Independent Pricing and Regulatory Tribunal

Effectiveness and efficiency of the NSW Home Building Compensation Fund

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Dear Jessica,

Effectiveness and efficiency of the NSW Home Building Compensation Fund

We are pleased to present Taylor Fry's response to the Independent Pricing and Regulatory request for advice on the effectiveness and efficiency of the NSW home building compensation fund.

We look forward to discussing the report with you.

Yours sincerely,

Scott Duncan

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1 Executive summary

1.1 Scope

The Independent Pricing and Regulatory Tribunal (IPART) has been asked to review the efficiency and effectiveness of the New South Wales (NSW) Home Building Compensation Fund (HBCF) in protecting consumers. To support the review, Taylor Fry has been engaged by IPART to advise on the:

a. Key drivers of home building compensation claims costs in NSW and how they compare to the Queensland Home Warranty Insurance scheme (*Section 6*)
b. Costs and benefits of operating the NSW HBCF under a first resort model (Section 7)
c. Costs and benefits of combining the licencing and eligibility assessment functions (Section 8)
d. Actions the NSW Government may take to encourage insurers to enter the market (Section 9).

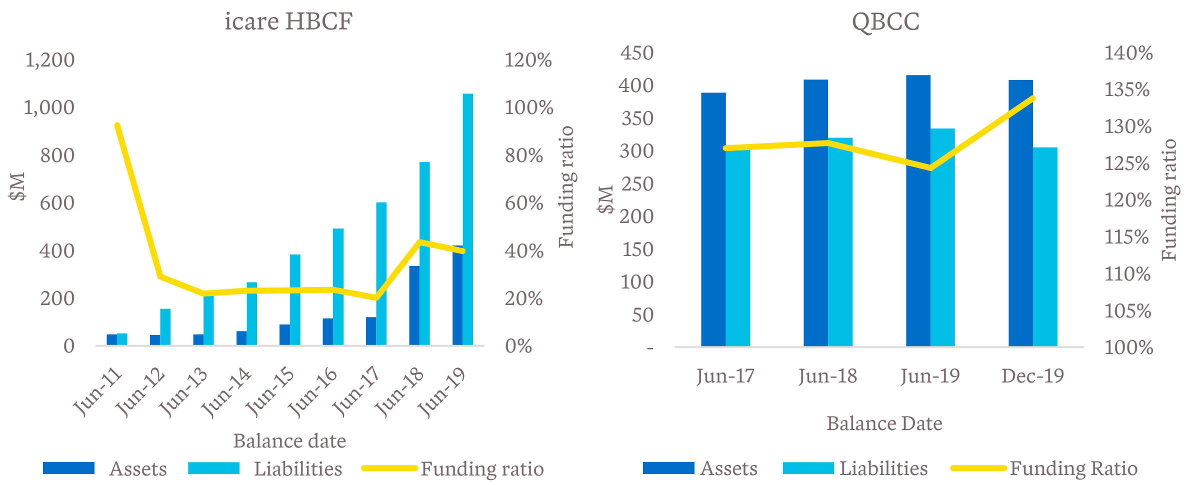
1.2 Key considerations and observations

Comparison of NSW and Queensland

- The NSW scheme is a last resort scheme. A homeowner can only make a claim against the scheme when the builder has become insolvent, died, disappeared or had their license suspended for failing to comply with a money order. The Queensland scheme is a first resort scheme. Homeowners can make a claim for all incomplete or defective work. Hence, the Queensland scheme provides greater protections to homeowners. Differences in scheme coverage are discussed in Section 4.
- There are several regulatory and operational processes that have a direct impact on the operation of the Home Building Compensation (HBC) and Home Warranty Insurance (HWI) insurance schemes. These functions include builder licencing, eligibility assessments, dispute resolution and regulation of building standards and building quality. In NSW, these functions are performed by separate organisations, while in Queensland, they are performed by the Queensland Building and Construction Commission (QBCC).
- When considering changes to the operation of the HBC Scheme, it is important to consider the scheme in the context of the wider construction industry. Changes made in one area (e.g. regulation of building standards) will impact experience in other areas (e.g. the volume of disputes and claims).
- The number of dwellings covered by HWI in Queensland is higher than in NSW which is driven by the lower threshold at which policies must be purchased – $3,300 in Queensland and $20,000 in NSW.
- Despite the lower number of certificates issued in NSW, total contract value is higher in NSW than in Queensland. In 2019, NSW HBC policies covered $15B in contract value while the Queensland HWI scheme covered $11B.
- New dwelling units (new single dwellings, new duplexes, triplexes and new multiple dwellings) account for a larger percentage of total contract value in Queensland than in NSW. The percentage has varied between 71%-82% in Queensland and 69-74% in NSW over 2011 to 2019.
- In NSW, GST (10%), Stamp Duty (9%) and brokerage are applied to premiums. In Queensland, GST (10%) is applied to premium rates. Stamp Duty does not apply in Queensland. There are no brokers in Queensland and therefore no brokerage.
- Current average premium rates in NSW are higher than in Queensland. Including charges, on average premium rates are 80% higher in NSW than in Queensland - 1.60% versus 0.91% of contract value. This is the case despite the Queensland scheme incurring expenses that currently fall outside the NSW scheme. For example, the cost of debt recovery when the builder is still trading.

- The multi-unit construction type has experienced large premium rate increases in NSW. Further increases are planned. In Queensland, there is no separate new multi-unit premium type. All new builds are charged the same premium rate.
- There has been a shortfall between the premiums collected and the cost of claims and expenses in NSW. Premiums have been sufficient to fund the cost of claims and expenses in Queensland.
- Figure 1.1 displays the historical funding ratio (assets divided by liabilities) for icare HBCF and QBCC[1]. At 30 June 2019, the NSW HBC Scheme had 40 cents in assets for every dollar in liabilities while the Queensland scheme has $1.24 in assets for every dollar in liabilities. The NSW scheme is reliant on funding from NSW Treasury.

Figure 1.1 – Historical funding ratio for icare HBCF and QBCC Insurance Fund



- Typically there is an inverse relationship between the level of construction activity and the number of claims reported (and therefore claims cost) in NSW. This is partly caused by the inverse relationship between construction activity and the risk of builder insolvency.
- For underwriting years 2011 to 2020, the average estimated ultimate claims cost as a proportion of contract values is 0.8% for NSW and 0.3% for Queensland. Adjusting Queensland claims experience for the difference in coverage in NSW increases the cost of claims as a proportion of contract value from 0.3% to 0.4%. The average estimated cost for Queensland is half of the average estimated cost for NSW (*Section 7*).

Operating the NSW HBCF under a first resort model

- While both schemes share the same objective of completing work and rectifying defects, there are significant differences in the NSW and Queensland claims processes. The key differences in the claims process are:
  - In NSW, the homeowner manages the process whereas in Queensland the QBCC is involved early and manages the process.
  - In NSW, the homeowner meets all costs associated with resolving the dispute whereas in Queensland the QBCC meets most of these costs.
  - The time to resolution / rectification is shorter in Queensland than in NSW.

[1] Liabilities for both states are reported at a 75% probability of sufficiency.

  - In Queensland, there is a strong incentive to prevent defects / rectify defective work through the strong link between the dispute resolution, licensing and insurance functions. The link in NSW does not appear to be as strong.
  - In Queensland, the QBCC holds data on all defects which they can use to understand trends and inform regulation. icare HBCF only holds data on defects associated with insolvent builders.
- Each element of the system must work together to support the viability of providing first resort cover. The factors that are critical to the successful operation of a first model include:
  - Robust builder licencing and eligibility requirements
  - Strong regulation and supervision of builders to reduce the cost and risk of defects
  - Strong incentives for builder to rectify defective work
  - The insurer must be able to handle a relatively high volume of disputes.
- NSW Fair Trading and NSW Civil and Administrative Tribunal (NCAT) have been unable to provide information on disputes and expenses at the level of detail required to support this analysis. The lack of relevant data has limited the analysis we have been able to perform. We note that collecting and analysing information on disputes and claims is important when it comes to informing regulation and policy decisions.
- Expenses collected through premiums are higher in Queensland than in NSW as a proportion of contract value. The QBCC covers expenses that currently fall outside the HBC scheme such as those currently incurred by NSW Fair Trading and NCAT.
- If NSW incurs the same claims cost and expenses as Queensland (as a percentage of contract value), fully funded premiums reduce from 1.6% to 1.1% of total contract value. Average premiums reduce from $3,700 to $2,500. Premium scenarios are presented in Section 7.

Combining the licencing and eligibility assessment functions

- Licensing and eligibility assessments have different focuses and tend to be performed with different frequencies. Builder licencing aims to ensure that only qualified builders can undertake building works whereas eligibility assessments are used to determine whether a builder should be able to obtain a certificate of insurance and under what conditions. The information required as part of the eligibility assessment process tends to be more comprehensive.
- While the advantages and disadvantages of combining the functions are similar for first resort and last resort schemes, there are additional factors that must be considered in a multi-provider market (*Section 8*).

Encouraging private insurers to enter the market

- There are several significant challenges currently facing the construction industry and NSW HBC scheme. Unless material risks are addressed, adequate insurance capital is unlikely to enter the market (*Section 9*).

1.3 Reliances and limitations

In undertaking this investigation, we have relied upon information supplied by various agencies. We have used the information without independent verification. However, where possible, the information received was reviewed for reasonableness and consistency.

Our analysis has been constrained by the available data. In particular, the following information was not available to support the analysis:

- The number, types and outcomes of disputes received by NSW Fair Trading and NCAT that relate to incomplete and defective building work
- Expenses related to the dispute resolution function of NSW Fair Trading and NCAT
- Expenses related to the licencing function of NSW Fair Trading, and the portion of these expenses recovered through licence fees
- Legal costs incurred by homeowners when seeking remedies from builders for incomplete or defective work.

It has been necessary to make a range of assumptions based on the information available. A high level of uncertainty therefore attaches to the estimate of the cost of operating the NSW scheme under a first resort model. Actual costs incurred may differ materially from the estimates provided.

2 Background and scope

Inside this section

We describe the background and scope of our review.

2.1 Status of report

This is the final version of this report and replaces all earlier drafts which are now to be considered withdrawn. No reliance should be made on the results contained in those earlier draft versions.

2.2 Background and purpose

This report has been prepared for the Independent Pricing and Regulatory Tribunal (IPART) for their internal use only.

IPART has been asked to review the efficiency and effectiveness of the New South Wales (NSW) Home Building Compensation Fund (HBCF) in protecting consumers. This includes whether the scheme can provide further incentives to builders for improved business practices, or whether additional processes would reduce the risks of insolvency.

To support the review, Taylor Fry has been engaged IPART to provide advice on the:

a. Key drivers of home building compensation claims costs in NSW and how they compare to the Queensland Home Warranty fund (Section 6)
b. Costs and benefits of operating the NSW HBCF under a first resort model (using the framework applied in Queensland) (Section 7)
c. Costs and benefits of removing the eligibility assessment from the scheme under a first-resort model, and instead conducting the same assessment as part of the builder licencing regime, including the operating costs of these assessments that would need to be recovered through licence fees. (Section 8)
d. Actions that the NSW Government should take to encourage private insurers to enter the market (Section 9).

In addition to the above, we have highlighted differences in scheme structure (*Section 4*) and summarised recent scheme experience (*Section 5*). This comparison provides useful context when interpreting differences in scheme costs.

2.3 Compliance

This report has been prepared in accordance with the requirements of the Practice Guideline 1 General Actuarial Practice.

3 Sources of information

Inside this section

We discuss the sources of information that have been used in our review.

icare HBCF, NSW Fair Trading, NSW Civil and Administrative Tribunal (NCAT) and the State Insurance Regulatory Authority (SIRA) have provided IPART with information as part of the review. We understand these organisations have been advised by IPART that Taylor Fry will undertake analysis using the information provided.

The Queensland Building and Construction Commission (QBCC) granted IPART access to information related to the Queensland scheme by way of written notice dated 10 July 2020.

Table 3.1 summarises the key sources of information that we have referred to in producing this report.

Table 3.1 – Sources of information

Organisation	Information
SIRA	▪ icare HBCF certificate, claims and payment datasets as at 30 June 2019 ▪ icare HBCF Premium Filing January 2020 ▪ Insurance and Care NSW Valuation of NSW Home Building Compensation Fund as at 30 June 2019 (performed by PricewaterhouseCoopers) ▪ December 2018 – Home building compensation report Dec 2018_ Data Tables
icare HBCF	▪ Data on each claim application as at 12 May 2020 ▪ icare HBCF contract with Gallagher Bassets for claims management services ▪ icare HBCF contract with Equifax for builder eligibility risk management assessment services
NSW Fair Trading	▪ Data on the number of licenced builders by licence class ▪ Information on the operation of the builder licencing function ▪ Information on the operation of the complaint management and dispute resolution function
NCAT	▪ Data on the number of home building lodgements by category ▪ Data on the number of home building matters by finalised order ▪ Data on the average number of days to finalisation for home building matters ▪ Information on the remuneration of staff
QBCC	▪ QBCC claim approvals datasets as at 31 December 2019 ▪ QBCC policy datasets as at 31 December 2019 ▪ Review of Home Warranty Insurance Premiums for 2020/21 (performed by Taylor Fry) ▪ QBCC Insurance Liability Valuation Update as at 31 December 2019 (performed by Taylor Fry) ▪ QBCC cost allocation model as at June 2019 ▪ Information from the QBCC on the operation of the dispute resolution function, eligibility assessments and debt recovery

We have relied on the data and information provided without independent audit or verification.

In many cases it has been necessary to extrapolate from the information available, as opposed to report on actual experience. This should be considered when interpreting our comments and observations.

4 The NSW Home Building Compensation scheme and Queensland Home Warranty Insurance scheme

Inside this section

We provide advice on differences in scheme structure in the following subsections:

4.1 What cover is provided by the Home Building Compensation and Home Warranty Insurance schemes?

0 Difference in coverage are discussed in Section 7.4.1.

Regulatory and operational processes impacting the schemes

4.1 What cover is provided by the Home Building Compensation and Home Warranty Insurance schemes?

The Home Building Compensation (HBC) and Home Warranty Insurance (HWI) schemes both provide cover to homeowners in the event of incomplete or defective building work. The main difference between these schemes arises from the circumstances in which a claim can be made:

- **The NSW HBC scheme is last resort** – A homeowner can only make a claim against the scheme when the builder has become insolvent, died, disappeared or had their license suspended for failing to comply with a money order (DDIO). If one of these conditions is not met, the homeowner and builder must seek to resolve the dispute outside the HBC scheme.
- **The Queensland HWI scheme is first resort** – Homeowners can make a claim for all incomplete or defective work. Section 7 outlines the steps required to file a claim in Queensland.

Table 4.1 summarises key features of the NSW and Queensland schemes.

Table 4.1 - Key features of the HBC and HWI schemes

	NSW HBC	QLD HWI
Is the scheme compulsory?	Yes. Builder purchases cover on homeowner's behalf for residential building projects valued at or above $20,000	Yes. Builder purchases cover on homeowner's behalf for residential building projects valued at or above $3,300
What losses are covered?	Defective and incomplete residential building work in buildings under four storeys	Defective and incomplete residential building work in buildings under four storeys
Is the scheme first or last resort?	Last	First
Maximum cover?	$340,000 for non-completion and defects in total.	Standard cover is $200,000 for both non-completion and defects (i.e. a claim with both a non-completion and defect component could reach up to $400,000 of cover in total). Additional cover can be purchased to increase

	NSW HBC	QLD HWI
		standard cover from $200,000 to $300,000.
How long is covered provided for?	Major defects – six years from completion Minor defects – two years from completion Non-completion – one year from failure to commence or cessation of work	Structural defects – six and a half years from payment of premium Non-structural defects – six months from completion Non-completion – two years from policy issue where work does not start, or two years from work commencing
Who provides cover?	icare HBCF. While the market is open to competition, there are currently no other providers.	QBCC.

Difference in coverage are discussed in Section 7.4.1.

4.2 Regulatory and operational processes impacting the schemes

There are several regulatory and operational processes that have a direct impact on the HBC / HWI insurance schemes:

- **Builder licensing** – How are builders assessed to have the appropriate qualifications and experience to perform a specific type of work?
- **Eligibility assessments** – How are builders assessed as being eligible to take out insurance, for what types of projects, and under what conditions?
- **Dispute resolution** – What happens if there is a dispute between the builder and the homeowner? For example, incomplete or defective building work, or contractual dispute.
- **Regulation of building standards and building quality** – How is the quality of the build assured?

Table 4.2 sets out how each of these processes occur in NSW.

Table 4.2 – Regulatory and operational processes impacting the NSW HBC scheme

Function	What occurs in NSW
Builder licencing	There are four licence classes: general building work, other building work, specialist work and trade work. Builders and contractors entering into residential building contracts requiring HBC cover must hold a current contractor licence. A contractor licence can be issued to individuals, partnerships or companies.
Eligibility assessments	Eligibility assessments consider a builder's financial performance, financial position, history and management structure, technical qualifications, and business capabilities. The assessment results in an eligibility profile which determines: ▪ The value and number of individual projects permitted under construction at any one time (open job limits)

Function	What occurs in NSW
	▪ The maximum contract price for individual construction categories (referred to as a construction profile).
Dispute resolution	Disputes may be initiated by the homeowner or the contractor.
Regulation of building standards and building quality	Accredited certifiers play a key role in regulating build quality through carrying out critical stage inspections during construction. The intention of these inspections is to ensure that building work is in accordance with the development consent and legislative requirements. The Public Accountability Committee's recent report *Regulation of building standards, building quality and building disputes* (April 2020) makes a range of recommendations covering inspections, flammable cladding and certification.

In NSW, these functions are performed by separate organisations while in Queensland, the functions are all performed by the QBCC. Table 4.3 lists the organisations performing the builder licencing, eligibility assessment and dispute resolution functions in NSW and Queensland.

Table 4.3 – Organisations and functions performed

Function	NSW	Queensland
Builder licencing	NSW Fair Trading	QBCC
Eligibility assessments	icare HBCF	QBCC
Dispute resolution	NSW Fair Trading: ▪ Provides dispute resolution services between homeowners and builders ▪ Building inspectors issue *Rectification Orders* where there are defects, incomplete or damages because of the contractor's work NCAT: ▪ Issues final orders when *Rectification Orders* are not complied with	QBCC: ▪ Provides dispute resolution services between homeowners and builders ▪ Issues *Direction to Rectify* when disputes are not resolved Queensland Civil and Administrative Tribunal (QCAT): ▪ Decides disputes related to building activities ▪ Reviews decisions made by QBCC related to disciplinary proceedings, licencing, rectification of work and insurance claims
Regulation of building standards and building quality	There are a number of organisations performing various functions that have an impact on building standards and building quality. NSW Fair Trading plays an important role through the regulation of accredited certifiers. The NSW Building Commissioner was appointed in August 2019 and has a range of responsibilities including investigating misconduct, overseeing licensing and auditing of the industry, and developing legislative reforms.	Certifiers: ▪ Building certifiers in Queensland are responsible for regulating compliance of buildings with the National Construction Code QBCC: ▪ The QBCC issues licences to the certifiers who must have achieved a certain level of qualification as determined by the Australian Institute of Building Surveyors (AIBS) or the Royal Institution of Chartered Surveyors (RICS)

5 Recent scheme experience

Inside this section

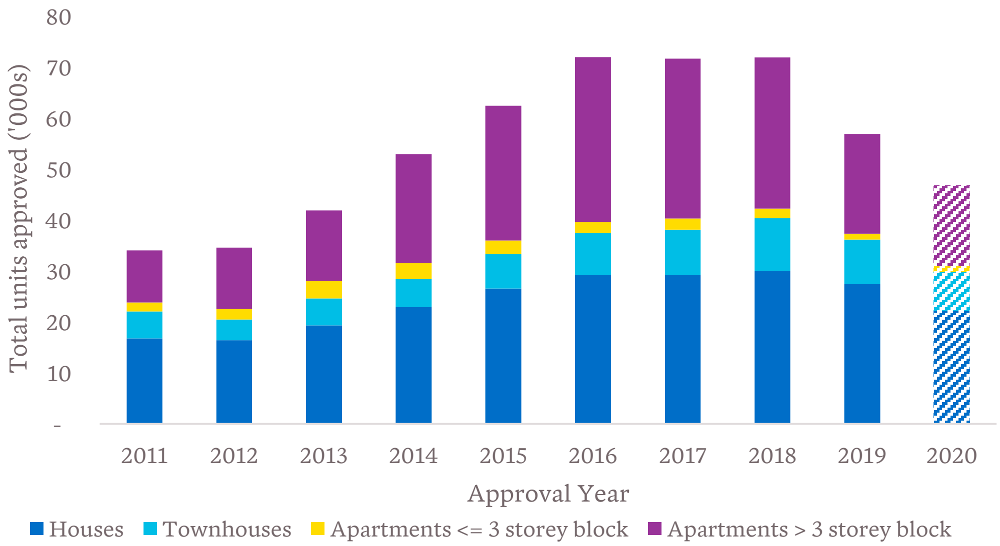
We discuss recent NSW and Queensland scheme experience. We focus on:

5.1 New building approvals
5.2 Certificates/policies of insurance
5.3 Contract value
5.4 Premiums
5.5 Financial position

5.1 New building approvals

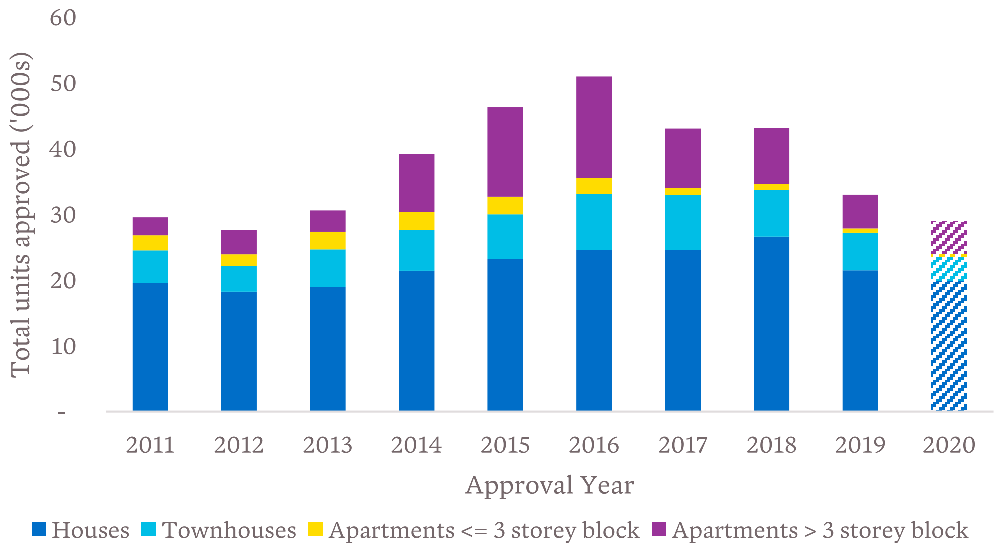
Figure 5.1 and Figure 5.2 display the number of new residential dwelling units approved in NSW and Queensland over the last ten financial years respectively. Houses, townhouses and apartments less than four storeys are covered by the HBC and HWI schemes. Apartments greater than three storeys are not covered by either scheme.

Figure 5.1 – New dwelling units in new residential buildings in NSW by construction type[2]



[2] Sourced from ABS Table 8371.0 Buildings Approvals, Australia. Figures for the 2020 approval year reflect nine months actual experience and three months projected experience. Projected experience does not reflect the impact of COVID-19.

Figure 5.2 – New dwelling units in new residential buildings in Queensland by construction type ('000s)[3]



Based on the ABS data we note:

- NSW and Queensland display similar trends in new dwelling unit approvals.
- In NSW, new dwelling unit approvals more than doubled increasing from 34,000 to 72,000 from 2011 to 2016. High-rise multi-units (> three storeys) accounted for a large component of the increase.
- In Queensland, new dwelling unit approvals increased by around two thirds from 30,000 in 2011 to 51,000 in 2016. Similar to NSW, high-rise multi units (>3 storeys) account for a large component of the increase.
- In NSW, residential construction activity reduced to 57,000 dwelling units in 2019 and is projected to reduce further to 47,000 dwelling units in 2020.
- In Queensland, residential construction activity reduced to 33,000 dwelling units in 2019 and is projected to reduce further to 29,000 dwelling units in 2020.

5.2 Certificates/policies of insurance

In NSW, HBC certificates of insurance are issued for new builds, alterations and renovations. One certificate is issued per dwelling. For example, a multi-unit construction with eight units would have eight certificates issued.

In Queensland, HWI policies of insurance are issued for new builds and alterations. A policy issued may cover multiple dwellings or building works. The number of dwellings covered by a policy is equivalent to the number of certificates issued on an HBC policy in NSW.

Figure 5.3 and Figure 5.4 display the number of HBC certificates and number of dwellings covered by HWI policies by cover type in NSW and Queensland respectively.

[3] Sourced from ABS Table 8371.0 Buildings Approvals, Australia. Figures for the 2020 approval year reflect nine months actual experience and three months projected experience. Projected experience does not reflect the impact of COVID-19.

Figure 5.3 – Number of HBC certificates issued in NSW[4]

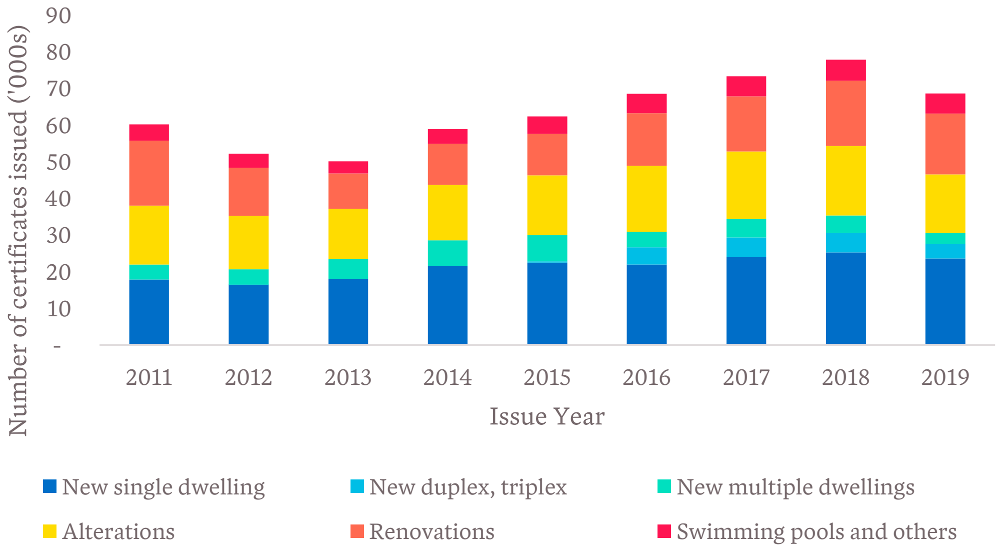
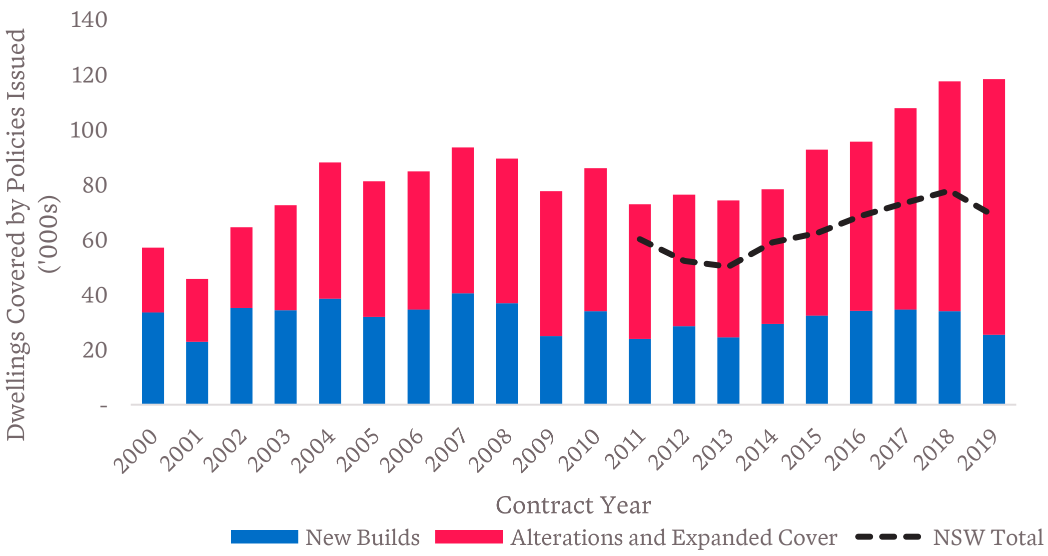


Figure 5.4 – Number of dwellings covered by HWI policies issued in Queensland[5]



We note:

- In NSW, HBC certificates issued grew from 50,000 in 2013 to approximately 80,000 in 2018. Certificates issued reduced to 70,000 in 2019 and are projected to reduce further over 2020.
- The number of dwellings covered by HWI policies issued in Queensland is higher than in NSW which is driven by the threshold at which policies must be purchased. HWI policies must be issued for projects valued over $3,300. In NSW, HBC certificates are only required for projects valued over $20,000.

[4] The "New duplex, triplex" cover code was introduced in 2016. Prior to this date, certificated related to duplexes and triplexes were coded under other construction types.

[5] Contract years post 2016 include an allowance for policies that are projected to be issued after the contract date.

- In Queensland, the number of dwellings covered by HWI policies has varied over the last twenty years in line with the building cycle and the population growth observed in the state.
- In November 2016, the QBCC implemented reforms which expanded the types of work covered to include pool and spa installation, painting, tiling and other non-structural works. As a result of these reforms, the number of building works covered by alterations policies increased from 2017.

5.3 Contract value

Figure 5.5 and Figure 5.6 display the total contract value of HBC certificates and HWI policies issued by cover type.

Figure 5.5 – Total contract value of HBC certificates issued in NSW

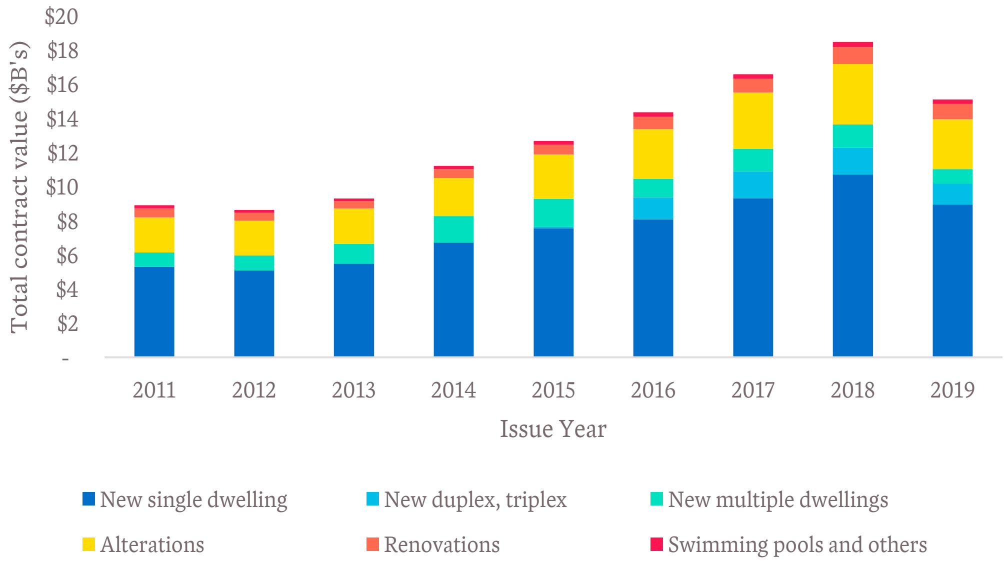
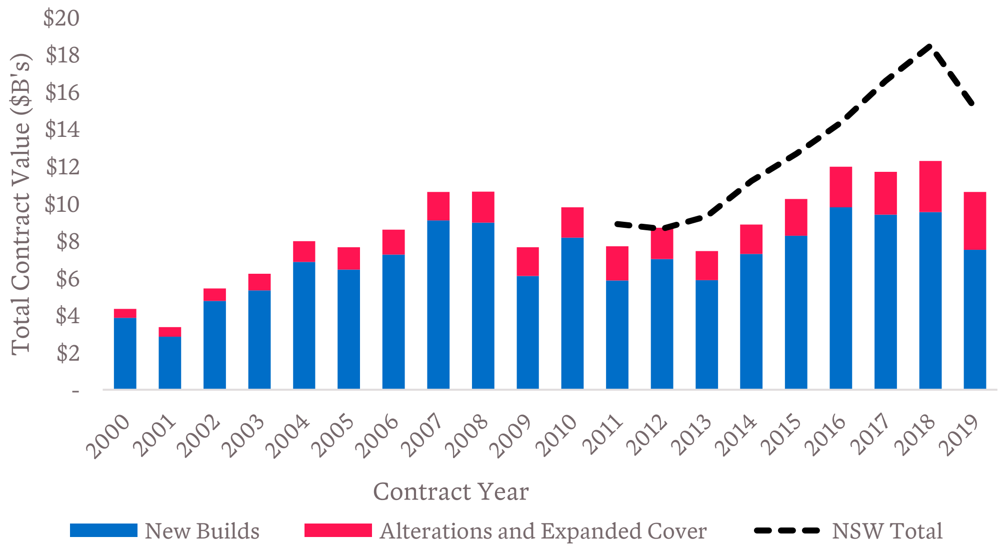


Figure 5.6 – Total contract value of HWI policies issued in Queensland[6]



[6] Contract years post 2016 include an allowance for policies that are projected to be issued after the contract date.

We note:

- In NSW, total contract value increased from $9B in 2011 to $18B in 2018. Total contract value reduced to $15B in 2019. New single dwellings account for 60% of activity in 2019, measured by total contract value.
- In Queensland, total contract value increased from $8B in 2011 to $12B in 2018. Total contract value reduced to $11B in 2019. 70% of total contract value in 2019 related to New Builds.
- Despite the lower number of certificates issued in NSW, total contract value is higher in NSW than in Queensland. In 2019, total contract value in NSW was 40% higher than in Queensland. It is useful to consider a comparison of median house prices, noting that median house prices will reflect land values as well as contract value:
  - Over 2019, median house prices in Sydney were on average 70% higher than those for Brisbane.
  - Over the same period, median house prices in the rest of NSW were on average 8% higher than those for the rest of Queensland.
- New dwelling units (new single dwellings, new duplexes, triplexes and new multiple dwellings) account for a larger percentage of total contract value in Queensland than NSW. The percentage has varied between 71%-82% in Queensland and 69-74% in NSW over 2011 to 2019.

Figure 5.7 shows the average contract value for HBC by cover type. Figure 5.8 shows the average contract value per new dwelling for HWI policies issued by cover type. Average contract value for New Builds and Alterations for NSW are also shown for comparison purposes.

Figure 5.7 – Average contract value of HBC certificates issued in NSW

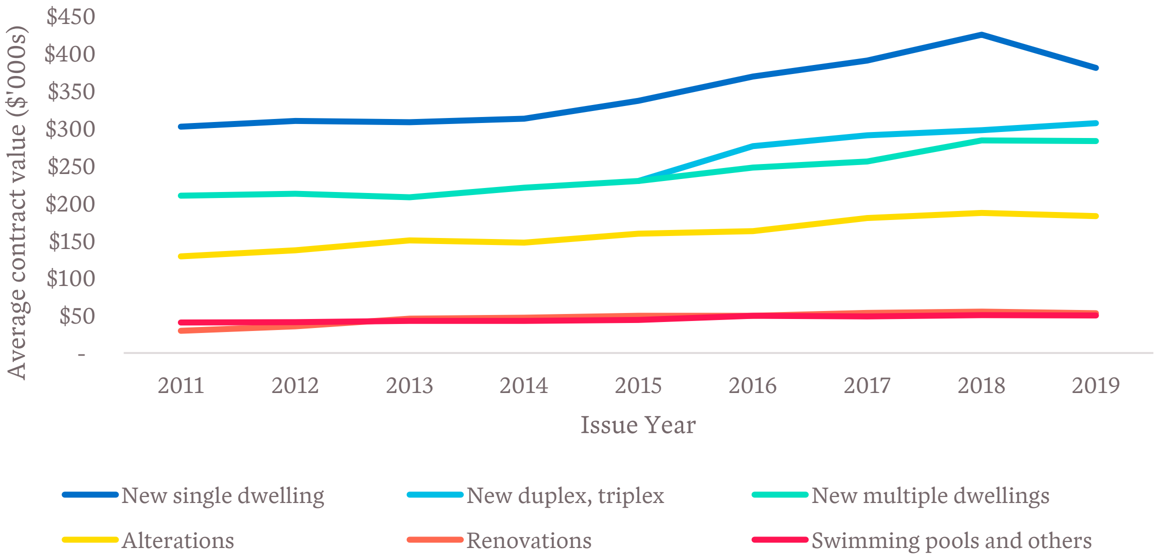
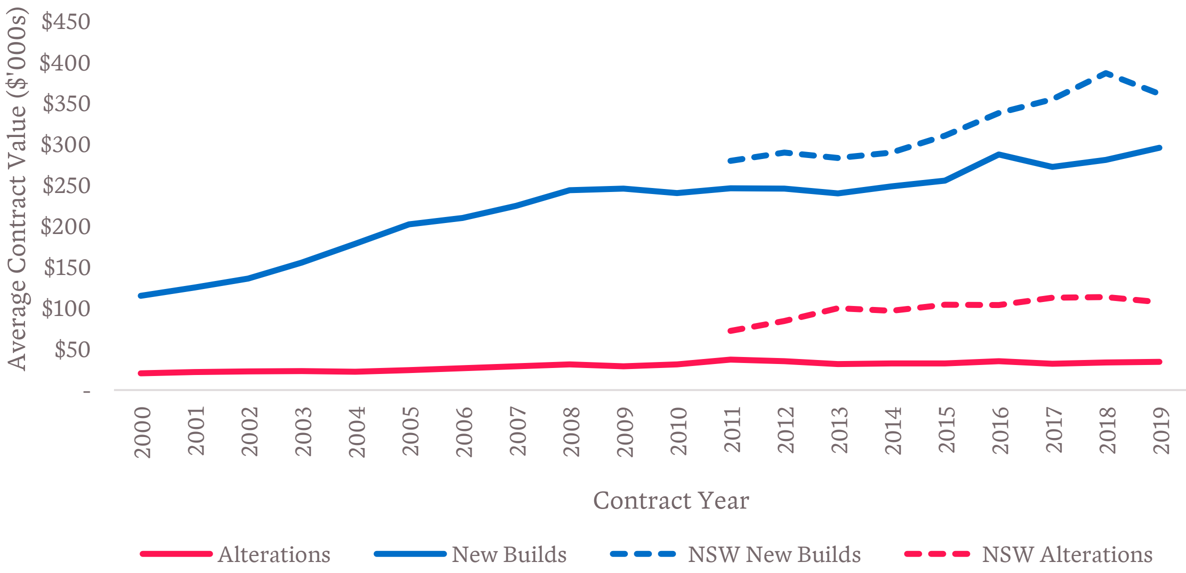


Figure 5.8 – Average contract value of HWI policies issued in Queensland[3]



We note:

- The average contract value for new single dwellings in NSW reduced from $425K to $380K from 2018 to 2019.
- The average contract value for New Builds in Queensland increased from $280K to $295K from 2018 to 2019. This is higher than the average growth rate of 2% p.a. over the past 10 years.
- For new dwelling units, the average contract value was 18% higher in NSW than Queensland over 2011-2019.
- For alterations, the average contract value was approximately three times (290%) higher in NSW than Queensland over 2011-2019.

5.4 Premiums

Premiums are set as a percentage of contract value and vary by construction type. In NSW, premiums also consider builder specific characteristics.

Figure 5.9 and Figure 5.10 display actual and proposed premium rates and average premiums[7] for HBC certificates in NSW. Premiums are sourced from icare's January 2020 premium filing and exclude GST, Stamp Duty and brokerage.

Figure 5.11 and Figure 5.12 display actual and proposed premium rates and average premiums for HWI certificates in Queensland. Premiums are sourced from the Review of Home Warranty Insurance Premiums for 2020/21 and exclude GST. There is no Stamp Duty or brokerage in Queensland.

[7] Average premiums are based on applying premium rates to 2020/21 projected average contract values.

Figure 5.9 – Premium rates for HBC certificates issued in NSW

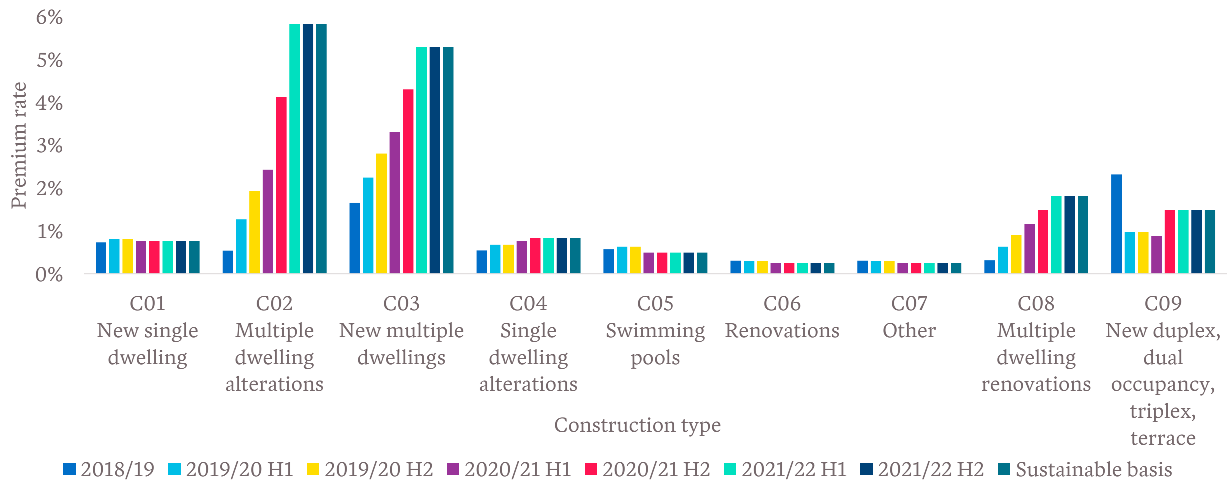


Figure 5.10 – Average premium for HBC certificates issued in NSW

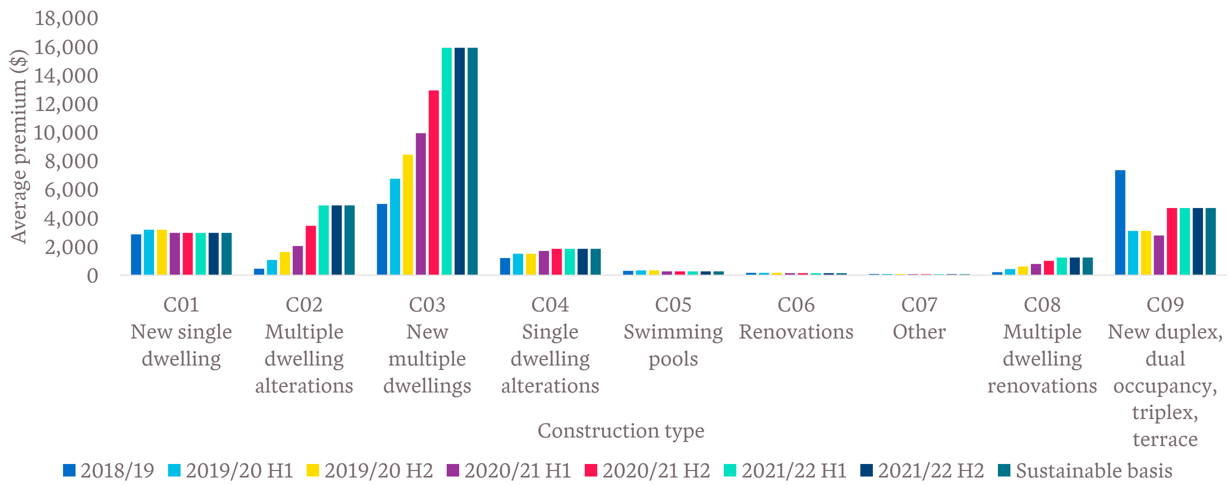


Figure 5.11 - Premium rates for policies issued in Queensland

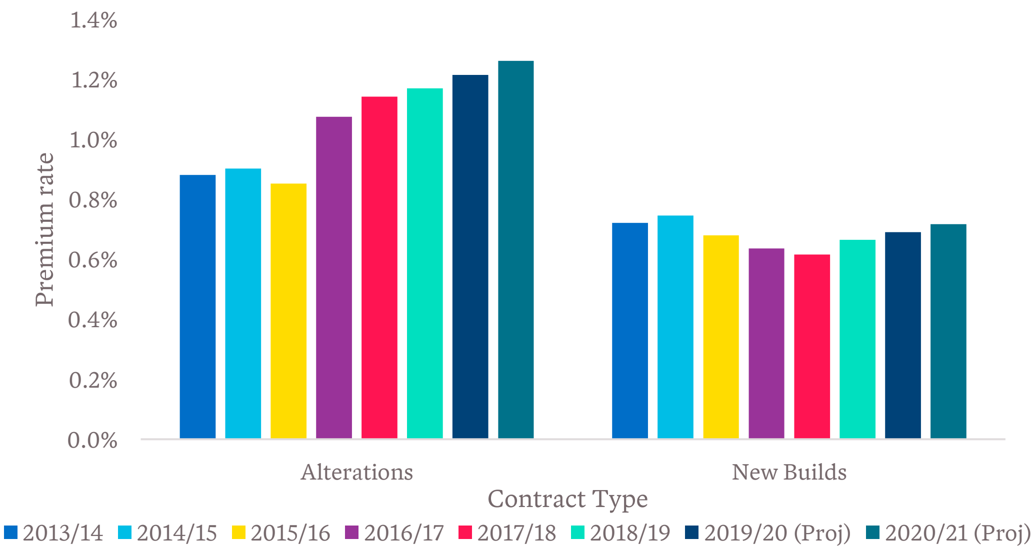
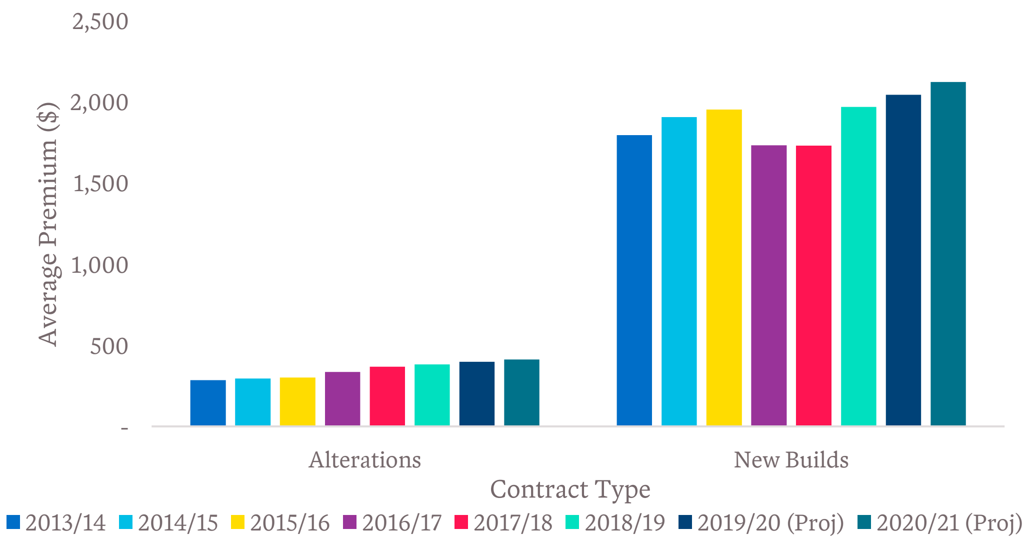


Figure 5.12 - Average premium for policies issued in Queensland

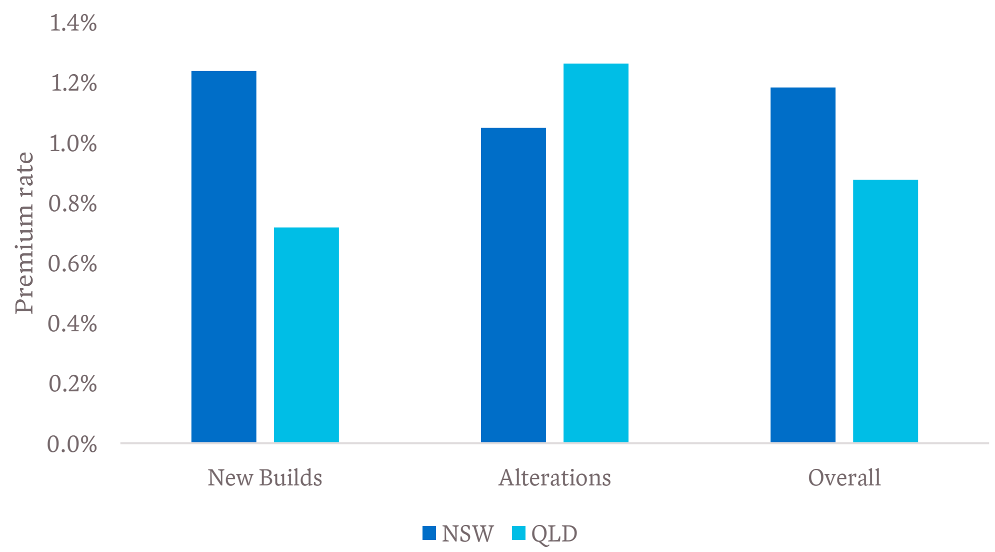


We note:

- Queensland has two categories for premium setting purposes whereas NSW has nine categories.
- In NSW, increases of 90%, 200% and 100% from 2019/20H2 rates are planned for new multiple dwellings, multiple dwelling alterations and multiple dwelling renovations, respectively.
- In NSW, the average cost per certificate per new multi-unit unit is approximately $16,000 on a fully funded basis. This compares to $2,000 in Queensland.

Figure 5.13 compares NSW and Queensland premium rates using Queensland's categories of New Builds and Alterations. Premium rates for New Builds and Alterations in NSW take a weighted average of construction categories that align with Queensland's categories. To allow for any differences in the mix of construction activity, the overall premium rate for both states takes a weighted average of the rates for construction categories based on the mix of construction activity in NSW. Sustainable basis rates and 2020/21 premium rates are displayed for NSW and Queensland respectively. Premiums exclude GST, Stamp Duty and brokerage.

Figure 5.13 - Comparison of NSW and Queensland premium rates - excluding charges



We note:

- For New Builds, at 1.24% the NSW weighted average premium rate is 73% higher than the 0.72% rate for Queensland
- For Alterations, the NSW weighted average premium rate is 17% lower than for Queensland (1.05% and 1.26% of contract value in NSW and Queensland respectively). We note that the higher rate in Queensland applies to a much lower average contract value and is largely reflective of the allocation of fixed costs.
- Overall, the NSW weighted average premium rate of 1.18% is 35% higher than the Queensland rate of 0.88%.

Figure 5.14 compares the overall premium rate between NSW and Queensland broken down by premium component. Premiums include GST, Stamp Duty and brokerage. Figures for Queensland will differ from Figure 5.13 as no adjustment is made to allow for differences in the mix of construction activity between states.

Figure 5.14 – Comparison of NSW and Queensland premium rates - including charges

We note:

- In NSW, a 15% profit / safety loading is included in premiums. In Queensland, a profit loading to cover the cost of reinsurance is included in premiums.
- In NSW, GST (10%), Stamp Duty (9%) and brokerage are applied to premiums. Brokers are engaged by builders to arrange HBC cover. Brokerage is normally applied as a loading to premiums and depends on the services provided. icare HBCF state that there is a wide variation in the fees brokers charge but that they are "*allowing the market to level out over time*"[8]. We understand that brokerage fees paid are not recorded by icare HBCF in the policy data records. We have made an allowance of 15% of premiums for brokerage which, based on anecdotal evidence, appears to be the order of magnitude of brokerage charged
- In Queensland, GST (10%) is applied to premium rates. Stamp Duty does not apply in Queensland. There are no brokers in Queensland and therefore no brokerage.

[8] https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/find-a-broker-distributor#gref

- Excluding GST, Stamp Duty and brokerage, on average premium rates are 43% higher in NSW than in Queensland - 1.18% and 0.83% of contract value in NSW and Queensland respectively.
- Including charges, on average premium rates are 80% higher in NSW than in Queensland - 1.60% versus 0.91% of contract value.

5.5 Financial position

Figure 5.15 and Figure 5.16 display the historical funding ratio (assets divided by liabilities) for icare HBCF and the QBCC respectively[9].

Figure 5.15 – Historical funding ratio for icare HBCF

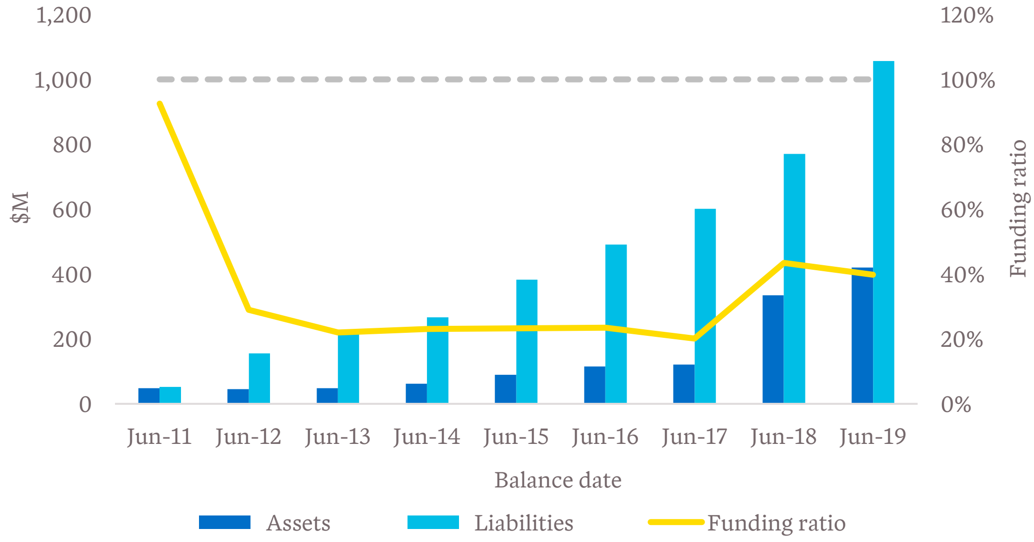
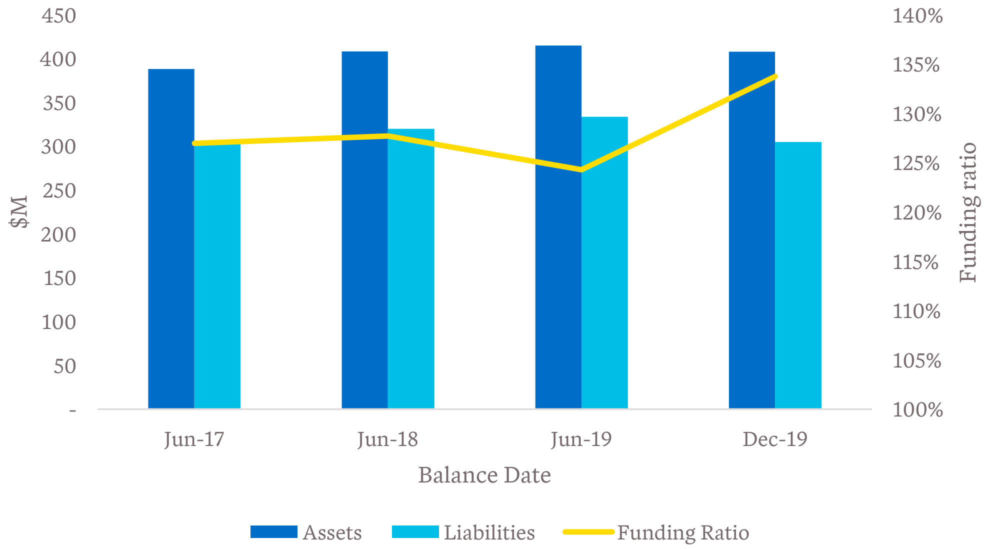


Figure 5.16 – Historical funding ratio for the QBCC Insurance Fund



[9] Liabilities for both states are reported at a 75% probability of sufficiency.

We note:

- At 30 June 2019, icare HBCF had 40 cents in assets for every dollar in liabilities.
- As at 30 June 2019, the QBCC had $1.24 in assets for every dollar in liabilities.
- Historically, NSW premiums have not been sufficient to fund the cost of claims and expenses. In Queensland, premiums have been sufficient to fund the cost of claims and expenses.
- In NSW, the increase in the funding ratio in 30 June 2018 is on account of a capital injection from Treasury.
- The solvency of the NSW scheme is heavily reliant on ongoing support from Treasury.

6 Key drivers of home building compensation claims costs

Inside this section

We discuss the key drivers of home building compensation claims costs in NSW and how they compare to Queensland HWI experience.

6.1 Drivers of home building compensation claims costs

6.2 A comparison of claims cost between NSW and Queensland.

6.3 Claims cost outlook

6.1 Drivers of home building compensation claims costs

6.1.1 Overview

The main drivers of insurance claim costs are:

1. Exposure to claims
2. Claims frequency (i.e. the number of claims reported)
3. The average size of claims

We outline the main factors influencing these claim cost drivers in home building compensation schemes.

Exposure

The level of exposure depends on the:

- **Volume of construction activity** – In general, the higher the total contract value covered, the higher the expected claims cost (See Figure 5.5 and Figure 5.6**).** The volume of construction activity is also influenced by the economic cycle. As a general rule, a booming economy contains a booming construction industry and vice versa.
- **Type of construction activity** – For example, the mix between new dwellings and alterations **(**See Figure 5.3 and Figure 5.4).
- **Statutory warranty periods** – The longer the statutory warranty period, the higher the expected claims cost (See Table 4.1).
- **Coverage** – The circumstance under which insurance is required and the level and nature of cover provided will impact claims costs. The differences in coverage summarised in Table 4.1 will impact the level of exposure under the NSW HBC and Queensland HWI schemes.

Claim frequency

The number of home building compensation claims reported depends on the:

- **Number of builder insolvencies** – The number of builder insolvencies is impacted by industry wide and builder specific factors. When the volume of activity reduces, builder insolvencies are more likely. The risk of insolvency for individual builders varies and depends on a variety of factors including their capital position and their ability to scale up or down their business in response to changes in demand.
- **Construction standards** – Construction standards will impact the number of building projects with defects and therefore the frequency of defect claims. Generally, during times of high construction activity, standards suffer due to the speed and volume of building works and the ability for poor quality tradespeople to get work.

- **Inspections / certification** – The number and depth of the inspections performed will impact the number of defect claims reported.
- **Mix of construction activity** – Changes in the mix of construction activity undertaken will lead to changes in claim frequency. For example, alterations and renovations tend to have a lower claim frequency than new builds.

Average claim size

The average size of home building compensation claims depends on the:

- **Cost of materials and labour** – When demand is high, these costs tend to increase.
- **Type of defects** – Differences in the types of defects reported will lead to differences in the average size of claims.
- **The timing of identification** – In general, the earlier defects are identified and rectified, the lower the average claim size.
- **Duration between defective / incomplete work being undertaken and claim resolution**: In general, the longer this period, the higher the cost of rectifying the defect as the initial defect is likely to have caused more flow-on damage or incomplete works to have weathered.
- **Mix of construction activity** – The cost to rectify defects is expected to vary by construction type. Claims cost will also depend on the extent to which the defect is systemic for duplexes, triplexes and multi-units (i.e. the same defect impacting multiple dwellings).

6.1.2 Quantifying the impact

While we are not able to rank the factors above in order of significance as many of the factors driving costs are correlated, we can analyse the relationship between the number of claims reported and the level of construction activity. Figure 6.1 and Figure 6.2 display the relationship between the number of new dwelling units approved and the number of claims reported by approval / reported quarter in NSW and Queensland respectively.

Figure 6.1 - Construction activity and reported claims in NSW

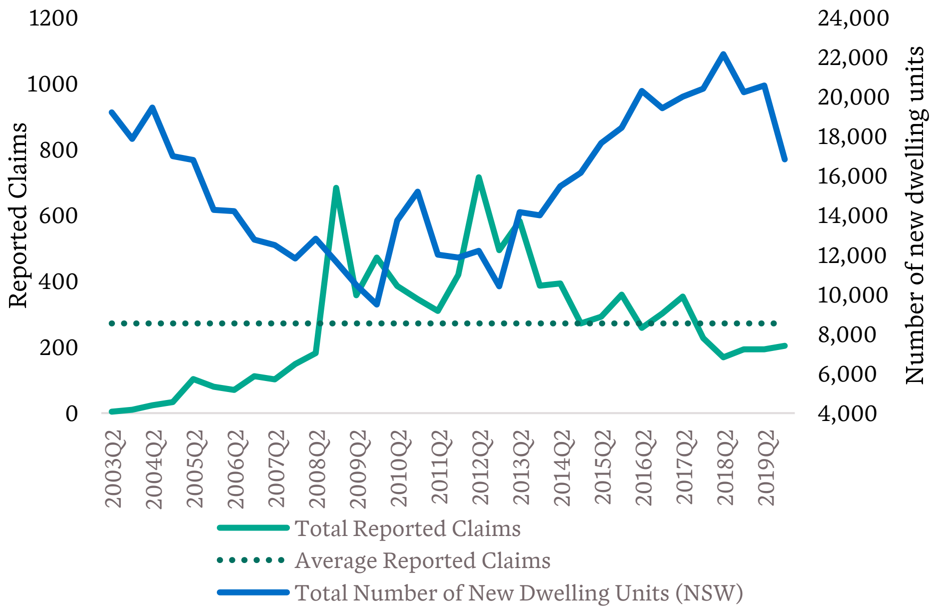
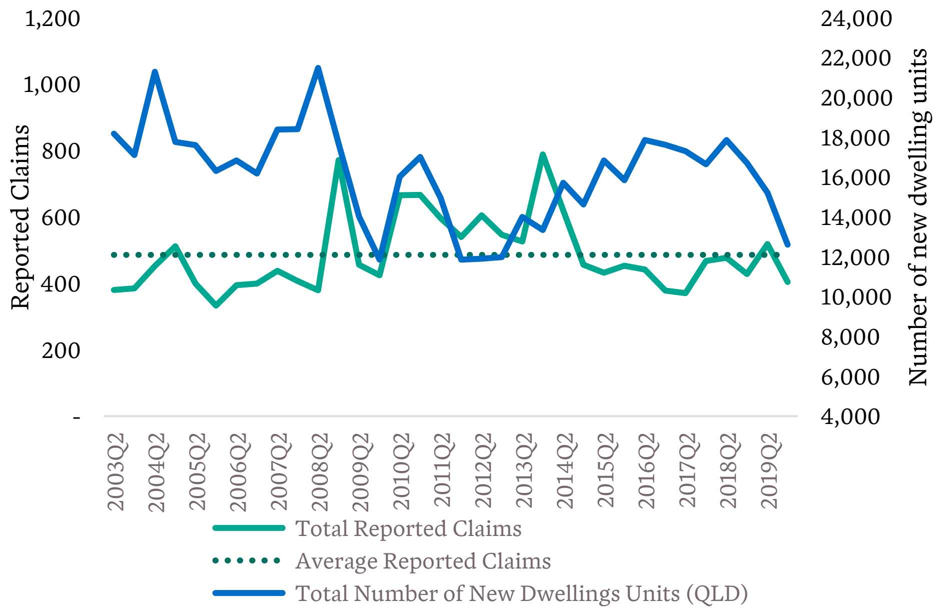


Figure 6.2 - Construction activity and reported claims in Queensland



We note:

- Typically, there is an inverse relationship between construction activity and the number of claims reported in NSW. This is partly caused by the relationship between construction activity and the risk of builder insolvency.
- The relationship between construction activity and the number of claims reported in Queensland is weaker than in NSW. This is partly a result of the first resort nature of the Queensland scheme where builders do not have to be insolvent for a homeowner to make a claim.

6.2 A comparison of claims cost between NSW and Queensland

6.2.1 Reported claims

Figure 6.3 and Figure 6.4 display the cumulative number of claims reported as at 30 June 2019 by underwriting year (i.e. the year in which an insurance policy is incepted) in NSW and Queensland respectively. A development year of 0 means the claim was received in the same financial year the policy was issued. A development year of 1 means the claim was received in the financial year after the policy was issued and so on.

Figure 6.3 - Reported claims development by underwriting year - NSW

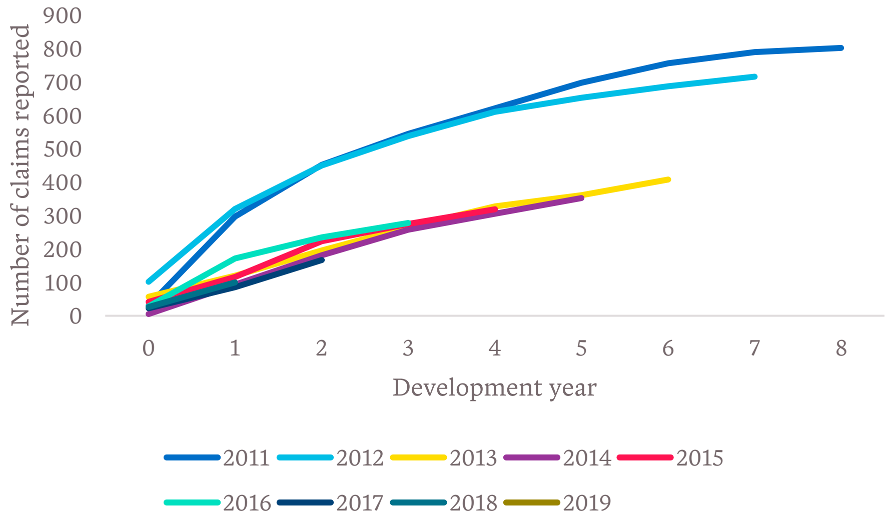
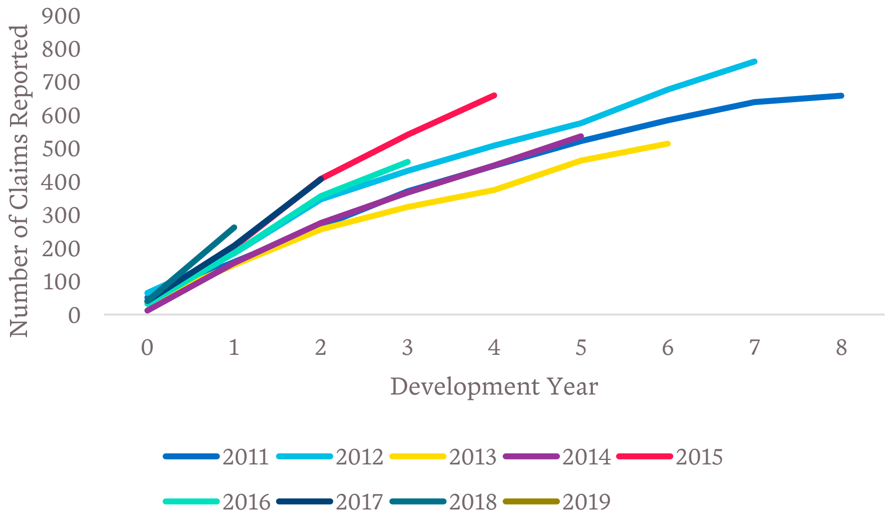


Figure 6.4 - Reported claims development by underwriting year - Queensland



We note:

- It can take many years for home building compensation claims to be reported. Claims continue to be reported in 2019 for the 2011 underwriting year – eight years after policies were issued in both schemes.
- There is less variation in the number of claims reported by underwriting year in Queensland than for NSW.
- Typically, claims are reported earlier in Queensland than in NSW. This is expected given the first resort nature of the Queensland scheme.
- The number of claims reported in NSW and Queensland are similar for the 2011, 2012 and 2013 underwriting years.
- The last resort nature of the NSW scheme means that the impact of economic downturns will tend to be greater than in Queensland due to the increase in builder insolvencies.

6.2.2 Claim payments

Figure 6.5 and Figure 6.6 display gross cumulative payments (i.e. exclusive of reinsurance and non-re-insurance recoveries) as at 30 June 2019 by underwriting year for NSW and Queensland respectively. Development year has the same definition as for reported claims.

Figure 6.5 - Gross claim payments development by underwriting year - NSW

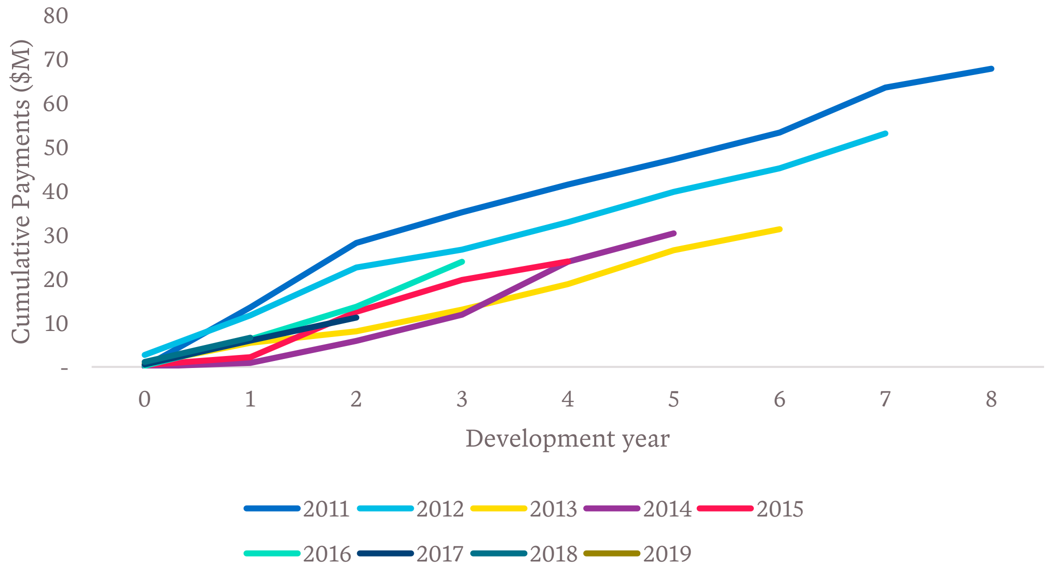
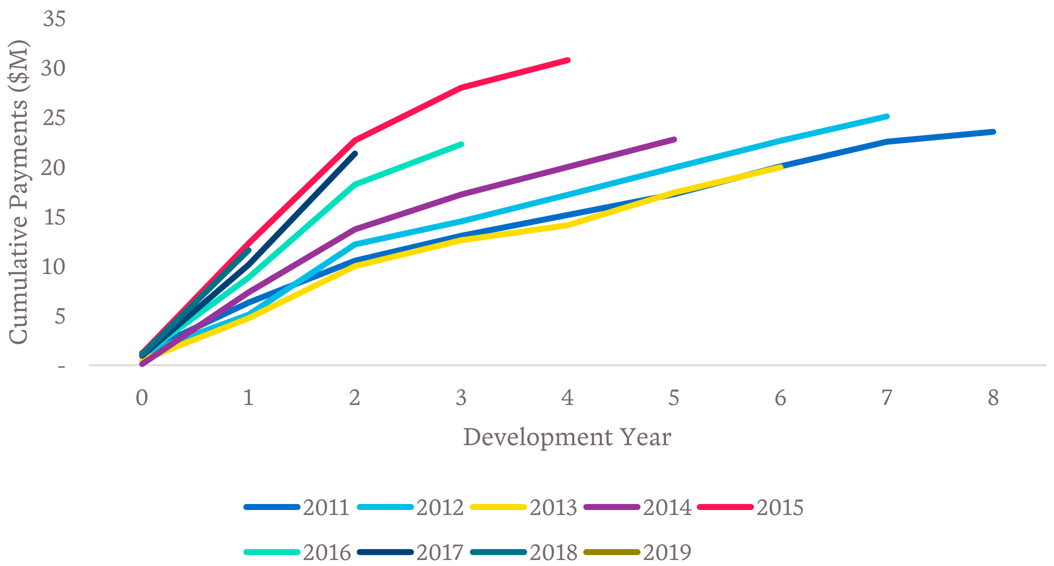


Figure 6.6 - Gross claim payments development by underwriting year - Queensland



We note:

- Payments continue to develop more than eight years after the policy was issued in both schemes.
- In NSW, the 2011 and 2012 underwriting years are tracking above other underwriting periods at the same stage of development.
- In Queensland, payment experience for underwriting years 2015 and later are tracking at higher levels than earlier underwriting years at the same stage of development which is to be expected given the higher volume of policies.

6.2.3 Projected ultimate claim payments

To project future claims experience, actuarial assumptions are applied to experience to date. Assumptions will consider a range of factors and change from year to year in response to emerging experience.

Assumptions will typically consider:

- Historical claim report / payment / reported incurred cost development patterns
- Experience to date and trends in recent experience
- The mix of construction activity
- Non-completion and defect claims separately, as non-completion claims are typically reported and paid earlier than defect claims
- Scheme design
- Underwriting and claims management processes
- As outlined in Table 4.1, policies are likely to be subject to a range of economic and construction environments - this is considered when applying actuarial assumptions.

Actuaries may have different views on what reasonable assumptions are, particularly where data is sparse. For NSW, the projections[10] displayed below are based on the icare Valuation of NSW Home Building Compensation Fund performed by PricewaterhouseCoopers as at 31 December 2019. For Queensland, the projections displayed below are based on the Insurance Liability Valuation Update performed by Taylor Fry as at 31 December 2019.

Figure 6.7 and Figure 6.8 display net cumulative payments (i.e. allowing for non-reinsurance recoveries) to 30 June 2020 and projected outstanding payments by underwriting year in NSW and Queensland respectively. Payments have been discounted to the middle of each underwriting year (the average time at which a certificate is issued) assuming the return earned on investments is equal to the rate of inflation.[11] This reduces the possibility that past fluctuations in the rate of inflation may distort the comparison between underwriting years.

[10]Projections for the 2020 underwriting year and transaction year are a mix of actual and projected values – actual payments up to December 2019 and projected payments for the March 2020 and June-2020 quarters.

[11] In line with PWC's valuation, NSW payments are inflated (and discounted) using a 75% / 25% weighted mix of movements in Average Weekly Earnings (AWE) and Consumer Price Index (CPI) in NSW. For Queensland, claim payments are inflated using Queensland House Construction Output Produce Price Index where available, in line with Taylor Fry's valuation.

Figure 6.7 - Projected claims cost by underwriting year - NSW

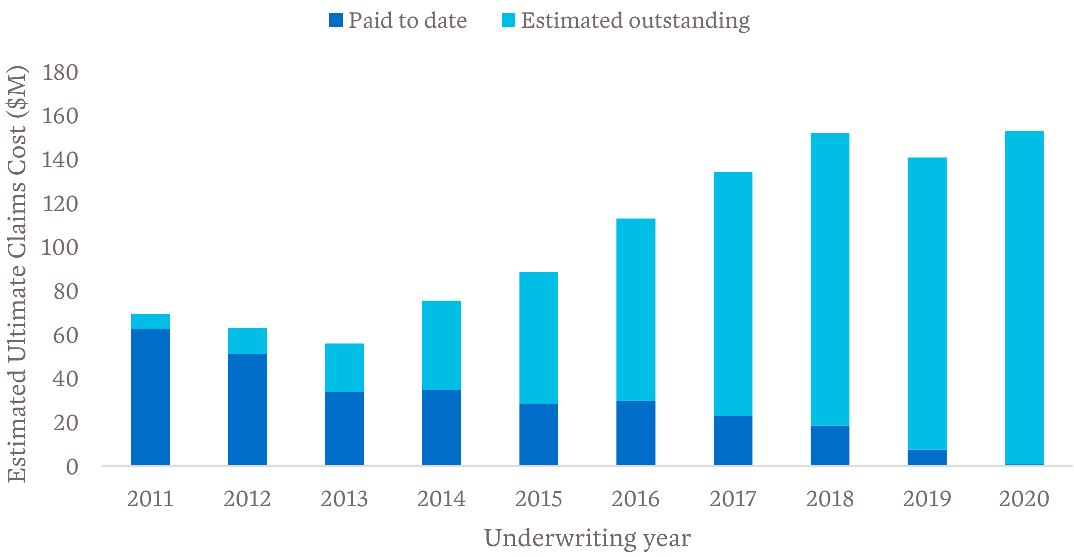
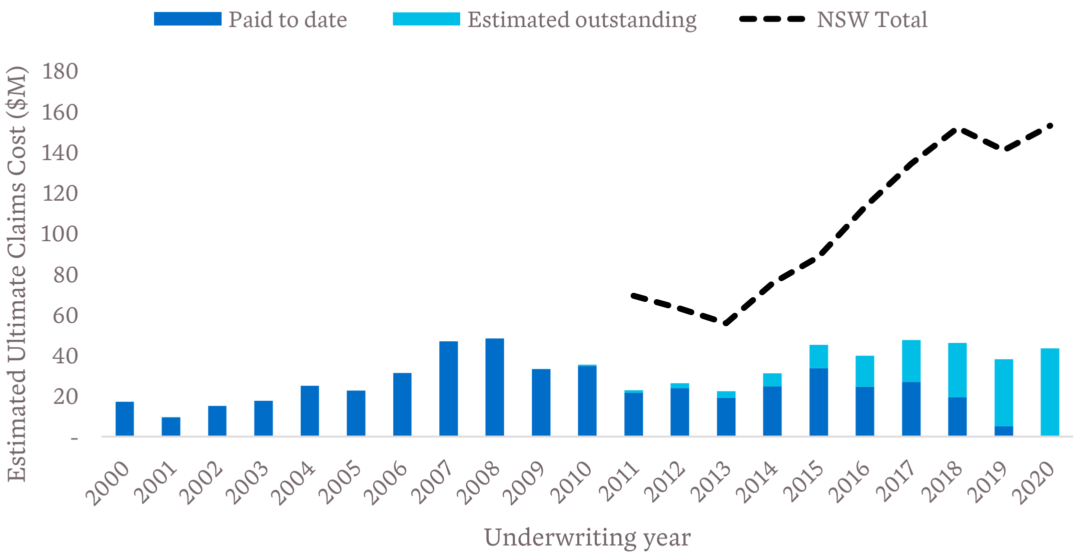


Figure 6.8 - Projected claims cost by underwriting year - Queensland



We note:

- In NSW, the average estimated ultimate claims cost is $105M over the 2011 to 2020 underwriting years.
- In Queensland, the average estimated ultimate claims cost is $36M over the 2011 to 2020 underwriting years.
- In dollar terms, the average estimated ultimate claims cost is three times higher in NSW than in Queensland before any adjustment for differences in construction activity and coverage.
- In Queensland, on average, the estimated ultimate cost in the best performing years is approximately half of the overall average, whereas in the worst performing years cost can range from 1.5 to 2 times the overall average. The experience of other schemes is similar.

Figure 6.9 and Figure 6.10 express the estimate of ultimate payments as a proportion of contract value.

Figure 6.9 - Estimated ultimate claims cost as a proportion of contract value - NSW

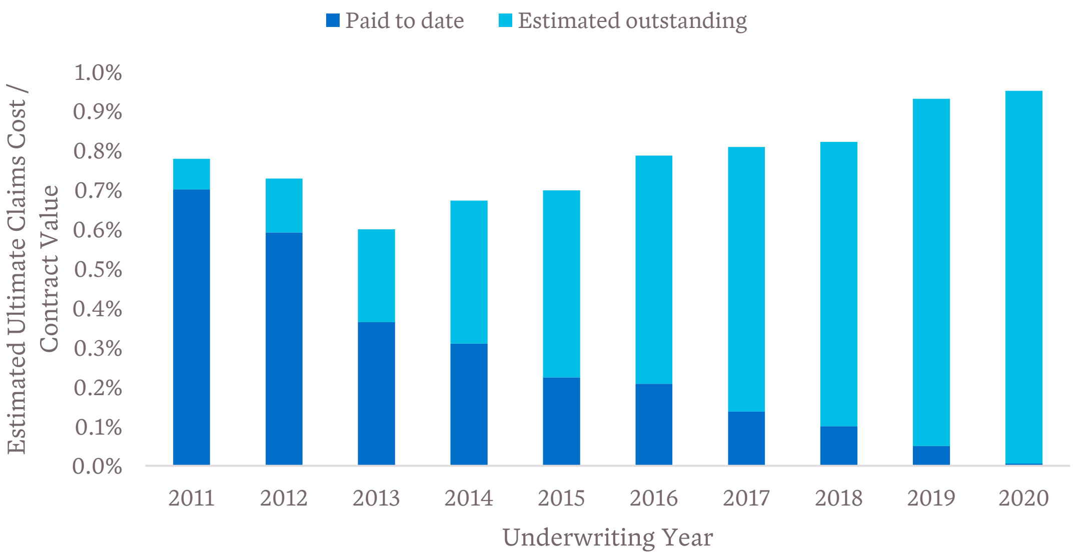
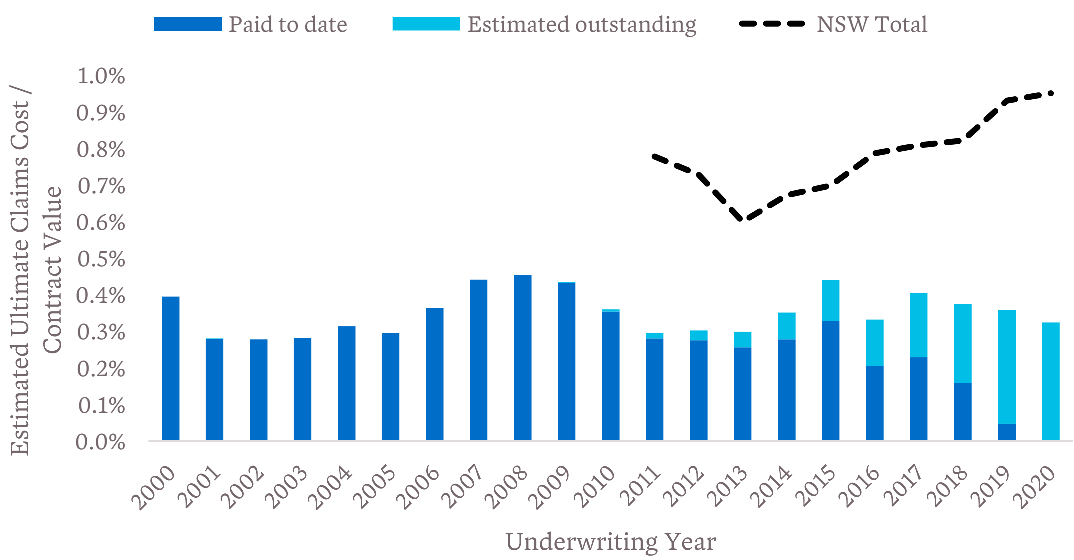


Figure 6.10 - Estimated ultimate claims cost as a proportion of contract value - Queensland



We note:

- In NSW, the average estimated ultimate claims cost as a percentage of contract values has increased from 0.6% for the 2013 underwriting year to 1.0% for the 2020 underwriting year
- In NSW, the average ultimate estimated ultimate claims cost is 0.8% of contract value over the 2011 to 2020 underwriting years
- In Queensland, the average estimated ultimate claims cost is 0.3% of contract value over the 2011 to 2020 underwriting years – less than half of the average cost for NSW.

6.3 Claims cost outlook

6.3.1 Impact of economic downturn

Claims cost is projected to increase over the coming years as construction activity reduces. Although construction activity had started to decline pre-COVID-19, the economic impacts of COVID-19, in isolation, would be expected to accelerate the reduction in construction activity. The Commonwealth Government's HomeBuilder program, announced on 4 June 2020, is likely to mean the reduction in construction activity is lower than would otherwise be the case.

The economic downturn on account of COVID-19 is anticipated to lead to:

- **An increase in the number of builder insolvencies**, leading to an increase in the number of claims reported. The temporary changes to insolvency laws may mean that observing the full impact is delayed. The statutory warranty period means that new claims reported may relate to policies issued many years ago. The increase in claims reported will place pressure on the scheme's financial position.
- **A reduction in construction activity and premium income**. Where premiums are adequate to cover the cost of claims and expenses, a reduction in construction activity will place pressure on the scheme's finances. However, for multi-units in NSW, where premiums are insufficient to cover the expected cost of claims and expenses, the reduction in activity is expected to have a positive impact on the scheme's financial position.
- **A reduction in investment income**. Sustained low investment returns will place pressure on the scheme's financial position.

6.3.2 Scenario analysis

We estimate the impact on the NSW HBC scheme under the following scenarios:

- **Scenario 1** – Construction activity reduces to post GFC levels where it remains for two years before increasing at 3% per quarter until certificates recover to average levels
- **Scenario 2** – Construction activity reduces to 125% of post GFC levels where it remains for two years before increasing at 3% per quarter until certificates recover to average levels.

We note that a high degree of uncertainty surrounds the projections and actual experience may differ materially from the projections shown. This analysis was undertaken in April 2020 and made no allowances for the impact of icare's response to COVID-19, the Federal Government's HomeBuilder stimulus program or icare's change in investment strategy.

Figure 6.11 displays the historical and projected new residential dwelling unit approvals under Scenario 1 and 2.

Figure 6.11 - New dwelling units in new residential buildings

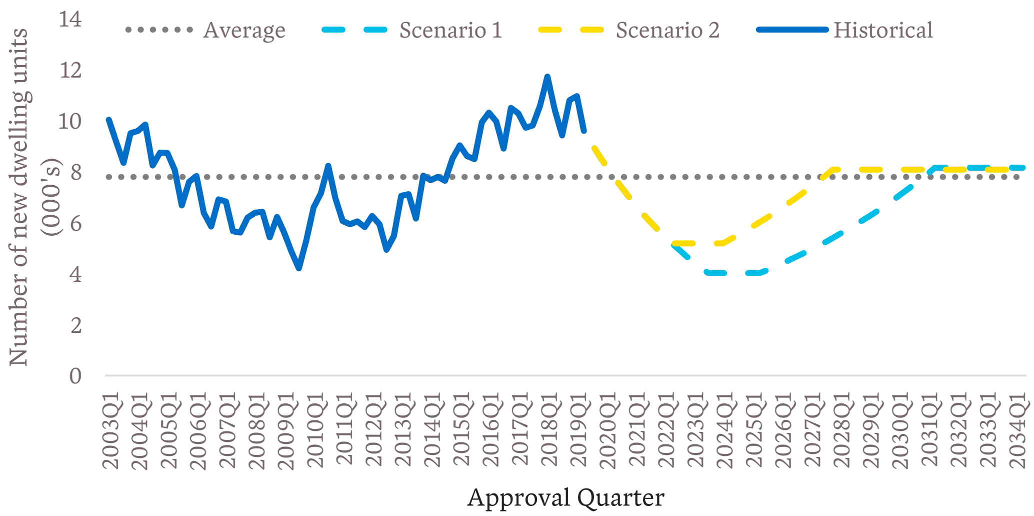


Figure 6.12 displays actual and projected claims reported under Scenario 1 and 2. The number of additional claims projected to be reported relative to average levels is 1,800 and 550 under Scenario 1 and 2 respectively.

Figure 6.12 - Reported claims

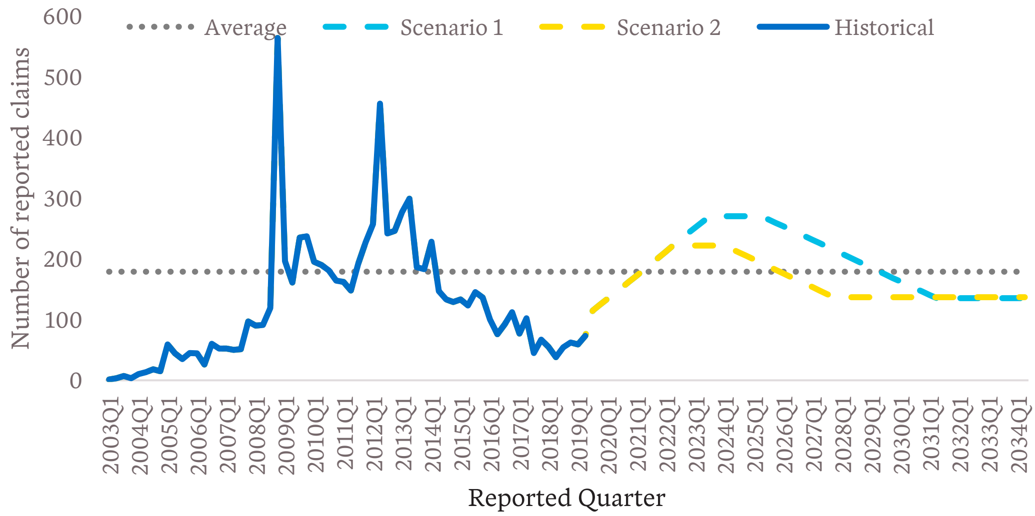
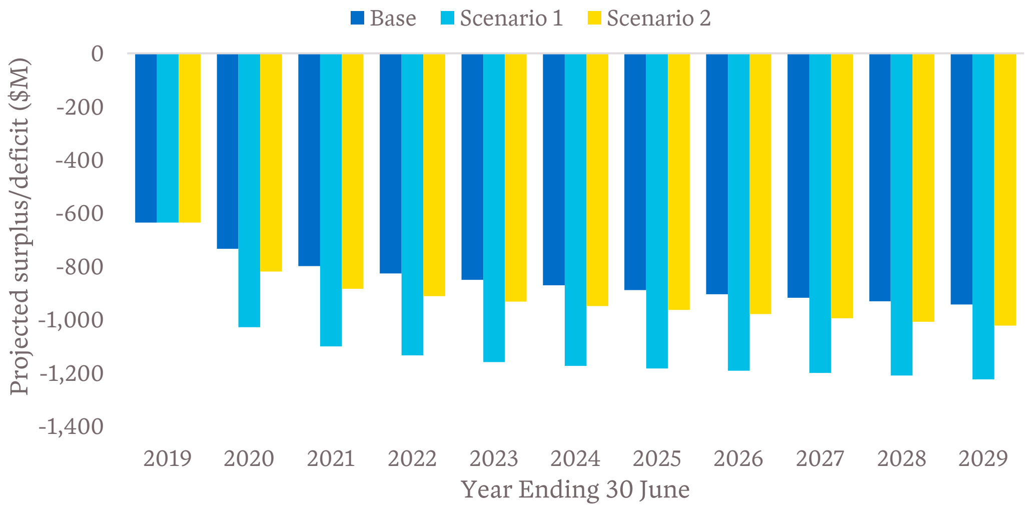


Figure 6.13 shows the projected increase in the funding shortfall.

Figure 6.13 - Projected deficit (projected scheme assets less liabilities)



The projected shortfall is projected to increase from $637M at 30 June 2019 to $1.030B at 30 June 2020 under Scenario 1. The shortfall is project to increase to $0.820B at 30 June 2020 under Scenario 2.

7 Operating the NSW scheme under a first resort model

Inside this section

We discuss operating the NSW scheme under a first resort model in the following subsections:

7.1 What is the difference between a first and last resort model?

7.2 How do the NSW and Queensland claims processes compare?

7.3 What are key success factors to the operation of a first resort model?

7.4 How do the costs of the current NSW and Queensland schemes compare after adjusting for differences in coverage and exposure?

7.5 Potential impact on premiums

7.6 Consequences for builders and potential new entrant insurers

7.1 What is the difference between a first and last resort model?

First and last resort models both share the same objective which is to provide a safety net for consumers in the event of incomplete or defective residential building work.

Under both models, the builder purchases the cover on behalf of the homeowner and the homeowner is beneficiary in the event of a claim. The two models differ in terms of when the safety net is provided:

- **Under a first resort model, the owner reports a claim directly to the insurer.** The insurer manages the claim and either ensures the builder completes or repairs the work or pays for the work to be completed and seeks recovery from the builder.
- **Under a last resort model, the scheme only manages the claim if specific triggers are met**. In NSW, these triggers are the builder has either become insolvent, died, disappeared or had their license suspended for failing to comply with a money order. If none of these conditions are met, the homeowner must seek to resolve the dispute outside the NSW HBC scheme.

When comparing models, it is important to place the home building compensation scheme in the context of the wider construction industry. Changes made in one area (e.g. regulation of building standards) will have effects elsewhere (e.g. the volume of disputes and claims).

Table 1.2 summarises the functions that have an impact on the HBC scheme. Each function is important when it comes to the efficient operation of a home building compensation scheme. However, specific functions become more important under different operating models. In particular:

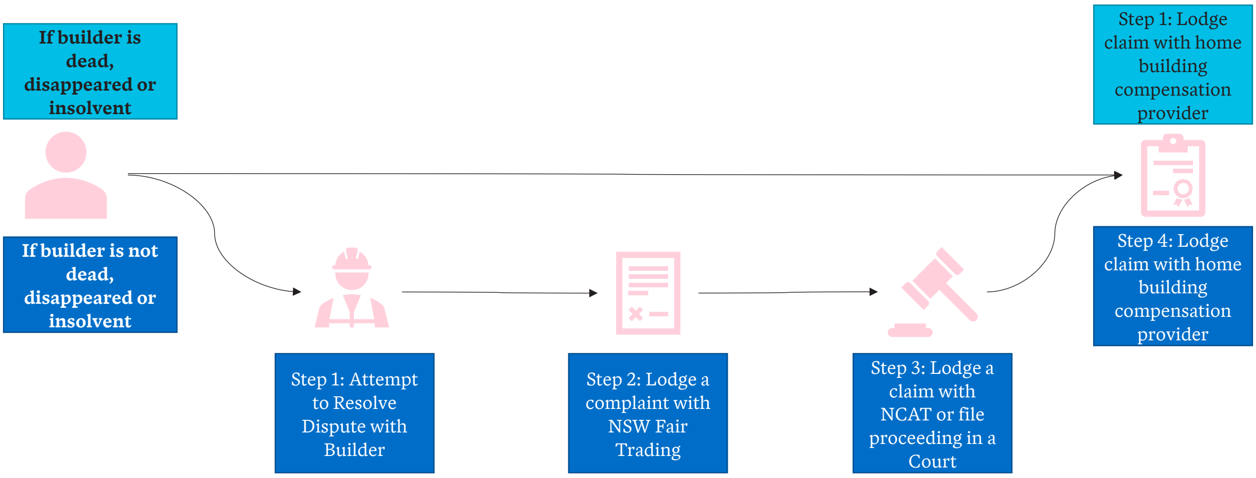
- **For a first resort model to be successful, there needs to be a strong incentive for builders to prevent defective work and rectify defects when they arise. This incentive is normally achieved through builder licencing requirements and conditions that link builders obtaining new contracts to the absence of outstanding claims.**
- **Dispute resolutions mechanisms are increasingly important in last resort schemes to assist consumers and builders, particularly as most disputes will take place outside of the insurance scheme.**

7.2 How do the NSW and Queensland claims processes compare?

7.2.1 NSW

Figure 7.1 outlines the steps a homeowner may take to resolve a dispute in NSW.

Figure 7.1 – Homeowner journey in NSW



In NSW, the steps a homeowner takes to resolve a dispute differs depending on whether the builder is dead, disappeared or insolvent.

Table 7.1 – Detailed homeowner journey in NSW

Scenario 1: Builder is dead, disappeared or insolvent

Step	When	Homeowner's responsibilities	Possible outcomes
1. Lodge claim with home building compensation provider	The homeowner may lodge a claim if the builder is unable to rectify the loss due to insolvency, death or disappearance.	Submit claim with insurer (currently icare HBCF).	

Scenario 2: Builder is not dead, disappeared or insolvent

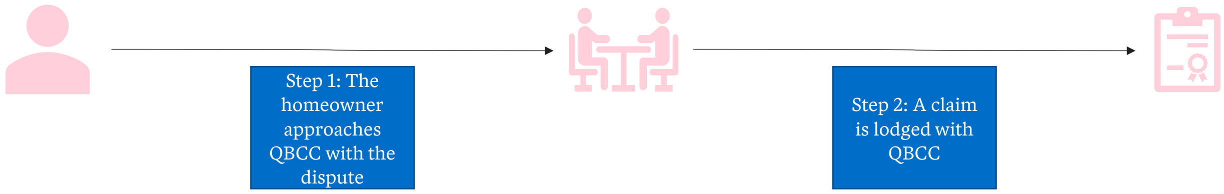
Step	When	Homeowner's responsibilities	Possible outcomes
1. Attempt to resolve dispute with builder	As soon as the homeowner identifies possibly defected or incomplete work.	If the homeowner believes there is incomplete or defective work, NSW Fair Trading encourages the owner to discuss resolution directly with the builder before lodging a formal complaint.	The parties agree between themselves on an acceptable resolution. Otherwise, the homeowner may proceed to lodging a complaint with NSW Fair Trading.

Step	When	Homeowner's responsibilities	Possible outcomes
2. Lodge a complaint with NSW Fair Trading	If the homeowner and builder cannot come to a resolution on their own, the homeowner then lodges a complaint with NSW Fair Trading.	The homeowner must lodge an application with NSW Fair Trading and have the builder agree to the attempt at resolution through Fair Trading. The homeowner must also at notify the builder's HBC insurer of the dispute	Fair Trading Building Inspector may arrange a building inspection. If the Inspector identifies matters that the builder needs to rectify, a rectification order will be issued. If the builder fails to comply with the rectification order, or if the homeowner is not satisfied with the resolution, they may proceed to lodging a claim with NCAT or a court, depending on the size of the claim.
3. Lodge a claim with NCAT or file proceedings with a court	If the builder fails to comply with a NSW Fair Trading Rectification Order or if the homeowner is not satisfied with the outcome of the NSW Fair Trading investigation they may apply for resolution via NCAT or a court for disputes on building work valued under/above $500,000, respectively. For building work valued at over $750,000, the homeowner must file with the Supreme Court.	Lodge an application form with application fee to a NCAT Registry. The homeowner may seek legal representation.	NCAT/the court may order that resolution between the homeowner and builder be found through conciliation/mediation or determine that the application proceeds to hearings. NCAT/the court may either issue a work order for the builder to rectify defective works or it may issue a money order to pay for the cost of rectifying work. If the builder fails to pay a NCAT or court issued money order, NCAT/the court may have their license suspended and the homeowner may lodge a claim with the builder's home building compensation provider.
4. Lodge claim with home building compensation provider	The homeowner may only lodge a claim after the builder has had their license suspended due to failure to comply with a NCAT or court-issued money order.	Submit claim with insurer (currently icare HBCF).	

7.2.2 Queensland

Figure 7.2 outlines the steps a homeowner may take to resolve a dispute in Queensland.

Figure 7.2 – Homeowner journey in Queensland



In Queensland the process is more streamlined than in NSW. The homeowner will contact the QBCC as soon as a problem arises with a builder.

Table 7.2 – Detailed homeowner journey in Queensland

Step	When	Homeowner's responsibilities	Possible outcomes
1. The homeowner approaches the QBCC with the dispute	As soon as the homeowner has a dispute with the builder.	The homeowner should take the dispute directly to the QBCC. If the dispute is in relation to the non-completion of a building where the licensee is still active, the homeowner should engage a solicitor to ensure that the contract is properly terminated.	The QBCC will initiate the dispute resolution process. If the issue is not resolved, the dispute will escalate to a claim with the QBCC provided the dispute relates to insurable work.
2. A claim is lodged with the QBCC	If the dispute is unable to be resolved through the dispute resolution process, it will be escalated to a claim.	The homeowner does not have any more responsibilities at this stage, the QBCC will automatically escalate the dispute to a claim if a resolution is not reached.	The QBCC will manage the claim.

7.2.3 Key differences between the NSW and Queensland claims process

Table 7.3 summarises the key differences in the claims process between NSW and Queensland.

Table 7.3 – Summary of key differences in the claims process between NSW and Queensland

NSW	Queensland
▪ The **homeowner manages the process**. ▪ The **homeowner meets costs associated with resolving the dispute**. NCAT and legal fees, for example. ▪ The **time to resolution may be several years**. The homeowner may go to NSW Fair Trading and NCAT before ultimately making a home building compensation claim. ▪ The **link between the dispute resolution, licencing and insurance functions is not as strong**. ▪ **icare HBCF only holds data on defects associated with insolvent builders**. Using this information alone to understand industry trends and inform regulation is sub-optimal (incomplete data and extended lag time).	▪ QBCC, the insurer, **is involved early and manages the process**. ▪ The **insurer meets most of the costs associated with resolving the dispute**. ▪ **The time to resolution / rectification is on average shorter than in NSW**. ▪ There is a **strong incentive to prevent defects/rectify defective work through the link with builder licencing and policy issuance**. ▪ The **QBCC holds data on all defects**. This information can be analysed to understand trends and inform regulation.

7.3 What are key success factors to the operation of a first resort model?

Each element of the building industry system must work together to support the viability of providing first resort cover. The factors critical to the operation of a first model include:

- **Robust builder licencing and eligibility requirements**. A detailed and thorough assessment process will mean that there are fewer defects and insolvencies.
- **Strong regulation and supervision of builders** to reduce the cost and risk of defects. Supervision may be undertaken by a central authority, the insurer, or both.
- **Incentives must exist for builders to rectify defective work**. This incentive is typically created through strengthening the link between disputes / claims, builder licensing requirements and policy issue. Without a strong incentive to prevent defects / rectify defects, first resort cover has proven to be unviable in Australia.
- **The insurer must be able to handle a relatively high volume of disputes**. According to information provided by NSW Fair Trading, there are between 2,000 and 2,500 building related disputes lodged each year. icare HBCF received approximately 400 claims each year on average over the last 5 years.

We note that many of these factors are also important in supporting a viable last resort scheme.

7.4 How do the costs of the current NSW and Queensland schemes compare after adjusting for differences in coverage and exposure?

To compare the costs of the NSW and Queensland schemes, we:

- Make several assumptions to adjust the Queensland claims experience to be on a like-for-like basis with NSW coverage limits and exposure
- Highlight how expenses may change in a first resort scheme.

7.4.1 Differences in coverage

The main differences in coverage between the NSW and Queensland schemes are displayed in Table 4.1. The material differences expected to impact claims costs are:

- The HWI scheme applies to projects above $3,300 while the HBC scheme applies to projects above $20,000.
- The QBCC manages all subsidence claims. The NSW HBC does not cover subsidence claims.
- The HWI scheme provides $200k of cover for non-completion and defects claims as standard (i.e. a claim with both a non-completion and defect component (including subsidence) post completion could reach up to $400k of cover in total)[12]. The HBC provides $340K of cover for non-completion and defects in total.

Differences in how coverage periods are defined for major / structural defects may also induce differences in claims costs. In NSW, the coverage period is defined from project completion, whereas in Queensland it is defined from the payment of premium. The distinction is expected to have the largest impact on projects where construction takes an extended period. For example, multi-units. We have not allowed for the impact of differences in coverage periods in the analysis below.

To adjust for the first two differences, we have limited our analysis to projects with a contract value above $20,000 and excluded subsidence claims. To adjust for differences in maximum cover we consider the number of reported claims with an average size greater than $200k. Our analysis is approximate only and documented in Appendix A. Nevertheless, we consider the observed results to be a fair representation of the schemes on a comparable basis. In summary, after adjusting for inflation, we found for the 2011 to 2017 underwriting years:

- 11% of claims reported reached the $200,000 limit in NSW, compared with 2% in Queensland
- Average claims costs above $200,000 represents 16% of claims costs below $200,000 for NSW, compared with 2% in Queensland.

More claims hit the cap in NSW than in Queensland. Potential reasons for this are:

- The last resort nature of the NSW scheme means that defect claims are left longer so they are more expensive to fix
- The increased incentive to prevent defects / rectify defective work through the strong link between the dispute resolution, licensing and insurance functions in Queensland.

To adjust for the difference in maximum level of cover, we applied a scaling factor to Queensland claims experience of 14% based on the difference between the NSW and Queensland cost above $200,000. If we assume no improvement on account of early detection of defects, the average claims cost in Queensland is $37M or 0.4% of contract value over the 2011 to 2020 underwriting years. This compares with an average cost of 0.8% of contract value in the current NSW Scheme. Thus, after adjusting for differences in coverage, the claims cost in the Queensland scheme is approximately half of the cost of the NSW scheme.

Figure 7.3 and Figure 7.4 display projected claims costs in Queensland after adjusting for differences in coverage in dollar terms and as a proportion of contract value. Payments are net and have been discounted on the same basis as Figure 6.8 and Figure 6.9.

[12] Where there is a non-completion claim and defects are identified, the cost of rectifying the defects contributes to the $200K limit.

Figure 7.3 – Projected Queensland claims cost after adjusting for differences in coverage

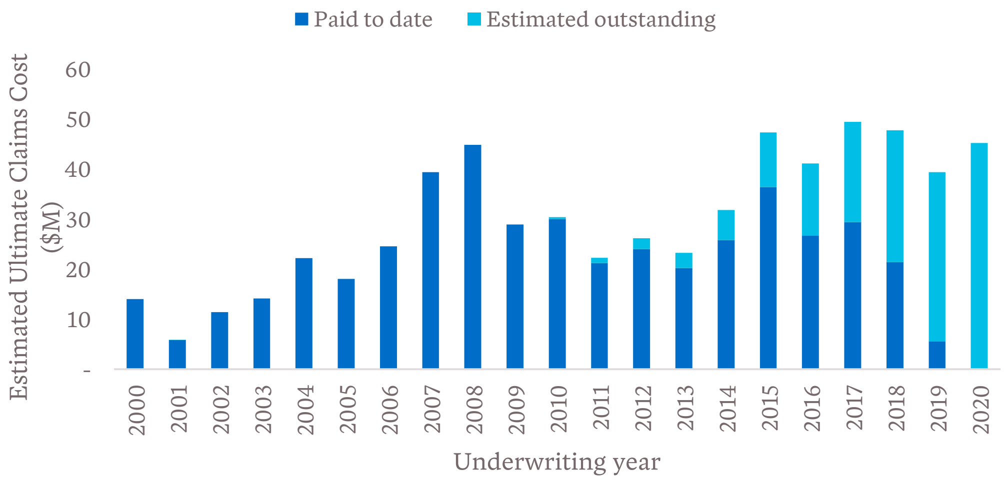
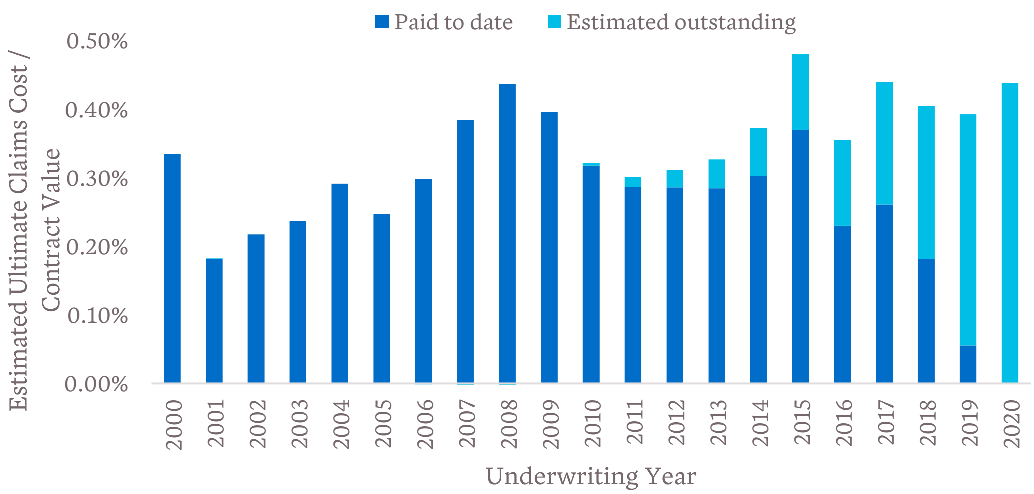


Figure 7.4 – Estimated Queensland ultimate claims cost as a proportion of contract value after adjusting for differences in coverage



7.4.2 Expenses under a first resort scheme

Table 7.4 compares the expenses incurred by the HBC scheme in NSW and HWI scheme in Queensland.

Table 7.4 – Scheme cost summary

Key cost component		NSW		QLD	
		HCBF	Outside HBCF	QBCC	Outside HWI scheme
Claims costs/ costs realised by homeowners	Incomplete or defective work where insolvency, death, disappearance or failure to comply with a money order (DDIO) can be identified	✓		✓	
	All other incomplete or defective work		✓	✓	
	Expenses associated with dispute resolution		✓	Not applicable	
	Brokerage commission		✓		
Expenses	Pursuing builders for recovery		✓	✓	
	Policy administration	✓		✓	
	Builder eligibility	✓		✓	
	Builder licensing		✓	✓	
	Building work inspection		✓		✓
Other costs	Profit/safety loading in premiums	✓			

One of the main differences is that in NSW, the homeowner meets dispute resolution expenses where the builder is not DDI. In Queensland, the QBCC meets theses costs.

Queensland funds expenses through a combination of HWI premiums, builder licensing and a nominal amount of other fees for service charges. In Queensland, the QBCC bears the cost of pursuing builders for recoveries after paying a claim. Being a first resort scheme, it is an important part of the process in that it encourages builders to rectify defective work and improve compliance, thereby reducing claims costs.

NSW Fair Trading and NCAT were unable to provide expense information at the level required to support a comparison of the expenses incurred in NSW and Queensland. However, we can compare expenses collected through premiums. Table 7.5 compares the type and level of expenses collected through HBC and HWI premiums. HBC expense information is derived from icare's January 2020 premium filing. HWI expense information is derived from the QBCC cost allocation model for the 2019 financial year.

Table 7.5 – Expenses collected through HBC/HWI premiums

	icare HBCF	QBCC HWI
Expenses include:	▪ Eligibility risk management ▪ Claims management ▪ Service fees to icare ▪ SIRA levies ▪ Expenses associated with system upgrades	▪ Claims Management ▪ Reinsurance costs ▪ Debt Recovery ▪ Underwriting Dispute Resolution (in relation to claims)
Expenses ($M)	$33.3	$34.5
Expenses as a percentage of 2019 contract value	0.2%	0.3%

We note:

- icare HBCF expects to collect $33.3M through premiums to meet expenses. The QBCC expects to collect $34.5M through premiums to allow for expenses relating to the management of the insurance scheme.
- Expressed as a percentage of contract value, the expense rate is higher in Queensland than in NSW. 0.3% in Queensland compared to 0.2% in NSW.
- The Queensland expenses include allowance for a range of services provided by NSW Fair Trading and NCAT. Expenses collected through premiums are higher in Queensland than in NSW as a percentage of contract value.

7.5 Potential impact on premiums

NSW Fair Trading and NCAT have been unable to provide information on disputes and expenses at the level of detail required to support this analysis. The lack of relevant data has limited the analysis we have been able to perform.

In the analysis that follows, we use Queensland experience to estimate the potential impact on premiums. We outline several scenarios to help IPART assess the sensitivity of changes in assumptions on premiums. The results are illustrative only. A comprehensive analysis of potential future experience is required to set actual premiums charged.

Conclusions from previous sections relevant to the potential impact on premiums are:

- In Section 4, we discuss the regulatory and operational processes that impact the HBC / HWI insurance schemes.
- In Section 5, we compare premium rates between NSW and Queensland. **The average fully funded premium rate in NSW is currently higher than in Queensland.**
- In Section 7, we compare claims cost between NSW and Queensland after making allowances for differences in coverage. **Claims costs in the Queensland scheme are approximately half the cost in NSW.**

  In Section 7, we compare expenses as a percentage of contract value. **Expense rates collected through premiums are higher in Queensland than NSW. The QBCC covers expenses that currently fall outside the HBC scheme such as those expenses currently incurred by NSW Fair Trading and NCAT.**

7.5.1 Premium scenarios

We make the following assumptions in all scenarios:

- Expenses are in line with the Queensland scheme (0.3% of contract value)
- A profit / safety loading of 15% is applied to claims cost and expenses
- GST (10%) and Stamp Duty (9%) is applied to premiums
- Brokerage (15%) is applied to premiums unless otherwise stated

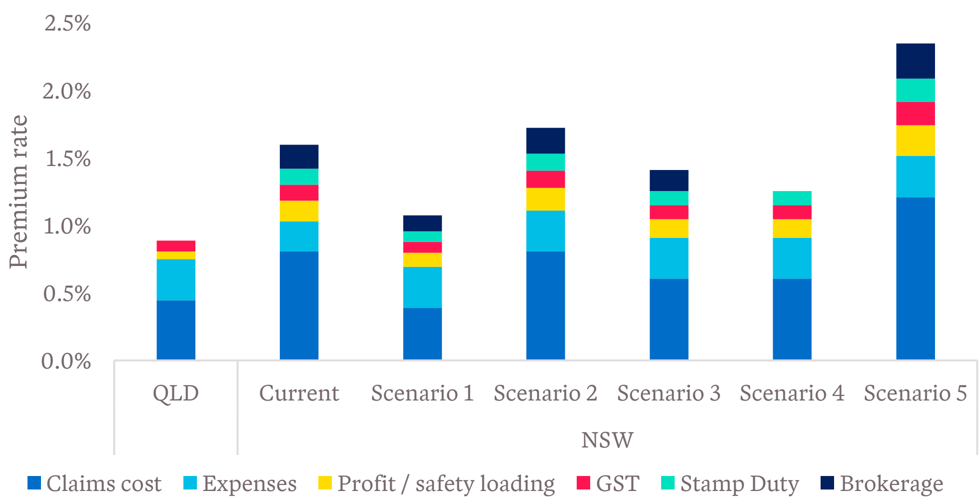
Table 7.6 summarises the scenarios used to illustrate the potential impact on premium rates. Claims cost and expenses are expressed as a proportion of contract value.

Table 7.6 – Potential impact on premium rates

Scenario	Description	Claims cost (%)
1	NSW reduces claims costs to the level observed in Queensland. Expenses are in line with the Queensland scheme.	0.4
2	NSW is not able to reduce claims costs. Expenses are in line with the Queensland scheme.	0.8
3	NSW reduces claims costs by 25%. Expenses are in line with the Queensland scheme.	0.6
4	NSW reduces claims costs by 25%. Brokerage is removed.	0.6
5	NSW claims costs increase by 50%[13]. Expenses are in line with the Queensland scheme.	1.2

Figure 7.5 and Figure 7.6 display premium rates and average premiums[14] under the scenarios. Premiums for NSW and Queensland under the current scheme are included for comparison purposes.

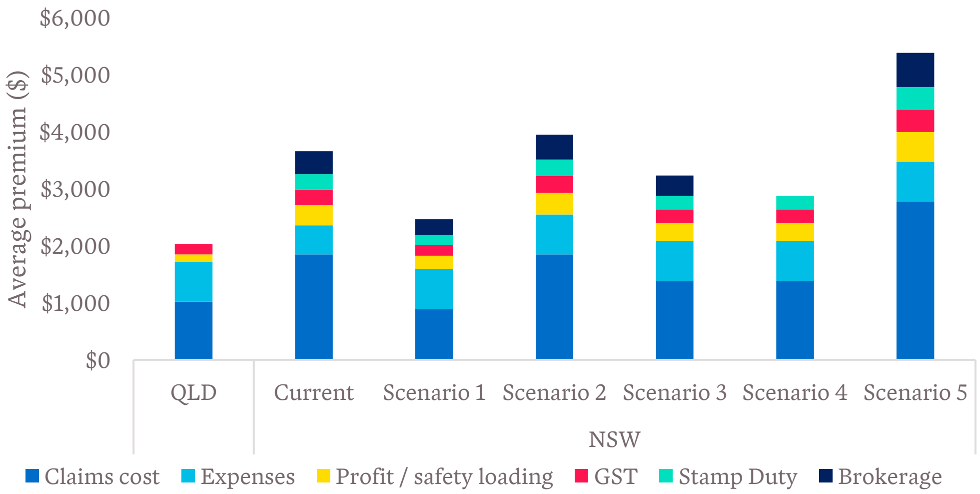
Figure 7.5 – Premium rate (%) under scenarios



[13] In the absence of changes in other areas, moving from a last resort to a first resort model will increase costs covered by the scheme. There needs to be a strong incentive to rectify defective work for a first resort scheme to be sustainable.

[14] Average premiums are based on applying the premium rates to average contract values over 2020/21.

Figure 7.6 – Average premium ($) under scenarios



The key conclusions are:

- If NSW incurs the same claims cost and expenses as Queensland (as a percentage of contract value), fully funded premiums reduce from 1.6% to 1.1% of total contract value. Average premiums reduce from $3,700 to $2,500
- If NSW is able to reduce claims cost by 25% relative to current levels, fully funded premiums reduce from 1.6% to 1.4% of contract value. Average premiums reduce from $3,700 to $3,200.

7.6 Consequences for builders and potential new entrant insurers

For a first resort model to be successful, there needs to be a strong incentive for builders to prevent defective work and rectify defects when they arise. Without a strong incentive to prevent defects / rectify defects, first resort cover has proven to be unviable in Australia.

This incentive is normally achieved through builder licencing requirements and conditions that link builders obtaining new contracts to the absence of outstanding claims. It may be harder to create these incentives in a multiple provider scheme where builders may switch providers. We discuss challenges and barriers to entry for private insurers, and outline actions the NSW Government may take to encourage private insurers to enter the market in Section 9.

Each element of the building industry system must work together to support the viability of providing first resort cover. Changes made to the scheme to support the operation of a first resort model will have consequences for builders. For example, builders may be subject to more robust builder licencing and eligibility requirements and stronger regulation and supervision designed to reduce the number and cost of defects.

8 Conducting eligibility assessments as part of builder licensing

Inside this section

We discuss conducting eligibility assessments as part of builder licensing under a first-resort model in the following subsections:

8.1 What are the objectives of builder licensing and eligibility assessments?

8.2 What does the eligibility assessment function currently cost the

8.3 What are the advantages and disadvantages of conducting eligibility assessments as part of builder licensing?

8.1 What are the objectives of builder licensing and eligibility assessments?

Table 8.1 compares the current builder licensing and eligibility assessment functions.

Table 8.1 – Comparison of the builder licensing and eligibility assessment functions

	Builder licensing	Eligibility assessment
What is the objective?	To ensure that only qualified builders can undertake building works	To determine whether a builder should be able to obtain a certificate of insurance and under what conditions
Who does it apply to?	Licences may be issued to individuals, partnerships or companies	Builders must be granted eligibility to be apply for a certificate of insurance
How often does it occur?	Licences may be issued for one or three years	Eligibility is the ongoing assessment of a builder's ability to undertake future work
What does it consider?	Builder licensing considers the nature and risk of work for which the builder is applying to be licenced for against their qualifications and experience, previous licence history and compliance history.	The eligibility assessment considers both financial (e.g. capital and profitability) and non-financial factors (e.g. management structure and quality assurance). Additional conditions may be imposed on the builders. For example, a condition to obtain an indemnity from a third party or to participate in a mentoring or review program.

Eligibility assessments play an important role in making sure there is a sufficient pool of suitably qualified and resourced builders. SIRA's Eligibility Guidelines state that HBC providers must have eligibility review processes in place to monitor a builder's risks and identify below benchmark performance. HBC providers must issue cover for all builders who hold eligibility. That is, it is not possible to grant eligibility and not offer HBC cover.

Builder licensing and eligibility assessments in Queensland

In Queensland, the QBCC performs multiple functions as a result of their integrated model. This integration means that eligibility assessments form an integral part of the licensing process. The QBCC performs an assessment of a contractor's financials, as well as their technical skills and their experience as part of the licensing process. This includes a requirement for contractors to undertake a business management course. All licensees (builders, certifiers, subcontractors and suppliers) must meet these financial requirements regardless of whether or not they are performing insurable work. This is the main component of the eligibility assessment in Queensland.

The QBCC provides licences for 1 or 3 years. A 1-year licence cycle is equivalent to assessing eligibility each year as the builder is required to meet certain financial requirements and the requirements for the type of licence they are seeking upon renewal. A 3-year licence may mean that a financial assessment is not undertaken every year. However, licences stipulate the amount of work a builder is able to undertake which should control for this. Only licenced contractors can purchase home warranty protection on homeowners' behalf.

If a builder has carried out defective work that has been rectified via the scheme, the QBCC may suspend or cancel the licence if the rectification costs are not paid by the builder to the QBCC. This is the built-in link which incentivises builders to address defective work. The QBCC also has powers to pursue directors of failed companies personally to ensure that builders are not fully absolved of responsibility upon the termination of a company. These powers mean that builders have sufficient incentive to rectify defective work when asked to do so.

If there is reason to believe that a builder does not still meet the financial requirements to hold a licence in the middle of a licensing period, the QBCC is able to conduct an audit to assess whether the builder is able to continue to operate. The QBCC is a member of industry specific credit-bureaus to ensure quick identification of 'at-risk' builders and timely auditing.

Table 8.2 considers the perspectives of builders and insurers in the eligibility assessment process.

Table 8.2 – Builder and insurer perspectives

Builders	Insurers
▪ Focus on **maximising eligibility limits** to avoid restrictions on the projects they can undertake. Builders want to be able to minimise financial constraints and the amount of "red tape". ▪ **Value the certainty that the eligible status provides.** Builders need to know they can purchase HBC cover and take on projects. Without eligibility, the builder is unable to commence projects.	▪ Focus on assessing **whether the builder has adequate resources and capacity** to take on projects. That is, eligibility is used as a means to control risk. ▪ **Value their ability to adjust eligibility limits in response to changes in the level of risk**. Insurers would prefer to place tighter restrictions on eligibility than builders would typically desire to control the level of risk that they are exposed to.

8.2 What does the eligibility assessment function currently cost the scheme?

icare HBCF outsources the eligibility assessment function to a third-party provider. Currently, Equifax is the contracted scheme agent. The contract between icare HBCF and Equifax includes an annual service fee ($10.4M in 2019) and a variable performance fee (up to $2.6M in 2019).

SIRA's data tables show there were approximately 19,000 builders with eligibility at December 2018.

8.3 What are the advantages and disadvantages of conducting eligibility assessments as part of builder licensing?

While the advantages and disadvantages are similar for first resort and last resort schemes, there are additional factors that must be considered for a market with multiple providers.

8.3.1 Single provider market

In a single provider market, the main advantage is that there **is likely to be an increase in efficiency and a better understanding of risk from combining licensing and eligibility functions.** However, it is worth highlighting:

- **Licensing and eligibility assessments have different focuses.** The information required as part of the eligibility assessment process tends to be more comprehensive.
- **Licensing and eligibility assessments are performed with different frequencies** – For example, eligibility may be reviewed in response to changes in the builder's financial position changes. These changes would not be expected to result in a change in licence status for the builder.

The disadvantages of combing the licencing and eligibility functions are:

- **The insurer may have less of an ability to actively manage risks through the builder eligibility assessment process** – There would need to be a close working relationship between the organisation performing the assessments and the insurer.
- **Changes to the manner in which eligibility assessments are performed will require consideration to be given to what changes are required for premium guidelines** – The strength of the eligibility assessment criteria will impact the premium insurers are required to charge. It is worth highlighting that in a competitive market where insurance cover is not compulsory (e.g. home insurance), the insurer is free to assess whether they will provide cover and at what price. Where insurance is compulsory, there is a need for greater control around coverage, pricing and in some cases profit (e.g. NSW CTP).

8.3.2 Multiple provider market:

There are challenges associated with builder eligibility assessments in a market with multiple providers. Before we demonstrate why this is the case, we discuss the implications of a single authority performing eligibility assessments.

Single authority performs eligibility assessment

Transferring the eligibility assessment to a central authority will only work if each insurer considers the assessment to be appropriate. Insurers may also not be comfortable offering cover based on the outcome of a third party's assessment. Premium guidelines will also need to be flexible enough to allow premiums to reflect differences in risk. While this has been implemented successfully in NSW's CTP and Workers' Compensation schemes, where there are well defined homogenous groups (e.g. vehicle class or occupation), this may be difficult to achieve in practice for the HBC scheme due to the variability in the nature of building projects and the relative size of the market.

Insurers perform their own eligibility assessment

Permitting insurers to perform their own eligibility assessments may lead to several challenges. The challenges are best illustrated by way of example.

Example A

Insurer A assessed that Builder X should have a $50M open job limit. Builder X also approaches Insurer B who grants them a $100M open job limit.

In this situation, Builder X could place $50M of work with Insurer A and $50M work with Insurer B (or $100M of work with insurer B if work placed with another provider is not considered).

The eligibility assessment made by Insurer B will impact the level of risk ultimately accepted by Insurer A.

If each insurer performs their own eligibility assessment and builders are free to switch between insurers, the eligibility granted by one insurer will impact the risk faced by other insurers. The example highlights that eligibility assessments granted by one insurer should be considered by other insurers. It will be necessary for eligibility assessments to be published and shared so that insurers can understand builders' current exposure levels. We note that insurers may be reluctant to share such information in a competitive market.

Allowing insurers to conduct their own eligibility assessment may only work if there is a requirement for builders to place business with a single provider. In this situation, we would expect the builder to place business with the insurer offering the highest open job limit. We note that builders are likely to be more concerned about eligibility limits than premiums as these costs are ultimately passed on to homeowners.

9 Role of private insurers in the market

Inside this section

We provide details of actions the NSW Government can consider in order to encourage private insurers to enter the market in the following subsections:

9.1 Overview

9.2 Principles of insurance

9.3 Current barriers to entry

9.4 Recommended actions

9.1 Overview

Over the last two decades, there have been numerous significant changes in the NSW HBC scheme relating to private insurer participation:

- **Private insurers commenced underwriting HBC insurance from 1997.** Prior to 1997, NSW operated a government underwritten first resort scheme.
- Large losses led to progressive scheme reforms including the removal of coverage for buildings greater than three storeys and transition from a first resort to last resort model. **Due to continued large insurer losses following these reforms, private insurers progressively withdrew from the market.**
- From 1 July 2010, the NSW Government passed legislation to create a **government underwritten HBC scheme.**
- In 2017, the government introduced a series of reforms that included **opening the scheme to private insurers and alternative indemnity product providers** to enter alongside icare HBCF.

Although the market is open for competition, icare HBCF currently remains the sole provider. There have been no successful applications from private insurers or alternative indemnity product providers to date.

9.2 Principles of insurance

For the relationship between the insurer and the insured to function fairly, there are several important principles that must be upheld. These principles are:

- **Losses must be fortuitous** – That is, losses must occur by chance.
- **Losses must be measurable** – The financial impact of losses should be able to be assessed through quantifying the frequency and size of expected losses.
- **The circumstances of loss can be defined** – Identifying whether a loss has occurred should be a clear and simple process.
- **Premiums charged must be affordable.**
- **There must not be excessive exposure to loss** – By offering insurance, insurers should not build up excessive levels of exposure through the accumulation of individual risks.
- **Insurance must not be against the public interest** – That is, insurance should not encourage immoral, unethical and illegal activities.

It is useful to reflect upon these principles of insurance when considering current barriers to entry for private insurers in the NSW home building compensation scheme.

9.3 Current barriers to entry

There are several significant challenges currently facing the construction industry and HBC scheme. These challenges discourage private insurers from entering the HBC market. We summarise these challenges and other barriers to entry for private insurers below:

- **Historic losses for private insurers and losses for the current scheme have been significant** – Private insurers withdrew from the market following significant losses over 2001 to 2009. Following the introduction of the government underwritten scheme in 2010, loss experience has failed to improve. Without evidence of a material changes in loss experience, private insurers will be reluctant to re-enter the market.
- **Overall, the total premium that is currently collected is below break-even levels** – Historically, icare HBCF's premiums have been insufficient to fund the cost of claims and expenses. Based on icare's latest premium filing, the premiums charged for the multiple dwelling construction types are not projected to reach break-even levels until 2022. To achieve a reasonable return on capital, private insurers would need to charge higher premiums than icare HBCF for this construction type.
- **The government backing of icare HBCF** – Although SIRA requires that icare HBCF operates under the principle of competitive neutrality, private insurers may be hesitant to enter the HBC market if they perceive icare HBCF has an advantage in the market. This may be due the government support icare HBCF receives, and any economies of scale that result from their large size, as well as the information they hold as the sole provider.
- **Complexities of the HBC product requires expertise and significant capital support.** The long-tailed nature of HBC covers means that experience takes many years to emerge. The links to the construction industry conditions means that experience is cyclical. The resulting uncertainty and volatility in claims cost mean that a significant amount of capital support and expertise is required to enter the market. Private insurers must consider whether the opportunities available from entering the market are worth the costs associated with developing the required expertise and the additional capital support.
- **Limited premium pool relative to other classes of insurance.** The relatively small premium pool mean that private insurers are likely to pursue other initiatives where the risks are lower and the potential payoff may be larger.
- **The HBC scheme is impacted by regulation of the construction industry and industry standards.** As discussed in Section 7, actions taken to regulate the construction industry will have far-reaching impacts on the volume and cost of claims in the HBC scheme. The Public Accountability Committee's report considers a range of issues impacting the construction industry and includes recommendations relating to a more robust inspection regime as well as rectification measures to address flammable cladding. The extent to which these recommendations are adopted and achieve their objectives adds to the uncertainty in claims cost.
- **COVID-19 is expected to heighten a number of these challenges.** The economic downturn on account of COVID-19 is likely to place increased pressure on insurers and their capital levels. As a result, insurers are likely to pursue less volatile and more profitable classes of business in the immediate future.

9.4 Recommended actions

It is important to consider the system in totality when identifying actions the NSW government would need to consider to encourage private insurers to enter the market. This is because actions taken in one area of the building industry can have far-reaching impacts on the outcomes in other areas. Similarly, consideration needs to be given to whether HBC insurance provided by the private sector supports broader construction industry policy objectives.

Table 9.1 summarises the actions the NSW Government may take to encourage private insurers to enter the market. These recommendations are based on the current last resort model of the HBC scheme. Consideration should be given to the key success factors in Section 7.3 if applying these recommendations to a first resort model.

Table 9.1 – Recommended actions to encourage private sector participation

1. Strengthen the regulation of the construction industry

Implementing initiatives to reduce the frequency of defective work in the construction industry should lead to reductions in the number of defect claims in the HBC scheme. Improvements in loss experience will reduce pressure on rising premiums and encourage private insurers to re-enter the market.

The Public Accountability Committee's report includes several recommendations relating to a more robust inspection regime. These may be effective in identifying and addressing defective work at an earlier stage.

We note that there have been several recent regulatory changes aimed at reducing defects in future. For example, the Design Practitioners Bill, Residential Apartment Buildings Bill and the appointment of the Building Commissioner.

2. Tighten licencing and eligibility requirements

Thorough and robust licencing and eligibility requirements should reduce the risks of insolvency and defective work, and potentially lead to reductions in the number of defect claims in the HBC scheme.

For a first resort model, there must be a strong link between builder licencing , issuance of certificates and disputes/claims to create incentives for builders to rectify defective work. This strong link acts to reinforce construction standards.

When assessing the robustness of the eligibility requirements, consideration should be given to whether current capital requirements adequately reflect risk. icare HBCF considers Adjusted Net Tangible Assets (ANTA) as part of the eligibility assessment process. Sufficient ANTA are required to allow builders to withstand shocks to their business. ANTA or capital is an important concept for most businesses.

3. Increase the level of information available

Providing information that supports the assessment of the frequency and magnitude of expected losses will enable private insurers to undertake enhanced analysis. This will improve insurer's capacity to price appropriately and identify market opportunities.

New entrants will need detailed information to help them answer key questions including:

- Are current premiums sufficient to cover the cost of claims and expenses?
- What are the risks and opportunities for each segments of the market?
- By introducing new product features and services, what market share is available?

4. Consider risk sharing options to reduce the volatility insurers may experience

The potential for sizeable losses is a hurdle when it comes to encouraging insurers to enter the market. In general, the higher the variability in profit, the more capital insurers need to hold. Reinsurance is one of the ways in which insurers manage the level of risk and therefore reduce capital requirements to manageable levels. The NSW government may consider what risk sharing options are available to encourage private sector participation. We note the relative impact on capital requirements from writing HBC cover for mono-line insurers is higher than for diversified insurers.

5. **Commission analysis of existing cross-subsidies in the market**

Competition will limit the opportunities to cross-subsidise certain groups of builders.

While there may be merit or benefits to cross-subsidising segments, consideration needs to be given to existing cross-subsidies before private insurers enter the market. Conducting analysis on existing cross-subsidies will support the assessment of:

- Are existing cross-subsidies a positive feature of the scheme?
- Should existing cross-subsidies be permitted to continue in a private market?

Depending on the outcome of the study, structures may be established to support achieving the identified objective. For example, the Compulsory Third Party (CTP) insurance scheme is open to private sector participation, but the premium filing process is heavily regulated by SIRA. This creates enforceable boundaries around what cross-subsidies insurers are able to include in premiums.

6. **Review current regulatory landscape**

To ensure that regulation is well-targeted and efficient, consideration should be given to whether any gaps or overlaps exist between APRA's and SIRA's prudential requirements.

While both agencies have important roles to play, the regulatory landscape should support and recognise differences in their areas of focus and the activities that they perform.

When assessing the effectiveness of the recommended actions in encouraging private insurers to enter the market, realistic timeframes need to be set. It will take time to demonstrate to the private sector that the market has changed, and importantly that profits are now commensurate with risk.

10 Reliances and limitations

Inside this section

We discuss the reliances and limitations of our analysis.

In undertaking this investigation, we have relied upon information supplied by various agencies. We have used the information without independent verification. However, where possible, it was reviewed for reasonableness and consistency.

NSW Fair Trading and NCAT have been unable to provide information on disputes and expenses at the level of detail required to support this analysis. The lack of relevant data has limited the analysis we have been able to perform. In particular, the following information was not available:

- **The number, types and outcomes of disputes received by NSW Fair Trading and NCAT that relate to incomplete and defective building work**
- **Expenses related to the dispute resolution function of NSW Fair Trading and NCAT**
- **Expenses related to the licencing function of NSW Fair Trading, and the proportion of these expenses recovered through licence fees**
- **Legal costs incurred by homeowners when seeking remedies from builders for incomplete or defective work.**

It has been necessary to make a range of assumptions based on the information available. A high level of uncertainty therefore attaches to the estimate of the cost of operating the NSW scheme under a first resort model. Actual costs incurred may differ materially from the estimates provided.

In many cases it has been necessary to extrapolate from the information available, as opposed to report on actual experience. This should be considered when interpreting our comments and observations.

This report has been prepared for the sole use of IPART for the purpose stated in 2.2 No other use of, or reference to this report should be made without prior written consent from Taylor Fry.

We have performed the work assigned and have prepared this report in conformity with its intended use by persons technically familiar with the areas addressed and for the stated purposes only. Judgments based on the data, methods and assumptions contained in the report should be made only after studying the report in its entirety, including its appendices, as conclusions reached by a review of a single section or sections on an isolated basis may be incorrect. Members of Taylor Fry are available to explain any matter presented in this report.

Third parties should place no reliance on this report, or the data it contains, which would result in the creation of any duty or liability by Taylor Fry to the third party.

Further qualifications on the results reached are expressed in earlier sections of the report and should be noted in any interpretation of it.

Appendix A Adjusting claims costs for differences in coverage

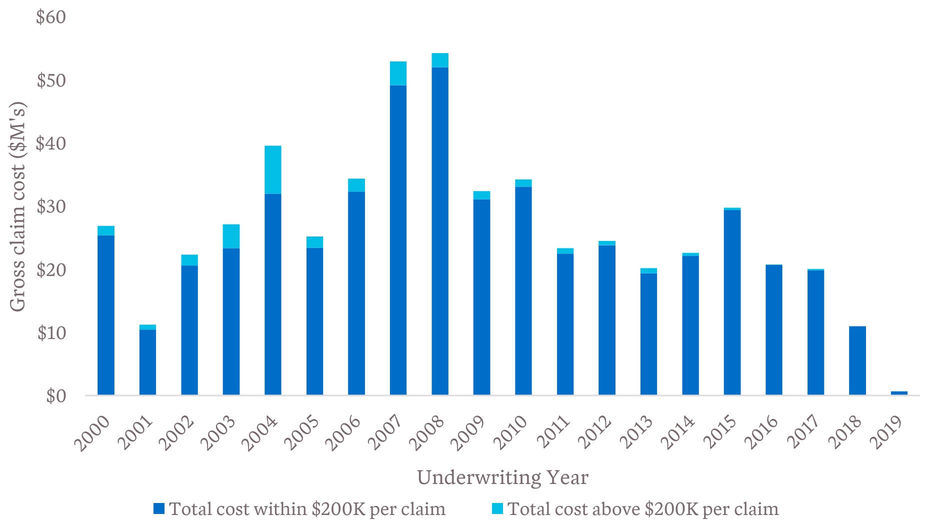
A.1 Queensland

For the purpose of the analysis, the non-completion and defect components of one claim are treated as two separate claims and past payments have been inflated to 30 June 2019 dollar values.

The following figures consider payments to date only. Therefore, claims experience for recent years is underdeveloped.

Figure A.1 displays the distribution of total claims cost in Queensland broken down by the costs that fall below and above $200k.

Figure A.1– Queensland: Claims cost distribution



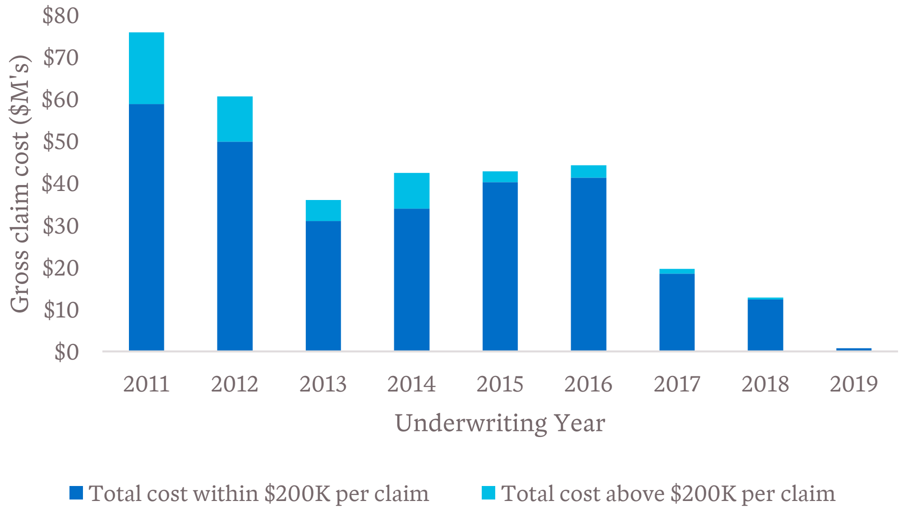
We note:

- Although the limit of cover is $200,000, there are claims with costs above this limit. This is due to the impact of inflating past payments to 30 June 2019 dollars.
- There are few claims that have reached the $200,000 limit.
- From underwriting year 2011 to 2017, average claims costs above $200,000 represents 2% of the claims costs below $200,000.

A.2 NSW

Figure A.2 displays the distribution of total claims cost in NSW broken down by the costs that fall below and above $200k.

Figure A.2 – NSW: Claims cost distribution



We note:

- In NSW, more claims exceed $200K in payments (inflated to 30 June 2019 values)
- A higher proportion of claims hit the cap for older underwriting years
- From underwriting year 2011 to 2017, average claims costs above $200,000 represents 16% of claims costs below $200,000.

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