

**Oregon CCF**  
**Insurance Analysis: Reforms, Alternatives, and Pricing**

Presentation of Second Draft Report  
July 26, 2006

Presented by  
Joseph W. Pitts, FCAS, MAAA  
William T. Flynn, MBA, CPA  
American Actuarial Consulting Group LLC

**Agenda**

- Background
- Updated Data Call Results
- Claim Survey Results
- Overview of Options
- Evaluation of Warranty
- Construction Defect/Warranty Cost Model

## Tasking

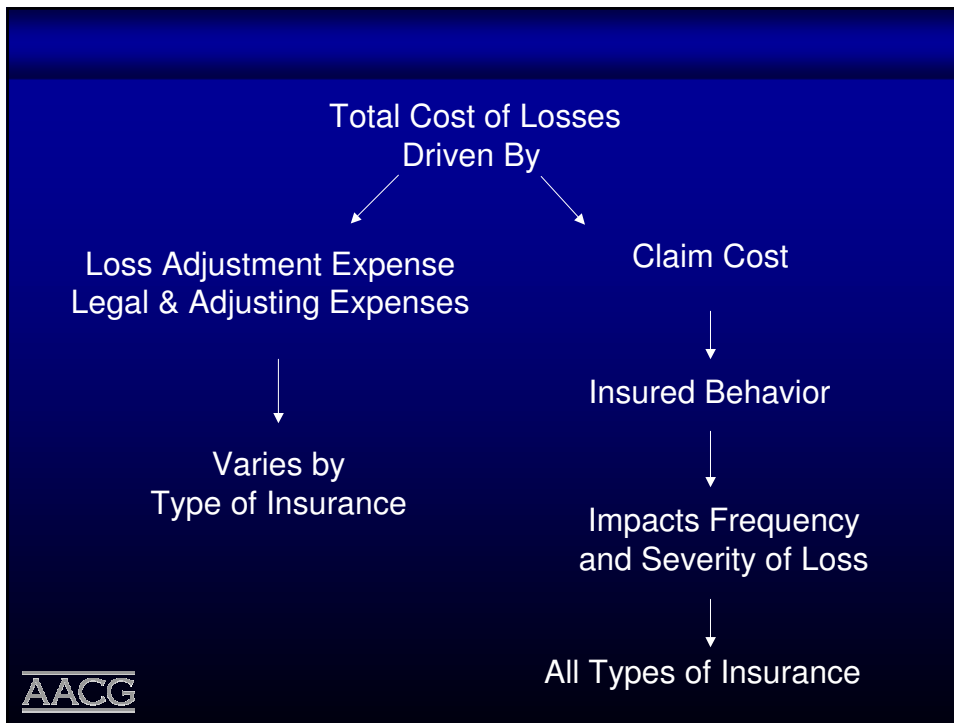
*“To study options and make recommendations regarding sound insurance reforms to provide construction contractor insurance required under Oregon Revised Statute 701.105. **Options are to be evaluated against the broad goal of enhancing the availability and affordability of contractor liability insurance without decreasing consumer protection.**”*

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## Availability and Affordability

Availability and affordability of liability insurance are directly related to the total cost of losses.

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## General Options

- Reduce Claim Cost
  - Improving Behavior
    - Adopting Best Practices
    - Reduce Frequency & Severity
- Reduce Loss Adjustment Costs
  - Legal and Adjusting
    - Friction Costs
  - Shifting Coverage to a form of Insurance with lower adjustment expenses

## Construction Defects and Consequential Damage

- Insurance Perspective
  - Property Damage
- Insurance Objective
  - Restoration

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## Property Damage

### Two Types of Insurance

- Direct Protection
  - Property Insurance
- Indirect Protection
  - Liability Insurance

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## Property Damage

Property Policies

Liability Policies

Objective  
Restoration

What is the difference?

**Friction Costs!!**

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## Property Insurance

### Definition

Protects the owner of real property or another party with an insurable interest in the property against loss from damage to or destruction of the property by specified perils.

- Basic Forms
  - Named Perils
  - All-Risk
- Policies are Property Specific
- Homeowner HO-3 Residential Property Policy
  - Most Comprehensive
  - Most Common
- Adjustment Expense

No Property Policies Currently Cover Defects

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## Liability Insurance

### Definition

Protects the Policyholder against the financial risk of damage to property of others that might occur in the course of Policyholder activities.

### Policies

- Specific to an Individual or Business
- Include Duty to Defend
- Indemnity
  - Dependent on Fault
- Legal & Adjusting Expenses

Commercial General Liability Policies Currently Provide Coverage for Defects

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## Construction Liability Insurance

### History

- **Manufacturers & Contractors (M&C)**
  - Work-in-progress only
  - 1976 Broad Form Property Damage Endorsement
    - Expanded M&C to include Completed Operations
    - Too restrictive for Construction Defect usage
- **1986 Commercial General Liability Ins. (CGL)**
  - Covers Work-in-progress and Completed Operations
  - Courts found coverage grant included Construction Defects
    - Still contested
  - Unusually high Legal and Adjusting Expenses

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### Updated Data Call Results (Loss Data)

- Roughly one-half of reported losses and loss expenses have been from construction defect claims.
- Legal costs (DCCE) from construction defect claims represent a substantial portion of the total claim dollars.
  - Construction Defect 14.2%
  - Premises Operations 3.3%
  - Products/Completed Operations 5.7%
- The data call results were used in a model to compare a potential reduction of construction defect claims with additional warranty premiums.

### Updated Data Call Results (Premium Data)

- The average premium per policy among those insurers reporting is roughly \$1,700.
- For the period 1998 – 2005, the average premium per policy has increased by roughly 113%.
- There are reports of individual contractors paying significantly higher premiums than reported in the data call.

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### Updated Data Call Results (Class Data)

- The average written premium for residential contractor classes range from \$400 - \$2,400 per policy.
- Policy counts for residential contractors involved with the building envelope have experienced severe declines.

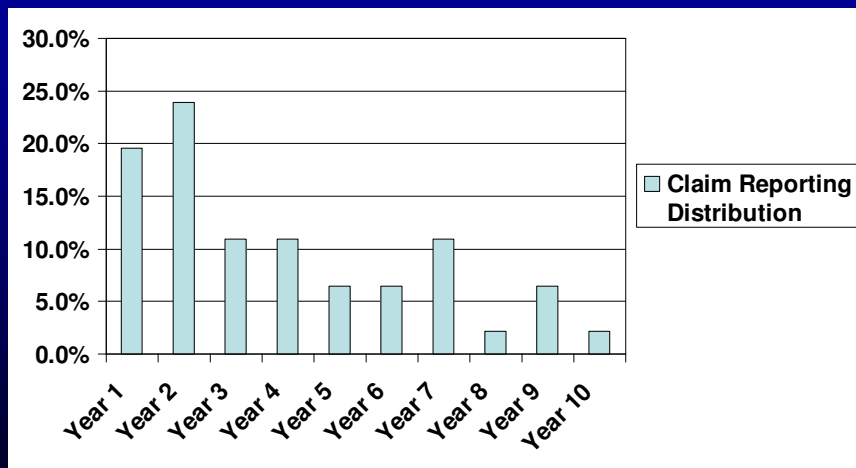
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## Actions Taken By Other States

Actions	NOR	Statute Warranties	Recovery Funds
Number of States	23	11	14

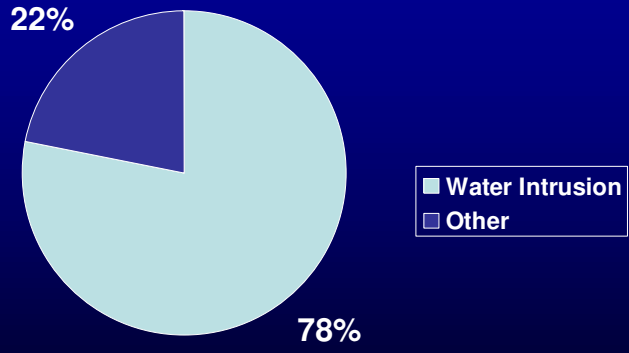
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## Construction Defect Claim Reporting



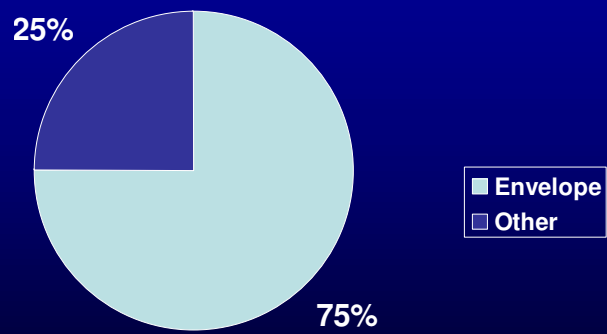
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### Cause of Loss



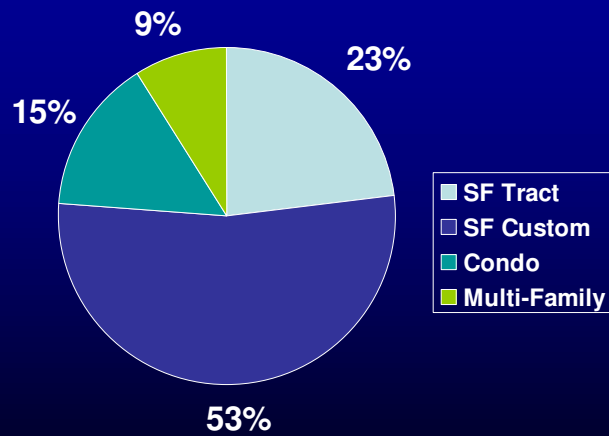
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### Location of Defect



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## Type of Residence



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## Options With Potential to Improve Insurance Environment

- Alternative Coverage Mechanisms
  - Warranty
  - Wrap Policies
- Pricing Options
  - Loss Control Discounts
  - Experience Rating

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## Options Without Potential to Improve Insurance Environment

- Single Private Insurer
- Assigned Risk Plan

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## Warranty Options

- Mandated Minimum Warranty Requirements
  - Mandate that a minimum warranty be provided with each new home.
- Mandated Third Party Warranty Insurance
  - Require mandated warranty requirements be backed by third party warranty insurer.

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## Warranty Definition

*"Guarantee of the integrity of a product and of the maker's responsibility for repair or replacement of defective parts."*

*Merriam-Webster's Collegiate Dictionary*

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## Example Mandated Warranty Requirements

In the New Home Warranty Act of Louisiana, every builder warrants the following to the owner:

- One year following the warranty commencement date, the home will be free from any defect due to noncompliance with building standards or due to other defects in materials or workmanship not regulated by building standards.
- Two years following the warranty commencement date, the plumbing, electrical, heating, cooling, and ventilating systems exclusive of any appliance, fixture, and equipment will be free from any defect due to noncompliance with the building standards or due to other defects in materials or workmanship not regulated by building standards.

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## Warranty Requirements (cont.)

- Five years following the warranty commencement date, the home will be free from major structural defects due to noncompliance with building standards or due to defects in materials or workmanship not regulated by building standards.
- If a builder violates this chapter by failing to perform as required by the warranties provided in this chapter, any affected owner shall have a cause of action against the builder for actual damages, including attorney fees and court costs, arising out of the violation. The damages with respect to a single defect shall not exceed the reasonable cost of repair or replacement necessary to cure the defect, and damages with respect to all defects in the home shall not exceed the original purchase price of the home.

The five year limitation on structural defects is based on Louisiana's five year statute of repose.

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## Mandated Warranty Requirements

### Pros:

- Ambiguities associated with implied warranties eliminated.
  - Common Understanding between Homebuyer and builder

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## Mandated Warranty Requirements

### Cons:

- Terms must be structured to meet the needs of Oregon.
  - Envelope Protection
- Compliance
  - Enforcement
    - Active Builders
  - Homeowner Protection
    - Absent/Inactive Builders

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## Third Party Warranty Insurance

In order to obtain warranty policies for their homes, builders must obtain membership in the warranty providers program. Underwriting process includes:

- Complete financial background review of the builder.
- Interviews with suppliers, bankers, local inspectors, and previous clients of the builder.
- Inspection of construction sites.
- Once accepted into the program, the builders are eligible to purchase warranty policies for the residences that they construct.

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### Example 1-2-10 Warranty Policy

- One year coverage on labor and materials
- Two years coverage on delivery systems for plumbing, electrical, heating, and air conditioning
  - Duct Work
  - Wiring
  - Pipes
- Ten years coverage on major structural components

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### Example 1-2-10 Warranty Policy (cont.)

Builder Retains Responsibility for:

- One year labor and materials
- Two years delivery systems
- Two years structural defects

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## Example 1-2-10 Warranty Policy (cont.)

### Warranty Insurer Responsible for:

- Guaranteeing builder performance
- Final eight years coverage on major structural components

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## Dispute Resolution

- Signed by homebuyer and builder at closing
- Mandatory Mediation
- Third Party Arbitration
- Failure of the builder to honor agreement or decision
- Warranty provider takes over claim and fulfills agreement or decision

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## Third Party Warranty

### Pros:

- Enforcement problem is resolved
- Major Structural Defects are insured
- Underwriting standards move builders to best practices

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## Third Party Warranty

### Cons:

- Terms must meet needs of Oregon
  - Envelope Protection
  - Consequential Damage
- Costs
  - Policy must be priced with your terms
- Underwriting
- Regulation

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## Construction Defect/Warranty Cost Model

### Assumptions (Liability Insurance)

- Contractor liability insurance premium: \$105 million.
- 49.9% of losses are construction defect.
- U/W Expenses and A&O costs are 35.5% of premium.
- Annual claim inflation is 3%.
- Residential contractors represent 55% of premium.
- Claim reporting pattern based on results of recent claim survey.

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## Construction Defect/Warranty Cost Model

### Assumptions (Warranty Insurance)

- New home starts total 37,000 per year
- Average Oregon new home value is \$205,000
- Annual claim inflation is 3%
- Third party warranty insurance rate is based on NJ state plan
  - Includes consequential damage
  - Envelope coverage not as rich as British Columbia

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## Liability Insurance Comparison

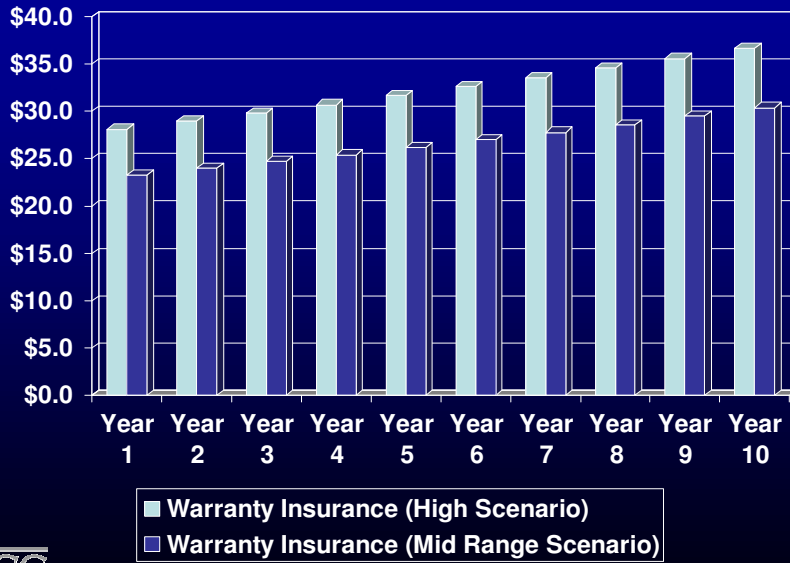
(Amounts in Millions)



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## Cost of Warranty Insurance - Two Scenarios

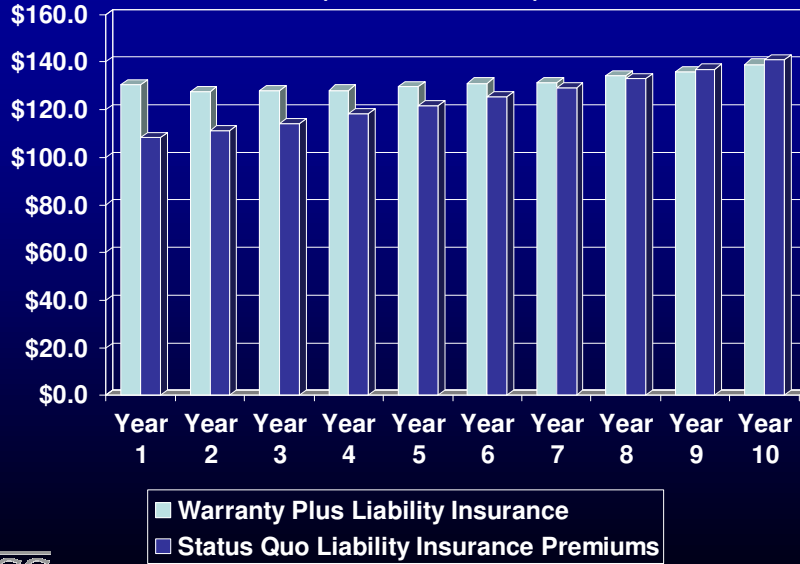
(Amounts in Millions)



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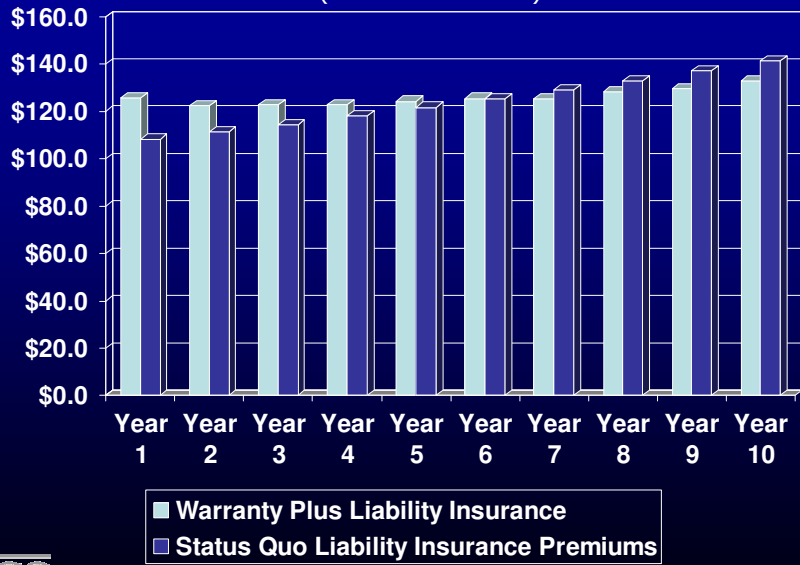
### Total Cost Model Results - High Warranty Scenario

(Amounts in Millions)



### Total Cost Model Results - Mid Range Warranty Scenario

(Amounts in Millions)



## Questions and Discussion

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### Summary of Warranty Statutes by State

	Labor and Materials	A/C, Plumbing, Electrical, delivery systems	Envelope defects which permit unintended water penetration	Structural	3 <sup>rd</sup> Party mandatory	Roof			
B.C.	1 year	2 year	5 years	10 years	yes				
Florida*	1 year	3 years		3 years	no	3 years			
Indiana	2 years	2 years		10 years	no	4 years			
Louisiana	1 year	2 years		5 years	no				
Maryland	1 year	2 years		5 years	no				
Minnesota	1 year	2 years		10 years	no				
Mississippi	1 year			6 years	no				
New Jersey	1 year	2 years		10 year	yes				
New York	1 year	2 years		6 years	no				
Texas	1 year	2 years		10 years	no				
Virginia	1 year	1 year		5 years**	no				

\*Statute only pertains to condominiums

\*\* Foundation Only