**<br>*Building Act 1972 (ACT)* | Eligibility required for registration. | Last resort | $12 000 | $85 000 | Non structural 2 years; structural 6 years from the date of completion. | Premiums are set by insurers based on risk assessment and value of project. | Master Builders Fidelity Fund underwrites insurance policies issued through MBA and HIA brokers. | Must be licensed; fidelity certificate is valid from sale/transfer up to a period of 5 years from Certificate of Occupancy being issued. |

**a** First Resort Schemes cover defects and workmanship and operate like normal insurance contracts; Last resort schemes only come into effect if a builder dies, disappears or becomes insolvent.

# APPENDIX C | VMIA PREMIUM RATES

# Domestic Building Insurance Rate Chart

| Domestic Building Insurance Rate Chart | | | | |
|---|---|---|---|---|
| Project Type | Project Size Band | A Rates | B Rates | C Rates |
| Structural Works | $12,000 | $ 411.40 | $ 556.60 | $ 889.35 |
| Structural Works | $12001-$25,000 | $ 423.50 | $ 574.75 | $ 919.60 |
| Structural Works | $25,001-$50,000 | $ 451.33 | $ 605.00 | $ 974.05 |
| Structural Works | $50,001-$75,000 | $ 464.64 | $ 626.78 | $ 1,004.30 |
| Structural Works | $75,001-$100,000 | $ 504.57 | $ 678.81 | $ 1,089.00 |
| Structural Works | $100,001-$150,000 | $ 584.43 | $ 786.50 | $ 1,260.82 |
| Structural Works | $150,001-$200,000 | $ 704.22 | $ 949.85 | $ 1,518.55 |
| Structural Works | $200,001-$250,000 | $ 863.94 | $ 1,165.23 | $ 1,863.40 |
| Structural Works | $250,001-$300,000 | $ 995.83 | $ 1,343.10 | $ 2,153.80 |
| Structural Works | $300.001-$350,000 | $ 1,128.93 | $ 1,524.60 | $ 2,438.15 |
| Structural Works | $350,001-$400,000 | $ 1,262.03 | $ 1,706.10 | $ 2,728.55 |
| Structural Works | $400,001-$450,000 | $ 1,395.13 | $ 1,881.55 | $ 3,012.90 |
| Structural Works | $$450,001-$500,000 | $ 1,458.05 | $ 1,972.30 | $ 3,158.10 |
| Structural Works | $500,001-$750,000 | $ 1,591.15 | $ 2,153.80 | $ 3,448.50 |
| Structural Works | $750,001-$1,000,000 | $ 1,724.25 | $ 2,335.30 | $ 3,726.80 |
| Structural Works | $1,000,000-$1,500,000 | $ 1,792.51 | $ 2,427.98 | $ 3,884.76 |
| Structural Works | $1,500,000-$2,000,000 | $ 1,882.43 | $ 2,547.98 | $ 4,076.60 |
| Structural Works | $2,000,000-$2,500,000 | $ 1,978.35 | $ 2,673.77 | $ 4,280.43 |
| Structural Works | $2,500,000-$10,000,000 | $ 2,074.27 | $ 2,811.63 | $ 4,496.25 |
| Non-Structural Works | $12,000 | $ 118.58 | $ 162.14 | $ 257.73 |
| Non-Structural Works | $12,001-$25,000 | $ 131.89 | $ 179.08 | $ 286.77 |
| Non-Structural Works | $25,001-$50,000 | $ 139.15 | $ 188.76 | $ 301.29 |
| Non-Structural Works | $50,001-$75,000 | $ 145.20 | $ 197.23 | $ 315.81 |
| Non-Structural Works | $75,001-$100,000 | $ 158.51 | $ 215.38 | $ 343.64 |
| Non-Structural Works | $100,001-$150,000 | $ 171.82 | $ 232.32 | $ 372.68 |
| Non-Structural Works | $150,001-$200,000 | $ 198.44 | $ 268.62 | $ 429.55 |
| Non-Structural Works | $200,001-$250,000 | $ 238.37 | $ 321.86 | $ 514.25 |
| Swimming Pools | $12,000 | $ 513.04 | $ 695.75 | $ 1,113.20 |
| Swimming Pools | $12,001-$25,000 | $ 531.19 | $ 716.32 | $ 1,149.50 |
| Swimming Pools | $25,001-$50,000 | $ 562.65 | $ 762.32 | $ 1,216.05 |
| Swimming Pools | $50,001-$75,000 | $ 580.80 | $ 786.50 | $ 1,252.35 |
| Swimming Pools | $75,001-$100,000 | $ 629.20 | $ 853.05 | $ 1,361.25 |

Note: Rates are inclusive of GST and Stamp Duty, and exclusive of broker fees

# APPENDIX D | DATA TABLES

## Table D.1 Registered builder claims — liability assessed and in dispute

| *Liability Status* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Being Assessed | 134 | 5 958 143 |
| Partially Assessed | 900 | 37 356 433 |
| Fully Assessed | 868 | 31 953 030 |
| Deemed Acceptance | 65 | 3 385 391 |
| In Dispute | 16 | 436 417 |
| **Grand Total** | **1983** | **79 089 413** |

| *Principal Cause* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Death | 36 | 1 213 211 |
| Disappearance | 73 | 2 029 882 |
| Insolvency | 1873 | 75 839 580 |
| Cause Not determined | 1 | 6 740 |
| **Grand Total** | **1983** | **79 089 413** |

| *Claim Type* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Failure to Commence | 61 | 1 348 267 |
| Failure to Complete | 640 | 35 429 356 |
| Structural Defect | 788 | 25 022 388 |
| Other Loss | 494 | 17 289 403 |
| **Grand Total** | **1983** | **79 089 413** |

| *Status of Claim* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Open | 733 | 37 452 218 |
| Finalised | 1250 | 41 637 195 |
| **Grand Total** | **1983** | **79 089 413** |

| *Premium Type* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| New Single Dwelling | 1218 | 48 719 039 |
| New Multi Dwelling | 2 | 30 000 |
| New Multi Dwelling < 3 Storeys | 462 | 20 454 379 |
| Alterations Additions | 222 | 83 99 047 |
| Swimming Pools | 50 | 1 111 658 |
| Renovations | 29 | 375 291 |
| **Grand Total** | **1983** | **79 089 413** |

(Continued next page)

Table D.1 (continued)

| *Year of Certificate Issue* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| 2002 | 85 | 3 391 187 |
| 2003 | 225 | 6 996 696 |
| 2004 | 221 | 9 112 928 |
| 2005 | 307 | 12 501 149 |
| 2006 | 256 | 9 353 740 |
| 2007 | 312 | 9 726 563 |
| 2008 | 300 | 11 213 859 |
| 2009 | 215 | 12 801 117 |
| 2010 | 61 | 3 899 344 |
| 2011 | 1 | 92 831 |
| **Grand Total** | **1983** | **79 089 413** |

| *Notification Year* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| 2002 | 2 | 332 76 |
| 2003 | 33 | 1 273 864 |
| 2004 | 36 | 1 324 861 |
| 2005 | 96 | 3 058 266 |
| 2006 | 108 | 3 576 064 |
| 2007 | 227 | 8 534 847 |
| 2008 | 319 | 10 334 772 |
| 2009 | 408 | 17 599 635 |
| 2010 | 476 | 20 516 832 |
| 2011 (Jan-Jun) | 278 | 12 836 996 |
| **Grand Total** | **1983** | **79 089 413** |

**Note:** Excludes 2001 certificate issue year. Includes Claims being assessed, accepted and in dispute. Includes 1st half of 2011 (Jan-Jun). Total Cost excludes internal claims handling costs but includes payments to third parties.

## Table D.2 **Registered builder claims — notified and denied**

| *Liability Status* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Notification only | 1070 | 4 794 89 |
| Denied | 767 | 2 247 412 |
| **Grand Total** | **1837** | **2 726 901** |

| *Principal Cause* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Death | 26 | 15 489 |
| Disappearance | 100 | 211 788 |
| Insolvency | 1705 | 2 499 624 |
| Cause Not determined | 6 | 0 |
| **Grand Total** | **1837** | **2 726 901** |

| *Claim Type* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Failure to Commence | 19 | 2 527 |
| Failure to Complete | 176 | 746 997 |
| Structural Defect | 343 | 13 63 178 |
| Other Loss | 1299 | 614 199 |
| **Grand Total** | **1837** | **2 726 901** |

| *Status of Claim* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| Notification Only | 328 | 471 956 |
| Open | 31 | 510 870 |
| Finalised | 1478 | 1 744 075 |
| **Grand Total** | **1837** | **2726901** |

| *Premium Type* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| New Single Dwelling | 981 | 1 506 347 |
| New Multi Dwelling < 3 Storeys | 563 | 838 575 |
| Alterations Additions | 217 | 343 250 |
| Swimming Pools | 20 | 31 376 |
| Renovations | 45 | 7 195 |
| Other | 11 | 157 |
| **Grand Total** | **1837** | **2726901** |

| *Year of Certificate Issue* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| 2002 | 174 | 78 630 |
| 2003 | 357 | 609 922 |
| 2004 | 298 | 229 899 |
| 2005 | 317 | 734 214 |
| 2006 | 246 | 305 695 |
| 2007 | 198 | 406 610 |
| 2008 | 131 | 196 790 |
| 2009 | 94 | 165 140 |
| 2010 | 22 | 0 |
| **Grand Total** | **1837** | **2 726 901** |

(Continued next page)

Table D.2 (continued)

| *NotificationYear* | *Number of Claims* | *Total cost ($)* |
|---|---|---|
| 2002 | 3 | 0 |
| 2003 | 37 | 2 926 |
| 2004 | 67 | 13 082 |
| 2005 | 122 | 69 444 |
| 2006 | 165 | 182 509 |
| 2007 | 187 | 356 300 |
| 2008 | 200 | 273 968 |
| 2009 | 274 | 747 077 |
| 2010 | 425 | 428 139 |
| 2011 (Jan-Jun) | 357 | 653 456 |
| **Grand Total** | **1837** | **2 726 901** |

**Note:** Excludes 2001 certificate issue year. Includes 1st half of 2011 (Jan-Jun). Total Cost excludes internal claims handling costs but includes payments to third parties.