



Independent Pricing and Regulatory Tribunal
New South Wales

REVIEW OF THE EFFICIENCY AND EFFECTIVENESS OF THE NSW HOME BUILDING COMPENSATION FUND



Draft Report

September 2020

Special Review

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Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 16 October 2020

We would prefer to receive them electronically via our online submission form [IPART: Lodge a submission](#)

You can also send comments by mail to:

Review of the NSW Home Building Compensation Fund

Independent Pricing and Regulatory Tribunal

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Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our [website](#) as soon as possible after the closing date for submissions. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed above.

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If you would like further information on making a submission, IPART's submission policy is available on our website.

Contents

Tribunal Members	ii
Invitation for submissions	ii
1 Executive Summary	1
1.1 Effective regulation in the housing construction market is required	2
1.2 Efficient dispute resolution mechanisms are needed for all homeowners	2
1.3 Our recommendations seek to increase HBC providers	3
1.4 Have your say on our draft findings and recommendations	4
1.5 Structure of this report	5
1.6 List of draft findings and recommendations	5
2 Approach to the review and key themes from stakeholders	8
2.1 What have we been asked to do?	11
2.2 How have we undertaken this review?	11
2.3 What have stakeholders told us?	12
2.4 What are the challenges in addressing stakeholders' concerns?	15
3 Effectiveness of the scheme in protecting homeowners	17
3.1 The regulatory framework should be improved to provide better customer protections	18
3.2 Protection for homeowners for the construction of high-rise apartments	23
4 Costs of the home building compensation fund	25
4.1 Overview of key findings and recommendations	25
4.2 Premiums in NSW are higher than in other states	27
4.3 Average claims costs are higher in NSW	31
4.4 icare's costs for operating the HBCF	35
4.5 The use of brokers should be voluntary under the scheme	37
4.6 More information on premiums for individual builders could lead to cost savings	38
5 Removing regulatory barriers to entry for alternative indemnity providers	39
5.1 We have found that there are regulatory barriers to entry for non-APRA licensed AIP providers	39
5.2 What stakeholders said in response to our Issues Paper	40
5.3 What is an insurance product?	42
5.4 What makes an alternative indemnity product an insurance product?	42
5.5 The <i>Insurance Act 1973</i> sets high prudential standards for general insurers	45
5.6 Why should non-insurers be allowed to provide alternative indemnity products?	45
6 Does the regulatory framework increase the costs of entry into the HBC market?	47
6.1 The regulatory framework discourages new entry	47
6.2 Should businesses require a licence to offer HBC products?	50
6.3 Does the regulatory framework discourage entry through unnecessary prescription?	53

6.4	Are there barriers to insurers and providers offering 'split' products?	60
7	Increasing SIRA's regulatory oversight of icare	63
7.1	icare's HBCF does not face competitive pressure to improve its services	63
7.2	icare's HBCF requires further regulatory oversight	64
8	Builder eligibility assessments	68
8.1	icare's approach to assessing eligibility is risk based	68
8.2	icare should provide greater transparency in its eligibility assessments	71
8.3	icare should resolve eligibility issues in a more streamlined and timely manner	75
9	HBCF product specifications	77
9.1	Making HBCF cover easier to understand	77
9.2	Swimming pool and spa works should continue to be covered by mandatory HBCF cover	80
9.3	Owner-builder work is exempt from mandatory HBCF cover	80

1 Executive Summary

Each year, more than 20 thousand new homes are built in NSW, and a similar number of renovations and alterations are in progress.¹ A small proportion of homeowners encounter problems – some builders do not finish projects, and some buildings are found to have defects. The builder is responsible for rectifying any major defects within a six-year warranty period after the building has been completed, and within two years for minor defects.

However, in some cases, homeowners will not be able to seek recourse from their builder because they no longer exist – often because they have become insolvent. In other cases the builder will have disappeared, died, or had their licence suspended for failing to comply with a money order.² In these circumstances, homeowners can make a claim under the home building compensation fund (HBCF) as a last resort.³

The key exception is where the building project is the construction of apartment buildings more than three storeys. The HBCF does not cover these high-rise apartments, but the NSW Government is currently putting in place quality assurance measures for these buildings that should encourage private insurers to enter this market in the future. In the meantime, an alternative mechanism, the Strata building bond and inspections scheme, applies to these buildings.⁴

For the residential buildings that are covered by the HBCF, builders must pay mandatory insurance at the beginning of every project covered under the scheme to fund any claims that may arise. Currently there is only one home building compensation (HBC) provider, the NSW Government insurer, icare. icare manages its exposure to claims by assessing the financial position of builders undertaking work covered by the scheme, and places limits on their construction activity and charges premiums that reflect their risk.

The NSW Government has asked Independent Pricing and Regulatory Tribunal of NSW (IPART) to review the efficiency and effectiveness of these arrangements. This report sets out the results of our analysis, our draft findings and recommendations, and seeks comment from all interested stakeholders.

After we have received feedback on our draft recommendations, we will make our final recommendations to the NSW Government. The Government has discretion about whether it implements those recommendations.

¹ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 17.

² Issued by the NSW Civil and Administrative Tribunal or NSW courts.

³ For projects worth more than \$20,000. Defects must be identified within the relevant warranty periods of six years for major defects and two years for minor defects.

⁴ From 1 January 2018, developers of new residential strata buildings (4 storeys and higher) have been required to pay a building bond to NSW Fair Trading equal to two percent of the building contract price. This building bond may be used to pay for any identified rectification work within 18 months of completion or is otherwise returned to the developer. See NSW Fair Trading, [Strata building bond and inspections scheme](#), accessed 16 September 2020.

1.1 Effective regulation in the housing construction market is required

Most builders in NSW produce high quality homes. However, some builders perform defective work, which increases risks in the HBCF. We have found that NSW homeowners face higher average premiums than those in other jurisdictions, reflecting the higher expected liabilities caused by costly defects.

The HBCF is a “last-resort” scheme, which means that a claim can only be made if the builder can no longer be pursued – usually because it has become insolvent. As a result, only a small number of claims are received each year (only around 0.4% of all building works⁵), and icare focuses on mitigating the risk of builder insolvency in order to manage the costs of the fund, rather than managing the risk that a defect will occur.

This means that a strong regulatory framework and enforcement of building standards in the first instance is required to reduce the incidence and severity of defects. Ensuring that all builders are held accountable for the quality of their work would reduce the cost of claims under the scheme.

The NSW Government is undertaking a number of reforms to make builders more accountable for their work. However, many of these reforms are focused on the multi-storey segment of the residential market at present, where the more expensive and systematic problems have occurred. The recently appointed NSW Building Commissioner is leading these reforms (see Box 3.1).⁶

Some of the reforms will apply more broadly to the residential building sector in future, but it will still take several years before they translate to a reduction in HBC claims. This is because insurers are liable for claims for up to 10 years after building work is complete.

1.2 Efficient dispute resolution mechanisms are needed for all homeowners

Under the current arrangements, new entrant HBC providers could provide first-resort cover on a voluntary basis for those builders and homeowners that value additional cover.

However, we considered whether a **mandatory** first-resort scheme could lead to better outcomes for homeowners. It could be less costly and time consuming for homeowners to resolve an issue if they could go directly to the insurer when a building issue arises.

Currently if the builder is not insolvent, homeowners must pursue the complaint through NSW Fair Trading and the NSW Civil and Administrative Tribunal (NCAT). Homeowners incur legal and building expert costs, as well as accommodation and other expenses associated with the long timeframes to resolve their building issue through the current dispute resolution mechanisms.

⁵ SIRA, Home building compensation scheme report – Data Tables, December 2018 and IPART calculations.

⁶ The Building Commissioner was appointed in August 2019. See [NSW Building Commission appointment](#), accessed 16 September 2020.

A first-resort scheme could also provide additional incentives for builders to comply with the building standards. Allowing claims to be made in relation to any defects that arose – not just those where the builder was no longer trading, would mean that home building compensation (HBC) providers would have an increased interest in managing construction risks (rather than just insolvency risks). If builders do not rectify defects quickly, providers could increase their premium, restrict their job limits for future work, or decide not to insure them for future work. If a claim is made, a provider can arrange to have any defects rectified by a third party contractor, and recover the costs of doing so from the builder.

Like regulatory changes, it would take time for a redesigned HBCF to improve building quality. In the meantime, more claims would be eligible under the HBCF in relation to defective work. It is likely that the costs of the scheme would rise in the short to medium term, which could result in higher premiums.

We support the NSW Government's approach to improving building quality through improving the compliance and enforcement regime under the Building Commissioner.

However, we consider that the NSW Government should do more to improve access and timeliness to dispute resolution processes for all homeowners, by ensuring Fair Trading and NCAT are sufficiently resourced and have the relevant expertise.

1.3 Our recommendations seek to increase HBC providers

In 2018, changes were made to the HBC scheme to open the market to insurers and alternative indemnity providers.⁷ However, icare remains the sole provider in the market. Without a choice of providers for builders, there is less pressure on icare to provide an efficient product and quality service.

New entrants have been discouraged from entering because icare's HBCF continues to make losses each year, as premiums were previously set below breakeven levels. The regulatory regime is also overly prescriptive and duplicative. In addition, there are regulatory barriers to entry preventing non-insurer alternative indemnity providers from entering the scheme.

We have recommended changes so that new entrants are subject to a less prescriptive regulatory approach that is proportionate to their influence on the market. Private providers have commercial incentives to price products and services to both attract customers, and make an economic return. They are also subject to prudential oversight to ensure they maintain adequate capital to meet their liabilities.

We have recommended changes to the *Home Building Act 1989* to give effect to the NSW Government's intentions of the 2018 reforms to allow non-insurer providers like fidelity funds to offer alternative indemnity products (AIPs) under the scheme. Currently, non-insurer applicants would not meet the legislative requirements to become a licensed AIP provider.

We also recommend that icare provides separate, cost-reflective construction period and warranty period products, which would allow new entrants to offer construction-period cover.

⁷ SIRA, [Home Building Compensation Scheme reforms](#), accessed 10 September 2020.

These changes may lead to entry by niche product providers in the medium-term, similar to the experience in the domestic building insurance market in Victoria. However, it is still likely to take a number of years to achieve a workable level of competition in the HBC market. This is especially the case in the current economic environment. The COVID-19 pandemic is likely to lead to a number of insolvencies as construction activity falls, increasing the number of claims, which would further discourage entry.

In the absence of this competition, icare is likely to remain the default provider in the short-to-medium term. Consistent with the NSW Government's approach to regulating other monopoly service providers, an independent regulator should determine icare's premium prices to replicate the outcomes of a competitive market. In addition, builders and homeowners would benefit from icare providing greater transparency about its eligibility decision-making process.

1.4 Have your say on our draft findings and recommendations

For this review, we are conducting public consultation as well as undertaking our own analysis. To date, we have:

- ▼ Released an **Issues Paper** in **April 2020** outlining our proposed approach to the review and invited comment, and
- ▼ Considered all submissions to our Issues Paper (published on our website) and met with different stakeholder groups, and
- ▼ Undertaken analysis to develop our **Draft Report**, including engaging Taylor Fry to compare the NSW Home Building Compensation Fund with the Queensland Home Warranty Scheme.⁸

We are now inviting submissions on the findings and recommendations in this Draft Report. Submissions are due by **16 October 2020**. Information on how to make a submission is on page iii at the front of this report.

We will hold a public forum on **29 September 2020**. This will provide the opportunity to comment on our draft recommendations. We invite any interested person to register to attend this forum on the [IPART website](#)

We will consider comments at the public forum and submissions to our Draft Report in preparing our Final Report and recommendations for the Minister for Customer Service by **30 November 2020**.

⁸ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020.

1.5 Structure of this report

The remainder of this report discusses our analysis, draft findings and draft recommendations in detail. It is structured as follows:

- ▼ Chapter 2 discusses the context for this review and how we have approached it
- ▼ Chapter 3 discusses the effectiveness of the scheme in protecting homeowners from loss
- ▼ Chapter 4 provides information about the costs and efficiency of the HBCF
- ▼ Chapter 5 discusses our draft findings and recommendations on regulatory barriers to entry into the scheme
- ▼ Chapter 6 discusses our draft findings and recommendations about the regulatory framework that applies to private insurers and providers
- ▼ Chapter 7 discusses our draft findings and recommendations about the regulatory framework that applies to icare
- ▼ Chapter 8 discusses our draft findings and recommendations on icare's builder eligibility process
- ▼ Chapter 9 discusses our response to other issues raised by stakeholders through our review

1.6 List of draft findings and recommendations

List of draft findings:

- | | | |
|---|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----|
| 1 | Building issues can be costly and take a long time to resolve through the dispute resolution mechanisms that apply when a builder is still trading (ie, has not become insolvent, died or disappeared, or has had their licence suspended). | 19 |
| 2 | HBCF premiums in NSW are significantly higher than premiums for similar schemes in other states. | 27 |
| 3 | We estimate that the average claim value in NSW is around 50% higher than claims made under similar schemes in Victoria and Queensland (after adjustments have been made for differences in coverage and building costs). | 27 |
| 4 | NSW has fewer claims than claims made under similar schemes in other states. | 27 |
| 5 | There are regulatory barriers inhibiting entry for private providers. In particular, it is unlikely that fidelity funds that are not regulated by the Australian Prudential Regulation Authority (APRA) could offer HBC cover in NSW under the current drafting of the legislation. | 40 |
| 6 | That the HBC licensing framework unnecessarily duplicates APRA's role in the prudential supervision of insurers, increasing costs of entry to the scheme for insurers. | 49 |
| 7 | That the regulatory framework deters entry by unnecessarily restricting how private insurers and providers compete in the market. | 49 |

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- 8 HBC is a 'long-tailed product', which means providers must hold capital to cover liabilities for up to 10 years, discouraging providers from entering the market. 49

List of Draft Recommendations

- 1 That the NSW Government improve access and timeliness to dispute resolution processes, by ensuring Fair Trading and NCAT are sufficiently resourced and have the relevant expertise. 19
- 2 That Fair Trading develop a program of proactive investigations and audits of building work in the low rise residential sector, similar to the approach being taken by the Building Commissioner in relation to apartment buildings. 19
- 3 Fair Trading and NCAT should collect information and publicly report on the number and type of complaints (including construction type, issue type, value of rectification and other costs), and the time taken to resolve them. 19
- 4 The lodgement of a complaint or dispute with Fair Trading or NCAT for a specified defect within the warranty period preserve a claim for insurance in relation to that defect. 19
- 5 SIRA report on costs as part of its annual performance monitoring review so that icare's costs can be more easily tracked over time, and compared with costs of the schemes in other states. 27
- 6 The use of brokers become voluntary under the scheme, to provide builders with more options on how they manage their HBCF obligations. 27
- 7 icare's premium calculator provide the estimated premium for each builder to help homeowners better manage their costs and understand the insolvency risk associated with different builders. 27
- 8 The NSW Government amends section 104A of the *Home Building Act 1989* and associated Regulation to allow alternative indemnity providers to offer a discretionary (non-insurance) product. 40
- 9 That SIRA simplifies its licence application process for insurers to recognise that APRA's prudential standards apply, removing the need for a duplicate assessment. This could reduce licence fees payable by insurers. 49
- 10 That the NSW Government: 49
 - limits the application of sections 103BD to 103BG of the *Home Building Act 1989* that regulate premium pricing to the default market incumbent, icare 49
 - removes the requirement for SIRA to approve private insurers and providers' eligibility and claims models, in favour of a market monitoring arrangement where SIRA reports on market participants' performance against high-level principles. 49

This should be reviewed in five years or earlier if the market composition has changed considerably. 49

11	That the NSW Government requires icare to make available separate cost-reflective construction period and warranty period products so that a new entrant could provide construction period cover only.	49
12	An independent regulator determines icare's premiums for the HBCF to ensure they reflect efficient costs. SIRA's role, as the scheme regulator, could be expanded to provide it with determination powers. Alternatively, IPART, as the NSW pricing regulator, could be given the on-going role of determining icare's HBCF premiums.	67
13	SIRA increases its regulatory oversight of icare by reviewing and determining icare's builder eligibility model and claims handling processes.	67
14	SIRA establishes appropriate KPIs against which it can measure and publicly report on icare's performance in resolving eligibility issues and finalising claims in a timely manner.	67
15	icare provides greater transparency in how it undertakes its eligibility assessments and how it determines individual builder loading/discounts used in risk-adjusted premiums	73
16	icare:	73
	– Provides information in plain language in the Builder Eligibility/Change application form or the Builder Self Service Portal, why particular information is sought and how it would be used in determining a builder's eligibility.	73
	– Provides information in plain language on how the information provided by builders was used to determine their eligibility profile and their individual loading/discount, including any conditions of eligibility.	73
	– Makes clear any adjustments that have been made to take into account any industry specific circumstances eg, the adjustment for a pool builder in determining their eligibility to account for 'sleeper pools'.	73
	– Periodically updates the work undertaken by the Data Analytics Centre in 2016, to examine whether the factors previously identified and currently used, continue to be significant in predicting builder insolvency, and if there is scope to reduce the amount of information sought without necessarily increasing risk.	73
17	icare reviews its dispute resolution processes to resolve eligibility issues in a more streamlined and timely manner	76
18	SIRA produces guidance for the building industry that addresses the following questions:	79
	– For contracts that require HBCF cover, whether items such as soft-scape landscape works and pool equipment can be excluded from HBC requirements	79
	– How to allow for variations in the cost of HBCF in contracts, if the exact contract price is not known at the time the contract is signed	79
	– Whether head contractors can require subcontractors to also purchase HBCF cover for subcontracted residential works exceeding \$20,000	79
	– Whether HBCF cover is required for alterations and renovations for multi-units above three storeys.	79

2 Approach to the review and key themes from stakeholders

In February this year, the NSW Government asked IPART to review the effectiveness and efficiency in the home building compensation fund in protecting consumers who are currently covered under the scheme.

This is not the first time the home building warranty/insurance schemes have been reviewed (See Box 2.1). Since the introduction of the scheme in 1972, there have been many inquiries, mainly due to the significant costs of the scheme. These have led to changes in its operation and coverage. In 1997 the NSW Government run scheme was privatised to reduce the risks to the state. The collapse of the major insurer HII four years later, which had 30 to 40% of the HBC market, led to reductions in coverage. As the remaining private insurers gradually withdrew from the market the NSW Government insurer re-entered the market as the monopoly provider in 2010. More recently, Fair Trading reviewed the financial sustainability of the scheme in 2015 as costs continued to escalate.⁹ In 2018 changes were made to transition premiums to cost reflective levels, and the scheme was reopened to competition.¹⁰

This chapter sets out the focus and scope of this review, and how we have approached our investigation. It also sets out stakeholders' key concerns about how the scheme is currently operating.

Box 2.1 Previous reviews on Home building compensation insurance and warranty schemes	
1992	Productivity in the Building Industry in New South Wales (Gyles Royal Commission) <ul style="list-style-type: none">▼ Recommends private underwriting
1993	Inquiry into the New South Wales Building Services Corporation (Dodd Inquiry) <ul style="list-style-type: none">▼ Finds the scheme is susceptible to claims of conflict because it is both the insurer and arbiter on disputes – therefore the 'one stop shop' approach is inappropriate▼ Recommends separating the key functions of industry regulation and consumer advice, dispute resolution and insurance▼ Recommends privatising the scheme – holding of the insurance risk is not in the best interests of the citizens of NSW
1997	▼ Scheme privatised

⁹ Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper* - December 2015.

¹⁰ SIRA, *Home Building Compensation Scheme reforms*, accessed 10 September 2020.

1998	Home building insurance extended to owner-builder work
2001	HIH collapses with 30 to 40% of the market. Other insurers raise their premiums, leading to builders being unable to afford insurance
2002	<p>National review of home warranty insurance and consumer protection prepared for the Ministerial Council on Consumer Affairs (the Allan Inquiry)</p> <ul style="list-style-type: none"> ▼ Finds that the “first-resort” schemes were in practice operating as “last-resort” schemes – insurers were expecting a homebuyer to exhaust all other avenues of appeal before claiming on their insurance policy ▼ Recommends placing less emphasis on insurance and giving more attention to strengthening the regulatory framework <p>Scheme becomes a ‘last-resort’ scheme for both breach of statutory warranty and non-completion (previously, claims for breach of statutory warranty could be made if the builder was still trading, but insurance claim for non-completion could only be made if the builder was insolvent, dead or could not be found)</p> <p>Period of cover for insurance split into 6 years cover for structural defects and 2 years cover for non-structural defects (previously 7 years for all defects)</p> <p>Claims for non-completion of building work capped at 20% of the contract price for the work</p> <p>The Minister able to approve an alternative home building indemnity scheme</p>
2003	<p>NSW Home Warranty Insurance Inquiry (the Grellman Inquiry)</p> <ul style="list-style-type: none"> ▼ Finds that private sector should continue to provide home warranty insurance ▼ Recommends excluding high-rise apartments from the scheme because they are commercial projects with materially different risks. ▼ Recommends introducing a system to regulate insurers with guidelines for premium determination and claims handling, and creating an industry deed setting out the basis for underwriting and participation by insurers
2004	<p>Residential construction buildings more than three-storeys excluded from mandatory insurance requirements</p> <p>Board established to monitor the scheme and advise the Minister. Guidelines for insurers on ‘market practice’ and ‘claims handling’ adopted and compliance with these became a condition of approval for insurers.</p>
2007	<p>NSW Legislative Council General Purpose Standing Committee No. 2, Inquiry into the Operations of the Home Building Service</p> <ul style="list-style-type: none"> ▼ Concerned by evidence about the poor consumer protections offered by the current scheme, in particular the ‘last resort’ nature of the scheme and the tendency to escalate disputes. Payouts were seen to be inadequate while the costs associated with exhausting other avenues before claiming can be exorbitant. ▼ Recommends that the NSW Government adopt the Scheme Board’s proposal for an extra ‘trigger’ to enable consumers to make a claim when a builder is not insolvent. ▼ Recommends early and fair dispute resolution.

2008	Productivity Commission, Review of Australia's Consumer Policy Framework <ul style="list-style-type: none"> ▼ Recommends improving the effectiveness of early stage consumer protection measures by better linking licensing to builder performance and better dispute resolution procedures.
2008	Senate Standing Committees on Economics – Australia's Mandatory Last Resort Home Warranty Insurance Scheme <ul style="list-style-type: none"> ▼ Finds that there are still problems with dispute resolution in domestic building – especially long-drawn-out tribunal cases. ▼ Recommends improving the builder licensing (linking performance to licencing) and dispute resolution arrangements directly, rather than to government ownership of the insurance. COAG should pursue a nationally harmonised 'best practice' scheme of consumer protections for domestic building. ▼ Rejects a voluntary scheme because this would leave consumers without a minimum level of protection if a builder collapsed.
2009	<p>Homeowners able to make a claim if a builder's licence had been suspended for not complying with a court or tribunal compensation order</p> <p>Lumley General, CGU Insurance announce their intention to withdraw from the scheme</p>
2010	<p>NSW Government assume responsibility for the scheme as a monopoly provider, and the remaining insurers, Calliden, QBE, and Vero stopped offering insurance</p> <p>The benefit of the insurance extended to successive title owners</p>
2015	NSW Fair Trading – Reform of the Home Building Compensation Fund <ul style="list-style-type: none"> ▼ Presents options to improve the financial sustainability of the fund <p>Owner-builders cover no longer issued</p> <p>The State Insurance Regulatory Authority (SIRA) becomes the scheme regulator</p>
2017	SIRA HBC eligibility and premium standards consultation <ul style="list-style-type: none"> ▼ Consults on how premiums should be calculated and assessed, and how building contractors should be assessed for eligibility for insurance
2018	<p>Reforms implemented to allow for private insurers to enter the scheme, and offer separate cover for the construction period and warranty period or combined cover</p>

Source: SIRA, [Home Building Compensation Scheme report - June 2018](#), pp 43-44, accessed 10 September 2020.

Fair Trading, [Reform of the Home Building Compensation Fund Discussion Paper - December 2015](#), pp 42-49; The Senate, Standing Committee on Economics, [Australia's mandatory Last Resort Home Warranty Insurance scheme](#), November 2018, Chapter 2, , accessed 10 September 2020; NSW Parliamentary Library Research Service, [Home Warranty Insurance](#), E-Brief 7/2010, March 2010, accessed 10 September 2020; NSW Government, [Independent Review of the Building Professionals Act 2005, Final Report](#), October 2015; Rippon J, [Closing the Gap: Decennial Liability Insurance – The solution to the strata living crisis in New South Wales](#), March 2020.

2.1 What have we been asked to do?

In reviewing the effectiveness and efficiency of the HBCF, the NSW Government has asked us to investigate:

- ▼ The scheme's incentives for building industry participants to undertake good risk management and encourage good business practices
- ▼ Whether the scheme needs to further mitigate builders' insolvency risk, for example, through enhanced information collection in relation to builder progress payments, critical stage inspections, and issuance of compliance certificates or other measures
- ▼ Any other impediments to private sector participation in providing insurance through the home building compensation scheme
- ▼ Whether there are unnecessary regulatory burdens and barriers to entry for building participants.

The review comes two years since the scheme was opened to private entry, and new guidelines were implemented on how insurers must manage their risks. No private providers have yet entered the market – although two providers applied to the scheme regulator for a licence to operate. These applications are not being progressed.

As a result, builders still do not have a choice of providers, and there is no competitive pressure to innovate, improve customer service, or reduce costs. Some builders are frustrated with their interactions with the Government insurer, icare, and consider that the scheme imposes a significant burden on their business. They have also faced increasing premiums (although these are usually passed onto homeowners in full) as they have been transitioned to cost reflective levels.

2.2 How have we undertaken this review?

IPART is an evidence-based consultative regulator. All reviews IPART undertakes, including this review of the Home Building Compensation scheme, use a rigorous, transparent and inclusive review process. We actively engage with stakeholders and undertake research and analysis, seeking expert advice where necessary. This approach:

- ▼ Maintains transparency
- ▼ Informs and strengthens our decisions
- ▼ Ensures genuinely impartial determinations and recommendations.

Specifically, for this review, we have undertaken detailed analysis and public consultation:

- ▼ In December 2019 we consulted on the draft Terms of Reference for the review and received eight submissions before finalising the [Terms of Reference](#) in February 2020.
- ▼ We held numerous stakeholder meetings in the first quarter of 2020 including meeting with the NSW Government insurer, icare, the scheme regulator, the State Insurance Regulatory Authority (SIRA), the NSW Building Commissioner, and the NSW Department of Customer Service, who are responsible for building and construction regulation policy.

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- ▼ In April 2020 we released an [Issues Paper](#), which set out the key issues for this review. We received 23 submissions, which have been published on our [website](#).
 - ▼ We have since met with stakeholders who made submissions to our review, including potential HBC providers, building associations, individual builders and icare. We have also met with the icare independent consumer advocate. The icare consumer advocate commenced a [review](#) of the scheme in June 2020, which has involved conducting in depth interviews and surveying builders and claimants on their experience with the scheme.¹¹ The review is due to be completed in September, and we will consider the findings in our Final Report.
 - ▼ We received detailed claims and cost data for HBCF from icare, and information on their risk mitigation processes.
 - ▼ We appointed actuarial consultants, Taylor Fry, to provide expert advice on the costs of the NSW scheme, compared with the [scheme in Queensland](#). The Queensland scheme provides a greater level of protection to homeowners because claims can be made even while the builder is still trading. This report has been made publicly available on our website, subject to any confidentiality.

Following the release of this Draft Report, we will hold a public hearing for stakeholders to provide feedback on our draft findings and recommendations at the end of September. Submissions will close shortly thereafter on the **16 October 2020** and be published on our website.

We will consider comments at the public forum and submissions to our Draft Report in preparing our Final Report and recommendations for the Minister for Customer Service by November 2020.

2.3 What have stakeholders told us?

Although homeowners are the beneficiary of the scheme, we have only heard from a few homeowners and consumer groups in response to our Issues Paper. As noted above, claimants have been surveyed about their experience with the scheme in a parallel process being run by the independent icare consumer advocate. To avoid duplicating this work, we will consider the findings of the consumer advocate in our final report. We have also considered the issues that homeowners have raised in response to other reviews in relation to the scheme, including the recent NSW Upper House Inquiry into the [Regulation of building standards, building quality and building disputes](#).¹²

The majority of stakeholders we have heard from during this review are residential builders and other contractors. The obligations under the scheme fall on these stakeholders, and many considered that they are overly burdensome. We have also heard from potential HBC providers who consider that there are barriers to them entering the market.

¹¹ icare, [icare Customer Advocate to review Home Building Compensation Fund](#), accessed 10 September 2020.

¹² Public Accountability Committee, [Regulation of building standards, building quality and building disputes](#), accessed 10 September 2020.

Key concerns of the different stakeholder groups are outlined below. Many of these issues have been raised in previous reviews, in particular, through Fair Trading's 2015 discussion paper on the scheme, and SIRA's 2017 [consultation](#) on the eligibility and premium standards.

Overall, there was general agreement between stakeholders that risk-management through the scheme is not enough to encourage better building practices. Lowering the risk-profile of the construction industry requires reducing defects through a more rigorous and independent quality assurance process than is currently in place (such as more independent critical stage inspections) and improving accountability through greater transparency (for example, through a builder ratings system, or the publication of complaints made to Fair Trading).¹³

2.3.1 Homeowners

We have heard from homeowners that it is currently very difficult for them to assess the likelihood of encountering problems when they are choosing their builder. When disputes with builders arise, it can be unaffordable and slow to resolve them.¹⁴ A common theme in previous reviews is that the scheme should be operated on a "first-resort" basis, so that if disputes are not resolved in a timely way, homeowners could make a claim to the insurer while the builder is still trading.¹⁵

Consumer groups are also concerned that some homeowners are excluded from the scheme. In particular, they consider that the scheme should apply to the construction of multi-storey apartment, and claims should be accepted for defects that occur within seven years (instead of six years) from the completion of the building.¹⁶

2.3.2 Builders

Builders are responsible for taking out HBC insurance on behalf of homeowners. Before they can do this, icare first assesses their eligibility to take out insurance. We received submissions from a number of building associations and builders explaining the impacts of icare's eligibility process on their businesses. Builders must provide detailed financial information to their insurance broker, and icare uses this information, along with its previous work history, to manage its exposure to risks. It does this by placing limits on the builder's construction activity, and if necessary, requiring it to meet other conditions (for example, putting more funds into the business). The insurer can also prevent builders from obtaining insurance if they pose too great a risk to the fund.

¹³ For example, see Law Society submission to IPART Issues Paper, June 2020, p 6; Tyrrell, submission to IPART Issues Paper May 2020, pp 1-2; Builders Collective of Australia submission, to IPART Issues Paper 31 May 2020, p 1; Risk Specialist Group submission to IPART Issues Paper, May 2020, pp 4-5,

¹⁴ For example see, submission to IPART Issues Paper, P. Gurrier Jones, June 2020.

¹⁵ For example, see Productivity Commission, *Review of Australia's Consumer Policy Framework*, 2008, pp 118-127; Senate Standing Committees on Economics, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, November 2008.

¹⁶ See Public Accountability Committee, [Regulation of building standards, building quality and building disputes](#), November 2019, pp 39, 53-54, 62, accessed 10 September 2020. The Law Society also considered that the three-storey height limit is arbitrary, and should be reviewed. Law Society submission to IPART Issues Paper, June 2020, p 1.

Limits on the number of jobs a builder can undertake can slow the pace a business can grow, and it can be time consuming and costly for builders to arrange to meet the conditions. These conditions can be imposed even when the builder has a strong record of producing high-quality work. If conditions are not met within the time periods allowed, builders' eligibility for insurance can be suspended, causing builders to lose building contracts.

Through the review, different builders have told us that they consider that:

- ▼ The scheme should not be mandatory, noting that very few homeowners benefit from the scheme and many may not purchase the insurance if they had the choice.¹⁷
- ▼ Exclusions to the scheme should apply to certain types of work (including non-structural work, pools and landscaping, low-rise apartments managed under a strata scheme, and single construction projects with a contract valued over \$10 million), or certain builders (including well-capitalised builders, who could self-insure), and longstanding builders with a proven track record of rectifying defects).¹⁸
- ▼ The scheme should be operated as a levy program (where premiums are not set on the basis of risk). This would produce an enormous saving in administration costs in relation to managing the eligibility process and create a level playing field for all builders.¹⁹
- ▼ icare should take a more flexible approach to eligibility, including applying a "light-touch approach" to market segments that pose a low risk such as sole traders and partnerships, and applying different rules to different sub sectors (such as for swimming pool businesses, where jobs can be "open" for longer periods).²⁰
- ▼ icare needs to improve its communication with builders, including explaining why certain information is required; and having discussions with builders about eligibility issues, including how financial information has been interpreted. When issues with their eligibility arise, they should be able to communicate to icare directly, rather than through a broker.²¹

Most builders we spoke to also said that they wanted a choice of HBC providers. With insurers competing to win the business of builders, there would be a greater incentive to provide good customer service to builders, and to tailor products and conditions that reflect the circumstances of their individual businesses.

¹⁷ Discussions with builders.

¹⁸ For example, see SPASA submission to IPART Issues Paper, June 2020, p 8; The Landscape association submission to IPART Issues Paper, June 2020, pp 1-2.

¹⁹ The Landscape association submission to IPART Issues Paper, June 2020, p 2.

²⁰ When a pool is constructed as part of a new home, the pool builder must start on the site at the commencement of the home building project, but cannot complete the work until the house construction is completed. SPASA submission to IPART Issues Paper, June 2020, p 3

²¹ For example see D Munro, All Trades Maintenance submission to IPART Issues Paper, April 2020, p 1; discussions with various builders.

2.3.3 HBC Providers

Stakeholders submitted that the following changes should be made to encourage entry into the market:

- ▼ Changes to legislation to give effect to the intent of the 2018 reforms to allow fidelity funds, which are not regulated by the Australian Prudential Regulation Authority (APRA), to enter the market.²² (However we also heard from an insurer that fidelity funds offer poor consumer protection compared to a licensed and reputable insurer with reinsurance, and will be undercapitalised, particularly in their infancy).²³
- ▼ Replacing icare's existing combined product with separate insolvency and defect products (that provide \$340 k of combined cover) so that each risk can be underwritten and priced according to the nature of the cover provided.²⁴
- ▼ Shortening the mandatory length of the warranty period to three years, with additional coverage offered voluntarily. Allowing for claims up to 10 years after completion in an unacceptable waiting period for providers.²⁵
- ▼ Removing SIRA oversight for insurers, as they are already regulated by APRA.²⁶
- ▼ Removing heavy-handed risk-acceptance requirements, including allowing providers to offer cover to a limited number of low-risk builders.²⁷
- ▼ Expanding the market by making insurance for owner-builders mandatory.²⁸

On the other hand, icare submitted that it would be more cost effective to remove the ability for alternative suppliers to enter the market altogether. It submitted that it could offer cover more cheaply if it did not have to include a margin for competitive neutrality (noting that this is around 9 to 15%), and if it wasn't required to pay for the framework that supports competition (ie, is agency capacity for evaluating competitors via a levy to SIRA).²⁹

2.4 What are the challenges in addressing stakeholders' concerns?

In considering stakeholder issues there are important trade-offs to be made. For example:

- ▼ Increasing the coverage under the scheme would lead to better consumer protections, and providing this assurance to homeowners could help return confidence to the sector. The flipside of this is higher claim costs, and therefore higher premiums – further adding to housing affordability concerns in an economic downturn.
- ▼ Reducing the financial requirements on builders would ease the burden on builders, but could increase the rate of insolvencies, leading to more homeowners left with incomplete homes. This would result in more claims under the scheme, increasing the cost of cover for all homeowners doing new building work. It could also have broader consequences for the industry. For example, a large number of additional insolvencies could further

²² SecureBuild submission to Issues Paper, May 2020, p 12.

²³ HIA submission to Issues Paper, June 2020, p 12.

²⁴ HIA submission to Issues Paper, June 2020, pp 5, 11, NIBA submission, May 2020, p 5..

²⁵ HIA submission to Issues Paper, June 2020, pp 5, 11.

²⁶ *Ibid*, p 15.

²⁷ *Ibid*; NIBA submission to Issues Paper, May 2020, p 6.

²⁸ For example, see Buildsafe submission to Draft Terms of Reference, January 2020.

²⁹ icare submission to IPART Issues Paper, June 2020, p 18.

reduce consumer confidence in the building industry, reducing activity in the sector, and causing even more insolvencies.

- ▼ Making it easier for new providers to enter the market by reducing regulatory requirements could lead to better choice and value in HBC cover products. However, this needs to be balanced against the risks of lowering protection for homeowners. If a large builder fails, it could result in insolvency of the provider, which would increase the costs of the scheme (SIRA would provide a safety net for policy holders if a provider is declared insolvent through a Building Insurers' Guarantee Fund³⁰).

These trade-offs mean that there is no “silver bullet” that will “fix” the scheme. Rather, the regulations and requirements on builders and insurers needs to be balanced so that their benefits exceed their costs. For example, the requirements on builders that are intended to reduce the number of insolvencies should result in benefits (lower claims costs, and maintaining consumer confidence in the construction industry) that are greater than the costs to builders of complying with the requirements, and the cost to the scheme.

In balancing these trade-offs, we have sought to make recommendations that deliver the following outcomes:

- ▼ A choice of products that improve outcomes for homeowners and builders
- ▼ Affordable cover
- ▼ Better administrative processes
- ▼ Confidence in the market for construction of residential dwellings
- ▼ Improved financial viability of the scheme.

³⁰ SIRA, [Home building compensation reforms](#), accessed 10 September 2020.

3 Effectiveness of the scheme in protecting homeowners

The residential construction sector has a number of checks and balance to help prevent defects from arising, and work being left incomplete. These include:

- ▼ Licencing for building professionals to ensure that they have the relevant qualifications³¹
- ▼ The Building Code of Australia which specifies the standard of building quality required³²
- ▼ Certification to check whether the construction is consistent with approved plans, and compliant and enforcement with legislative requirements and conditions of consent,³³ to address non-compliant work, and
- ▼ Checks that builders have sufficient capital to undertake the building work through the HBCF eligibility process.

The regulatory arrangements are regularly reviewed and revised to help improve building quality in NSW.³⁴ However, inevitably some defects will still arise, and it can be costly to resolve them.

The HBCF provides protection for homeowners as a last resort when they have not been able to seek recourse from their builder for defective or incomplete building work because are insolvent, they have had their licence suspended, or have died or disappeared.

This chapter describes the protection that the scheme provides after a dispute arises, and considers whether changes to the HBCF are required to improve customer protections.

³¹ NSW Fair Trading, *Building (general building work)*, accessed 10 September 2020.

³² NSW Government, *National Construction Code*, accessed 10 September 2020.

³³ NSW Fair Trading, *Certified Responsibilities*, accessed 10 September 2020.

³⁴ For example, see *NSW Government Response to the Independent Review of the Building Professionals Act 2005*, September 2016, , accessed 10 September 2020; *NSW Government Response to the Shergold Weir Building Confidence Report*, February 2019, , accessed 10 September 2020.

3.1 The regulatory framework should be improved to provide better customer protections

Homeowners can make a claim under the HBCF when they can no longer pursue their builder. When a defect arises and the builder is still trading, homeowners are able to make a complaint to Fair Trading after seeking rectification works from their builder. They can then pursue the matter in NCAT if the issue remains unresolved or a builder does not comply with a rectification order from Fair Trading.

Resolving a claim through NCAT takes an average of almost nine months for disputes over \$30,000.³⁵ However, it can take some homeowners considerably longer. The service standard requires that 80% of matters are finalised within 18 months.³⁶ We understand that delays caused by COVID-19 has meant homeowners have faced a 10 month wait this year between lodging a claim and it proceeding to a hearing. A stakeholder to our review submitted that they are still pursuing their builder after five years for a non-completion claim for a build that should have taken 8 months.³⁷

This can be very costly for homeowners. Many homeowners cannot afford a year or more of alternative accommodation costs while matters remain unresolved. In most cases homeowners will also have to engage expert advice (legal, engineering etc) to substantiate that the builder is at fault, which cost several thousand or tens of thousands of dollars.

At the end of the dispute resolution process, some builders may not have the financial capacity to undertake the works required under an NCAT order, or they may otherwise not comply with an order, leading to a licence suspension. At this point, the homeowner is able to commence a claim under the HBCF with icare.³⁸

This process also takes time, because icare undertakes its own investigations (and engages its own expert advice) to determine whether a claim is payable. icare's average claim resolution time (including rectification or completion of a project) is around 14 months.³⁹

A common theme in previous reviews is that the scheme should be operated on a "first-resort scheme" basis, so that if disputes are not resolved in a timely way, they could make a claim to the insurer while the builder is still trading.⁴⁰ Under the current arrangements in NSW, new entrant HBC providers could provide "first-resort" cover on a voluntary basis for those builders and homeowners that value additional cover.

While first-resort schemes are not uncommon outside of Australia,⁴¹ Queensland is the only Australian jurisdiction that provides mandatory first-resort cover to homeowners.⁴² The Queensland scheme is administered by the Queensland Building and Construction

³⁵ Data provided by NCAT, 2 June 2020.

³⁶ *Ibid.*

³⁷ Gurrier Jones P, submission to IPART Issues Paper, June 2020.

³⁸ icare, [Home Building Compensation Fund](#), accessed 10 September 2020.

³⁹ Based on data received from icare, 18 June 2020.

⁴⁰ For example, see Productivity Commission, *Review of Australia's Consumer Policy Framework*, 2008, pp 118-127; Senate Standing Committees on Economics, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, November 2008.

⁴¹ For example, first resort schemes operate in New Zealand, the UK, much of Canada and in some states of the US. Covec, [Guarantees and Insurance Products: market and policy analysis](#), October 2018, Annex D, , accessed 10 September 2020.

⁴² Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 17.

Commission (QBCC), which is both the building quality regulator (undertaking all functions relating to compliance and enforcement of building regulations), and the monopoly government insurer. This arrangement is often referred to as a ‘one-stop shop’.

A mandatory first-resort scheme could provide a better customer experience, and could also provide additional incentives for builders to improve building quality. However, it would take time for any changes to translate to improved outcomes. In the meantime, more claims would be eligible under the HBCF in relation to defective work. It is likely that the costs of the scheme would rise, and could result in significant increases in premiums. We consider that improved customer protections should be delivered through regulatory mechanisms to complement the existing last-resort arrangements.

IPART draft finding

- 1 Building issues can be costly and take a long time to resolve through the dispute resolution mechanisms that apply when a builder is still trading (ie, has not become insolvent, died or disappeared, or has had their licence suspended).

Draft recommendations

- 1 That the NSW Government improve access and timeliness to dispute resolution processes, by ensuring Fair Trading and NCAT are sufficiently resourced and have the relevant expertise.
- 2 That Fair Trading develop a program of proactive investigations and audits of building work in the low rise residential sector, similar to the approach being taken by the Building Commissioner in relation to apartment buildings.
- 3 Fair Trading and NCAT should collect information and publicly report on the number and type of complaints (including construction type, issue type, value of rectification and other costs), and the time taken to resolve them.
- 4 The lodgement of a complaint or dispute with Fair Trading or NCAT for a specified defect within the warranty period preserve a claim for insurance in relation to that defect.

3.1.1 Improved dispute resolution mechanisms are needed in NSW

Under a first resort scheme, the homeowner would engage the insurer much earlier in the process, because a claim can be made while a builder is still trading. Homeowners are still required to attempt to resolve the issue first, and the insurer may become involved in the dispute resolution. But if the dispute is not resolved within specified timeframes, a claim can proceed, and the insurer can arrange for a third party to rectify the work and pursue the builder for recoveries.

In Queensland, around 40% of defect claims and 25% of non-completion claims relate to builders that are still trading.⁴³ However, only a small proportion of costs are recovered from builders. This is because many of these builders become insolvent at a later date—ie, the reason that the contractor does not rectify the defects, or defaulted on the contract, is because of their financial incapacity, even though they were not formally insolvent at the time of the

⁴³ Correspondence with QBCC, 11 September 2020.

claim. This means that some of these claims may still have been made under a last-resort model, just at a later time.⁴⁴

However, the threat of recoveries is credible, because the insurer regularly deals with building disputes and are well equipped to resolve issues. As a result, builders that **do** have financial capacity have a strong incentive to rectify defects that arise.

If the dispute resolution mechanisms in NSW were more timely and accessible, they would present a more credible threat to builders, similar to being pursued by an insurer for recoveries. This could involve:

- ▼ A sufficiently resourced Fair Trading, with expertise across all building aspects.
- ▼ Faster access to NCAT and time-limits for the resolution of issues
- ▼ NCAT directly engaging independent experts, rather than both homeowners and builders separately engaging competing experts and duplicating costs.

Shorter dispute resolution times could replicate the outcomes under a first-resort insurance scheme. If the builder does not comply with an NCAT order within a specified time period, their licence would be suspended. In line with the current HBCF arrangements, homeowners would be able to make a claim under the scheme.

3.1.2 Greater enforcement of building standards would improve building quality

The HBC scheme is limited in the incentives it can provide to builders to complete quality work in the first instance. This is because by the time a homeowner makes a claim through the scheme, the builder has become insolvent or has otherwise ceased trading. If a builder does have a history of complaints and NCAT claims, insurers can impose lower building limits on them, and increase the risk-based premium that it pays. However, the incentives under the HBCF have a much greater focus on good-financial management, because insolvency is the main reason that claims arise.

A first-resort insurer has increased interest in the construction risks of an individual build and its delivery, because any defect could become a claim under the scheme and impact on the sustainability of the scheme. To manage these risks, it might be cost-effective for the insurer to have a role in ensuring compliance with the building standards, particularly for higher risk builders. A first-resort insurer is able to penalise builders that perform poor quality work while they are still in business as a builder. If builders do not rectify defects quickly, providers could increase their premium, restrict their job limits for future work, or decide not to insure them for future work.

We consider that builders could be held equally accountable under a last-resort scheme. The NSW Building Commissioner recently commenced a new audit regime for apartment developments which allows it to stop an occupation certificate from being issued, and require rectification works in the event that defects are discovered.⁴⁵ We are recommending that Fair Trading take a similarly proactive approach in enforcing building standards for low-rise residential building works.

⁴⁴ *Ibid.*

⁴⁵ NSW Fair Trading, [Building industry reforms](#), accessed 10 September 2020,

Licence suspension by Fair Trading would function in the same way as cancelled eligibility under an insurance scheme – builders could not continue trading in either case until an issue has been rectified.

3.1.3 Moving to a first resort scheme could result in significant cost increases

We engaged actuarial consultants, Taylor Fry to consider the potential costs of moving to a first-resort scheme in NSW. It considered several different scenarios (Figure 3.1).

In several of the scenarios, premiums reduced as a result of lower claims costs. This reflects the experience in Queensland, where cover is provided at a lower cost compared to icare (see Chapter 4 for more detail), even though it accepts claims under a broader set of circumstances. This would occur as a result of better incentives for builders to perform high-quality work, and defects being addressed more quickly, both because of the effective early dispute mechanisms processes, and because if the dispute remains unresolved, it can proceed to a claim. Faster resolution of defects can have a significant impact on the severity of defects such as water-proofing issues, which are likely to worsen over time.

However, Taylor Fry also considered a scenario when average claim costs are maintained, but the number of claims costs increased, and expenses increased (Scenario 5). We consider this is a likely scenario in the short to medium term because it would take time for changes to be implemented under a first-resort scheme, and for builders to respond to incentives. In these circumstances, average premiums could increase from about \$3,700 to about \$5,500. This would be a significant increase in the cost of premiums, reducing affordability for homeowners.

Figure 3.1 Average premium under scenarios for first-resort cover in NSW



Note: Scenario 1: NSW reduces claims costs to the level observed in Queensland; Scenario 2: NSW is not able to reduce claims costs and overheads (expenses) are slightly higher in line with Queensland; Scenario 3: NSW reduces claims costs by 25% and expenses are in line with Queensland; Scenario 4: NSW reduces claims costs by 25% and brokerage is removed; Scenario 5: NSW adopts a first resort scheme with increased claims costs and higher expenses in line with Queensland.

Data source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 47.

In conducting its analysis, Taylor Fry sought information about the number and types of complaints and disputes brought to NSW Fair Trading and NCAT. However, NSW Fair Trading and NCAT were unable to provide the information in sufficient detail. Therefore, these scenarios are largely based on Queensland data.⁴⁶

We are recommending that Fair Trading and NCAT collect information and publicly report on the number and type of complaints (including construction type, issue type, value of rectification and other costs), and the time taken to resolve them. This would enable icare and the NSW Government to better understand the potential costs of claims that could arise under the scheme. Improved information about the extent that building defects occur in NSW and the total costs to homeowners would also inform the design and implementation of cost-effective and fit for purpose policy responses.

3.1.4 Preserving a claim when the builder is still trading

As explained above, a homeowner only has an eligible claim under the scheme if the builder can no longer be pursued. In some instances, a defect occurs within the warranty period while the builder is still trading, but the builder later becomes insolvent.

In order to have an eligible claim with icare:

- ▼ a homeowner must notify icare that a defect has been identified within the warranty period, or within six months of the loss becoming apparent where it occurs in the last six months of the warranty period,⁴⁷ and
- ▼ the builder must become insolvent within ten years of the work being completed.⁴⁸

For example, if a structural defect is identified five years after the work has been completed, and the builder becomes insolvent seven years after the work is complete, the homeowner will have an eligible claim at this time, but only **if** they notified the insurer within the warranty period. If they wait until year seven to raise the issue with the insurer, then they will not have an eligible claim.

We consider that if there is evidence that the defect occurred within the warranty period, the claim should be preserved, regardless of whether the insurer is notified. Otherwise homeowners face very different outcomes depending on their own actions taken. Our draft recommendation is that claims are accepted by icare if there is evidence of a complaint or dispute with Fair Trading or NCAT occurring within the warranty period. However, homeowners should still be encouraged to notify icare of their issue.

⁴⁶ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 5, 56.

⁴⁷ icare, *HBCF Claims Information for Homeowners*, January 2020, p 6, , accessed 10 September 2020.

⁴⁸ SIRA, *Home Building Compensation Scheme report - June 2018*, p 35, , accessed 10 September 2020; icare HBCF, *Policy of Insurance under Part 6 of the Home Building Act 1989 (NSW)*, June 2018, p 2, , accessed 10 September 2020.

3.2 Protection for homeowners for the construction of high-rise apartments

Mandatory HBC cover for the construction of multi-storey apartments over three-storeys was removed from the Home building scheme in 2004.⁴⁹ This was because reinsurance was not available at the time, and so it would not have been viable for private insurers to remain in the market if cover for these buildings remained mandatory.

High-rise residential buildings are still the most risky sector of the market. While this means that these homeowners are most in need of customer protections, it is also the most costly to provide these protections.

As discussed in the next chapter, the current average break-even premium for new multi-dwelling apartments **under** four storeys is around 5.5% (or almost \$25,000 for a \$350,000 contract including charges), reflecting the high risks of these buildings. This is six times the premium for new single dwellings.⁵⁰ The premiums currently being charged are just over half of this, with the remainder being funded by NSW taxpayers. The risks for high-rise buildings are likely to be significantly higher again, which means that it is currently unaffordable to include these buildings under the scheme.

Improving building quality in the high-rise residential sector is the focus of the newly appointed NSW Building Commissioner. The “Construct NSW” reforms underway (Box 3.1) are laying the groundwork for private insurers to re-enter the market, by reducing the risks in this sector and improving information about the quality of individual buildings and building professionals.

This would make it feasible for insurers to offer high-quality builders 'decennial liability insurance product on a voluntary basis (a 10 year first resort policy)'.⁵¹ Given the loss of confidence in this sector, there is likely to be an incentive on developers and builders to provide this assurance to homeowners.

⁴⁹ This was because reinsurance was not available at the time, and so it would not have been viable for private insurers to remain in the market if cover for these buildings remained mandatory. SIRA, [Home Building Compensation Scheme report - June 2018](#), p 43, , accessed 10 September 2020.

⁵⁰ icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 13.

⁵¹ Public Accountability Committee, [Regulation of building standards, building quality and building disputes](#), p 40, accessed 10 September 2020.

Box 3.1 How the NSW Building Commissioner is improving the quality of high-rise buildings in NSW

The Building Commissioner is currently undertaking a work program that aims to rebuild confidence in the market by 2025. A key part of this work is the creation of a public digital framework for capturing, storing, and sharing building-relating data. This platform will be used by Government to measure performance and inform compliance activity that is supported by new powers and penalties. It will also facilitate market settings to allow decennial liability insurance to be offered for high-quality apartment buildings.

More information and greater accountability

- ▼ A “single view of project” platform (SvOP), containing plans, variations, declarations, certifications, and practitioner information. From July 2021, registered designers must register building designs and variations through this platform, and declare their compliance with the Building Code of Australia.
- ▼ A digital assurance solution which will aggregate certificates of all building inputs and their risk profile to determine a trustworthy index for a building
- ▼ A new multi-party risk rating tool will provide information to government, project financiers, insurers, and client advisers on the trustworthiness of the key players delivering apartments in NSW.
- ▼ From 10 June 2020, owners of buildings with defects will benefit from the statutory duty of care that applies to new buildings, and existing buildings where an economic loss first became apparent in the previous 10 years.
- ▼ Roles and accountabilities will be clearly defined in template construction contracts.

More compliance checking

- ▼ From 1 September 2020, inspection teams of engineers, architects and builders will be auditing apartment developments, and will be able to stop an occupation certificate from being issued, order developers to rectify defective buildings, and issue stop work orders. In time, the audits will be informed by the risk rating and the digital building assurance solution.
- ▼ Separately, the NSW Fair Trading has expanded its audit program of certifiers, broadened the grounds for disciplinary actions, and increased information for homeowners about a certifier’s disciplinary record on an enhanced public register.

Registration of building professionals

- ▼ From 1 July 2021, there will be compulsory registration for practitioners involved in design and building work, including professional engineers.

Source: NSW Fair Trading, [Building industry reforms](#), accessed 10 September 2020, NSW Government, [Tools for change](#), , accessed 10 September 2020; NSW Government tendering, Customer Service / Building Assurance Solution - DICT691221, 5 May 2020; NSW Fair Trading, [NSW Building Commissioner Insights 006 - Office of the Building Commissioner](#); NSW Fair Trading, [Changes to building and development certifier laws](#), accessed 10 September 2020; [Building Confidence Report Jurisdictional Update](#), December 2019, p 8; accessed 10 September 2020.

4 Costs of the home building compensation fund

In reviewing the efficiency of the home building compensation scheme, we have considered the key cost components of the scheme, how they are being managed, and how they are recovered through premiums and taxpayer funding. SIRA is responsible for assessing whether premiums are financially viable and reflective of risks before changes to premiums take place.⁵² We have had regard to icare's most recent premium filing, as well as its detailed underlying claims data.

To help understand whether the scheme is likely to be delivered efficiently, we compared the costs of the NSW HBCF to similar schemes. To assist us with this task, we engaged Taylor Fry to compare the NSW scheme with the home warranty insurance scheme in Queensland. Its report is available on our website.

This chapter outlines our findings on what is driving the differences in costs between the NSW HBCF and other schemes. We have used these findings to identify opportunities to improve the efficiency of the scheme in NSW.

In the longer term, we consider that the best way to improve the efficiency of the scheme is if there is a choice of providers and more cost-effective providers enter the market offering insurance at lower premiums. New providers would also have an incentive to provide an attractive product offering and good customer service to gain market share. Our recommendations on encouraging competition are set out in detail in Chapters 5 and 6.

4.1 Overview of key findings and recommendations

Average premiums in NSW are significantly higher than in other states. At an average of around 1% of the building contract price (exclusive of charges), premiums in NSW are around 20% higher than Queensland, and three times as high as Victoria. In addition, unlike in other states, taxpayers in NSW must make a significant contribution to the costs of the scheme – mostly because premiums have previously been set too low to recover the costs of claims.

Premiums are higher in NSW due to significantly higher average claims costs, rather than a higher rate of claims. There are less claims in NSW than in Queensland and Victoria, but the average cost of a claim in NSW is two to three times higher. In part, this reflects a higher level of cover than other states, higher building costs, and a larger proportion of eligible apartments (which are significantly more risky than single dwellings). However, once adjustments are made to account for these differences, we estimate that claims costs in NSW are still around 50% higher than other states.

⁵² SIRA, [Home building compensation reforms](#), accessed 9 September 2020.

This could reflect more severe defects in NSW, as a result of weaknesses in the broader regulatory environment. It is also possible that the higher claims cost could reflect higher cost rectification works in NSW as a result of icare's claims management processes. However, further evidence is required to understand whether this is a factor. As discussed in more detail in Chapter 7, one of our draft recommendations is that price regulation is required for icare because it is a monopoly provider. As part of this process, the price regulator should review whether the current arrangements for rectifying works are resulting in efficient outcomes.

We are also recommending that SIRA report on costs as part of its annual performance monitoring review so that icare's costs can be more easily tracked over time, and compared with costs of the schemes in other states. This should include a metric of average cost of claim per dwelling, by construction type and claim type, and track operating costs by function over time.

We are making two further draft recommendations to help reduce the costs of the scheme for builders and homeowners. Firstly, we are recommending that the use of brokers be made voluntary under the scheme. It is currently mandatory for builders to use brokers to apply to become eligible for HBC, and also to purchase certificates of insurance. It is estimated that these costs add around 15% to the costs of cover. Providing builders with more options around how they manage their obligations under the HBCF provides a greater incentive for brokers to demonstrate value for money, placing downward pressure on their fees, and well as allowing builders to avoid these costs entirely.

Secondly, we are recommending that icare provide more transparency around the costs of home building insurance that will be paid by individual builders. Individual builders attract a loading or a discount on the base premium rate of up to +/-30%, depending on risk factors such as age of their business, and their business structure (ie, company, sole trader, or partnership). However, this information is not publicly available. To help manage their costs and to better understand the risks of insolvency associated with different builders, we recommend that icare's premium calculator provide the estimated premium for each builder.

IPART draft findings

- 2 HBCF premiums in NSW are significantly higher than premiums for similar schemes in other states.
- 3 We estimate that the average claim value in NSW is around 50% higher than claims made under similar schemes in Victoria and Queensland (after adjustments have been made for differences in coverage and building costs).
- 4 NSW has fewer claims than claims made under similar schemes in other states.

Draft recommendations

- 5 SIRA report on costs as part of its annual performance monitoring review so that icare's costs can be more easily tracked over time, and compared with costs of the schemes in other states.
- 6 The use of brokers become voluntary under the scheme, to provide builders with more options on how they manage their HBCF obligations.
- 7 icare's premium calculator provide the estimated premium for each builder to help homeowners better manage their costs and understand the insolvency risk associated with different builders.

4.2 Premiums in NSW are higher than in other states

Home warranty insurance is mandatory in every state in Australia except Tasmania,⁵³ however the products vary between states. In particular, some of the key differences include:

- ▼ The amount of cover offered (for example, claims of up to \$340,000 can be made in NSW compared to \$200,000 in Queensland for each claim type (pre-completion and post-completion) and \$300,000 in Victoria).
- ▼ The project threshold for mandatory cover (for example, \$20,000 in NSW, compared to \$3,300 in Queensland).
- ▼ When a claim becomes eligible under the scheme. Notably, the scheme in Queensland is different to other states because claims can be made before a builder becomes insolvent (ie it is not a last resort scheme), and therefore can give rise to more claims.⁵⁴

Figure 4.1 shows that the premium of 1.01 %⁵⁵ for the NSW HBCF is significantly higher than similar schemes in other states. Differences in premiums will reflect some of the factors outlined above. However, differences may also indicate opportunities to deliver the cover more efficiently. These are considered in more detail in the next section.

⁵³ Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 17.

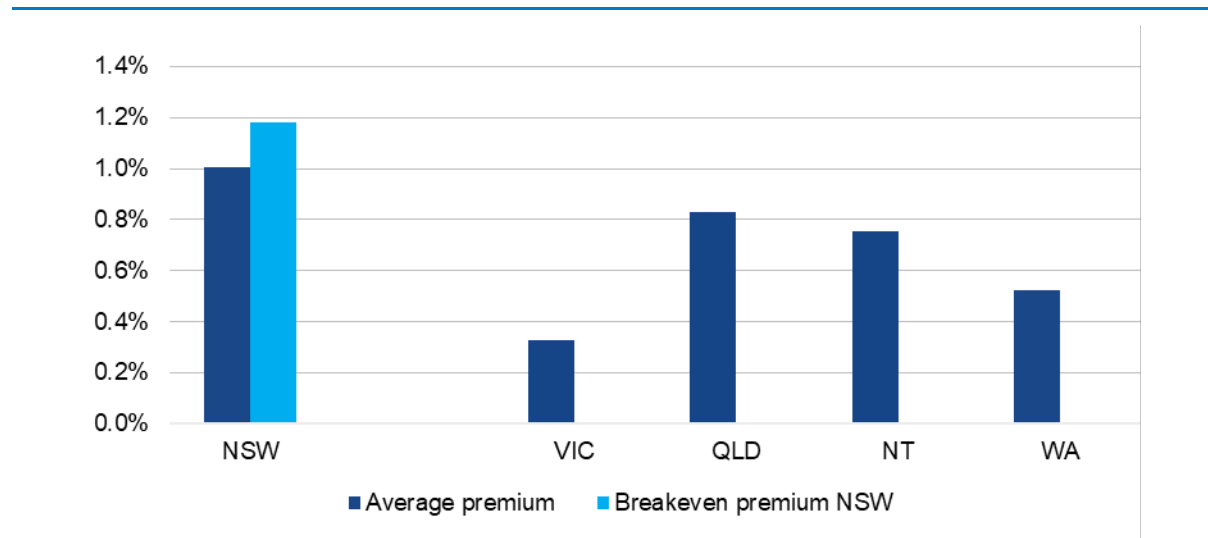
⁵⁴ icare, *Home Building Compensation Fund*, accessed 10 September 2020; QBCC, *Home warranty insurance*, accessed 10 September 2020; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 11; VBA, *Insurance for building and plumbing work*, accessed 10 September 2020.

⁵⁵ This is the overall premium. The premium for each construction type varies (See Figure 4.2). icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 13.

We consider the premium in Victoria is the best comparator for NSW. Victoria has a similar level of building activity to NSW, and the coverage, project threshold, claims criteria and administration of its domestic building insurance are similar to NSW. It has an average premium of 0.325%⁵⁶ which is around a third of the cost of the NSW scheme.

The residential construction industry in Queensland is the next closest in terms of level of activity. The average premium in Queensland is 0.83%,⁵⁷ which is higher than Victoria, but still lower than NSW. The coverage provides a lower maximum claim amount, but homeowners can make a claim on the fund when a dispute is unable to be resolved while the builder is still trading.

Figure 4.1 Comparison of average premium rates by state (exclusive of charges)



Source: icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 13, 17; Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, p 14, 29 November 2019, accessed 10 September 2020; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23; Master Builders Fidelity Fund, *Fidelity fund contribution scale rate*, accessed 10 September 2020; Information received from WA Department of Mines, Industry Regulation and Safety, 7 August 2020.

In addition to having higher premiums, the NSW HBCF also requires taxpayer funding to cover the costs of claims. Unlike in Victoria and Queensland, where premiums are set at breakeven levels, the current premiums in NSW are only forecast to recover around 85% of costs (Figure 4.1). This is primarily because premiums on multi-dwellings are still below breakeven levels (single-dwelling structural alterations are also slightly below breakeven levels) (Figure 4.2).⁵⁸

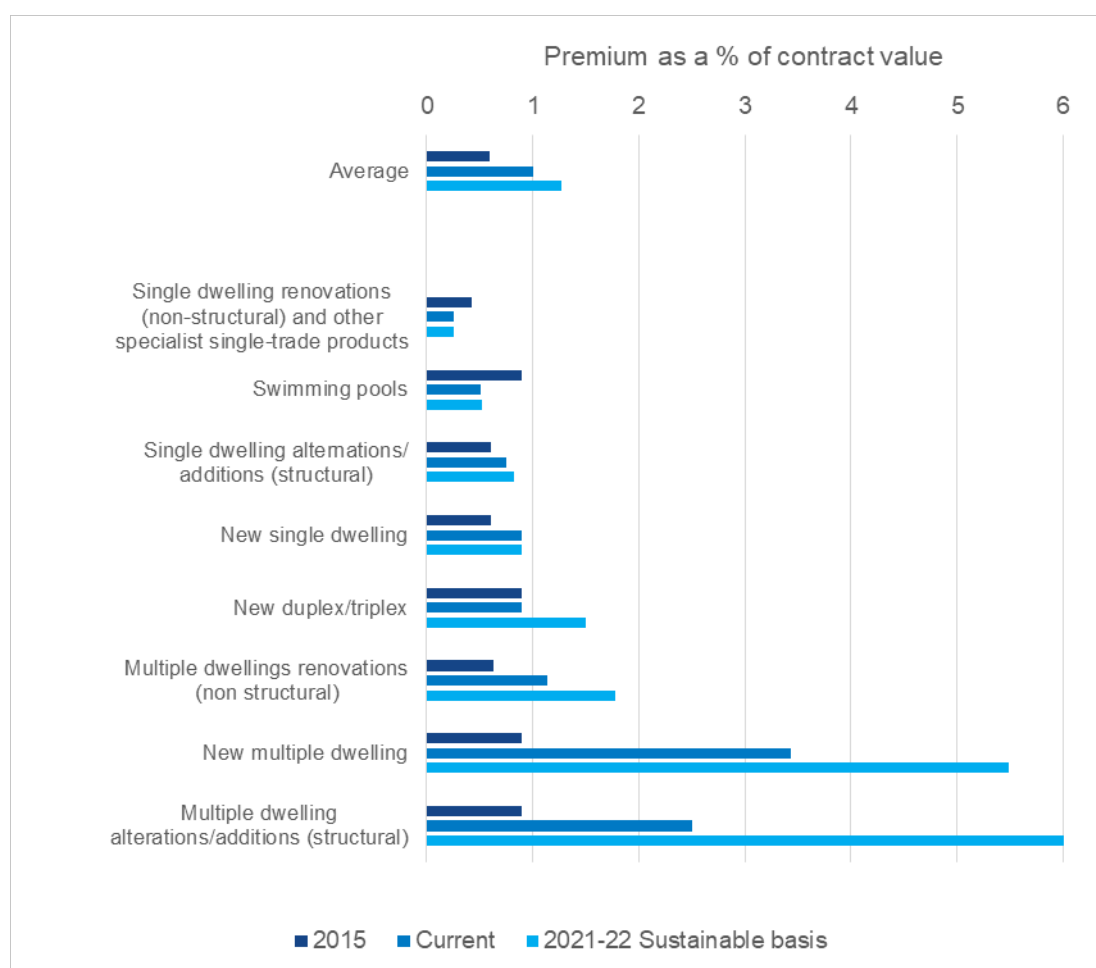
⁵⁶ Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, 29 November 2019, p 14., accessed 10 September 2020.

⁵⁷ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 24.

⁵⁸ icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 11, 17.

After several years of price increases, the premiums for other building types have now reached a sustainable level (they are expected to cover the costs of future claims). The transition path for multi-dwellings to reach breakeven levels has been longer because much more significant increases were required to reflect their higher risks. Figure 4.2 shows that premiums for new multi-dwellings and structural alterations to multi-dwellings have roughly tripled compared to 2015 levels, and will need to double to around 6% to become sustainable.⁵⁹ The deficit is funded by taxpayers until these policies expire (which can take more than ten years in some cases) (Box 4.1).

Figure 4.2 icare's HBCF premium rates by construction type (exclusive of charges)



Data source: icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 13; Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 19.

⁵⁹ *Ibid*; Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 19.

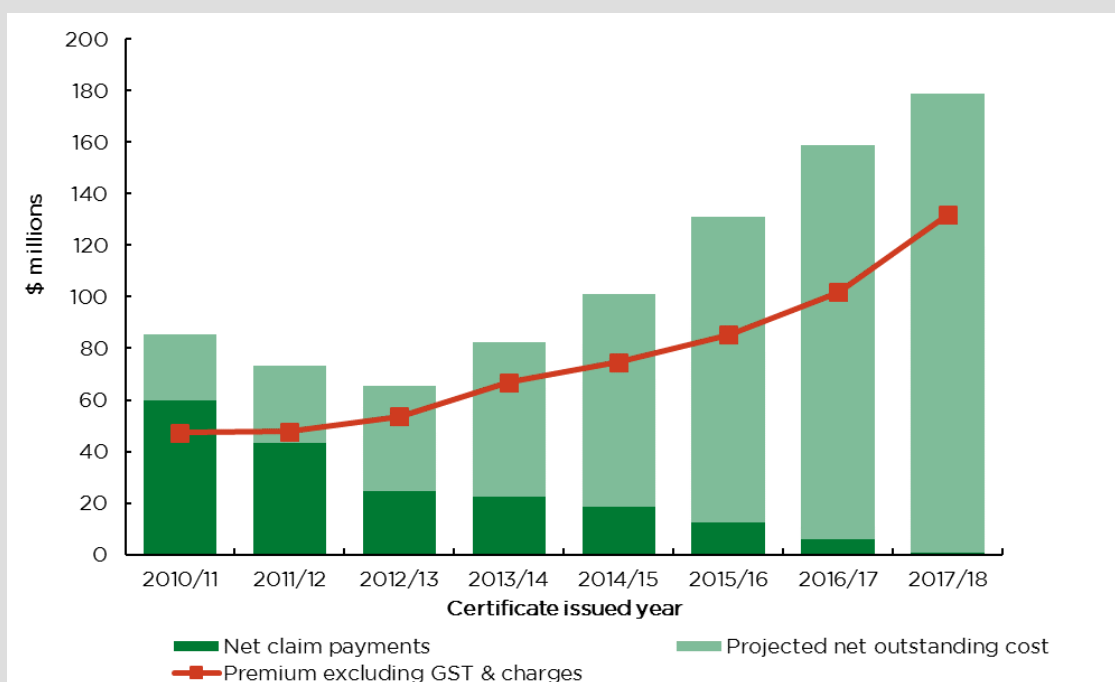
Box 4.1 Significant taxpayer funding will be required to meet the costs of the scheme for the foreseeable future

The HBCF is heavily reliant on NSW Government funding to cover the cost of claims on policies issued over the last decade. This is because premiums on these policies have been set lower than the amount required to cover the cost of the claims. In Figure 4.3, the forecast level of taxpayer subsidy for policies for previous years is the difference between the height of the total costs (green bars) and the premium (the red line).

Figure 4.3 also shows that liabilities remains outstanding for many years after a policy is issued, which makes it a 'long-tailed' product. It shows that in June 2018, claims could still arise from policies written in 2010-11, and the projected outstanding cost for claims in this year remained over \$20 million. However, the total actual claims cost of these policies will not be known until at least 2020-21 (when the policies expire) and may be higher or lower than the estimated \$85 million shown in this chart.

During 2017-18, icare received \$138.4 million in funding relating to reimbursements of prior year losses and an additional \$43 million in respect of policies written post 1 July 2018. As at June 2019, the fund had assets of around \$400 million, compared to forecast claims liabilities of just over \$1 billion. This means it still has a forecast deficit of around \$650 million, which will need to be funded by taxpayers.

Figure 4.3 Premiums compared to costs by certificate year



Source: SIRA, *Home building compensation scheme report*, 30 June 2018, p 35, accessed 10 September 2020.

Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, pp 5, 23; icare, p 211.

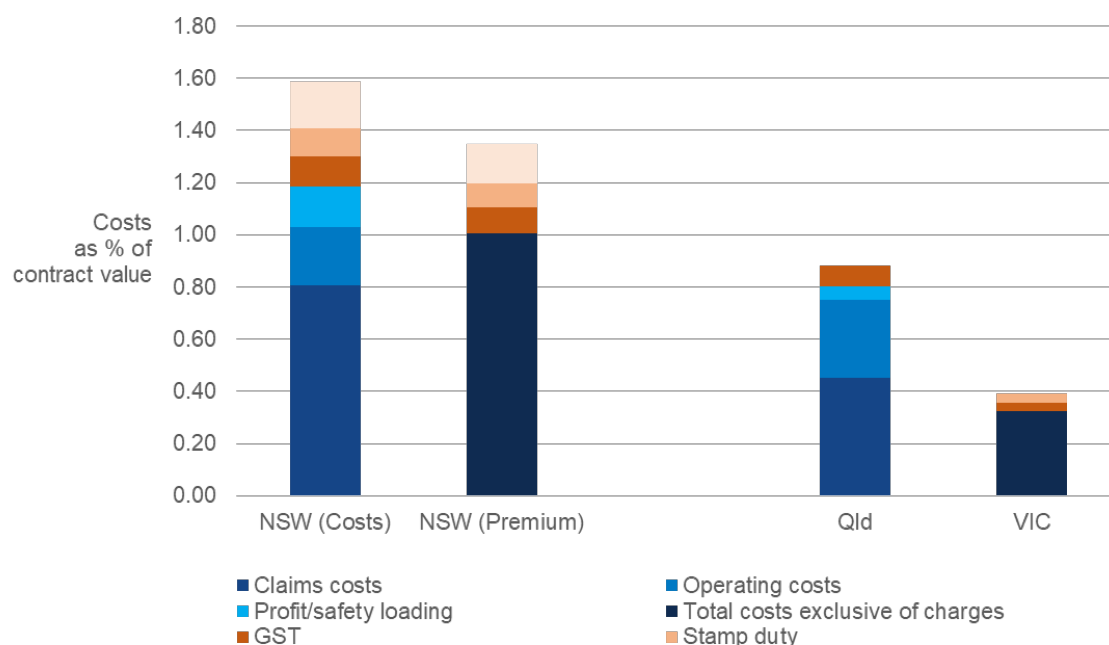
4.3 Average claims costs are higher in NSW

Claims costs are the primary costs of the NSW Home Building Compensation scheme, making up around 70% of total costs (excluding the charges shown in orange in Figure 4.4). The costs of operating the scheme make up a further 20% of costs. A profit/safety margin is then added to these costs, bringing the total cost in NSW to 1.2% as a percentage of the average building contract values (exclusive of charges).⁶⁰

In addition, GST (10%), stamp duty (9%), and brokerage (around 15%) adds roughly another 34% to the costs of the scheme.⁶¹ Including these costs, the average cost of the scheme in NSW is around 1.6% of the contract price, or around \$5,500 for a \$350,000 contract.

As noted in the previous section, premiums have not yet been set at breakeven levels. On average, builders are currently paying around 15% less than costs.

Figure 4.4 Costs of the schemes as a % of the average building contract value (2020)



Note: In Queensland, no stamp duty is payable on home warranty insurance premiums. There is also no brokerage fees applicable as builder eligibility is undertaken as part of builder licencing, and builders purchase certificates of insurance specific to each project directly from the Queensland Building and Construction Commission (QBCC) the statutory provider of home warranty insurance in Queensland. We do not have a breakdown of costs for the Victorian scheme.

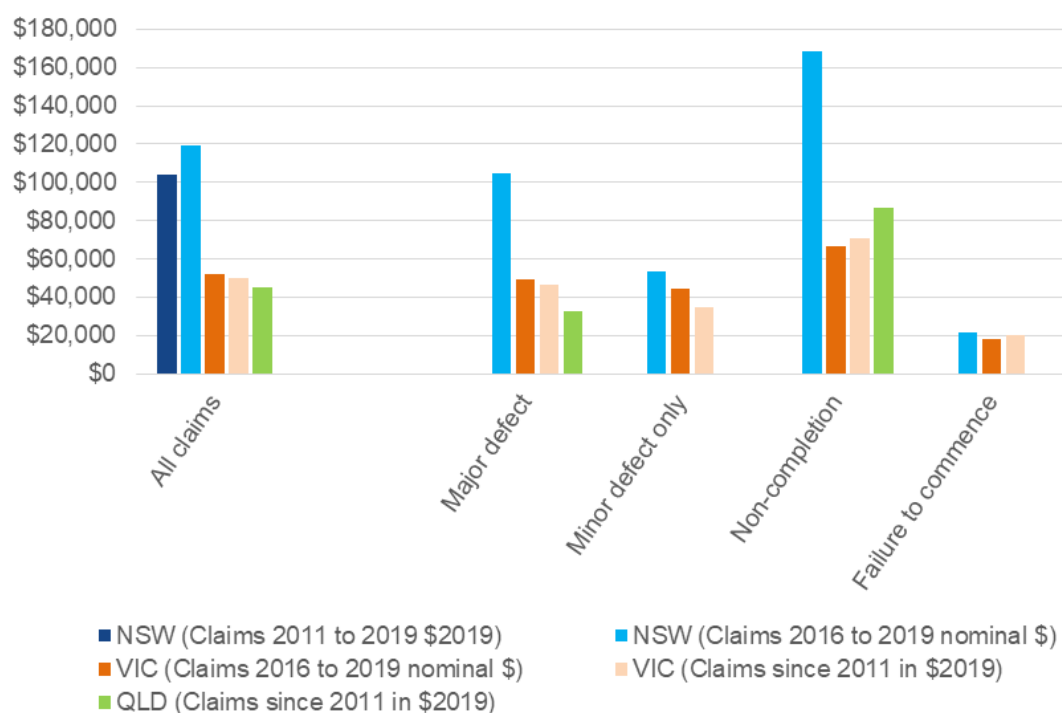
Data source: icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 11, 17; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23; Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, 29 November 2019, p 14, accessed 10 September 2020.

⁶⁰ icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 11, 17.

⁶¹ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23.

Figure 4.4 shows that claims costs are equal to around 0.8% of contract values in NSW. This is significantly higher than other states—exceeding the total premium in Victoria. These are being driven by higher average claims costs, rather than more claims. Figure 4.5 shows that claims for major defects in Queensland and Victoria average around \$30,000 and \$50,000 respectively, compared to around \$100,000 in NSW. Claims that occur before the building is complete (non-completion claims) average almost \$170,000. Just over half of the total claims costs for non-completion claims reflect the costs of an associated defect. Non-completion claims make up around 40% of all claims in NSW (Figure 4.6).

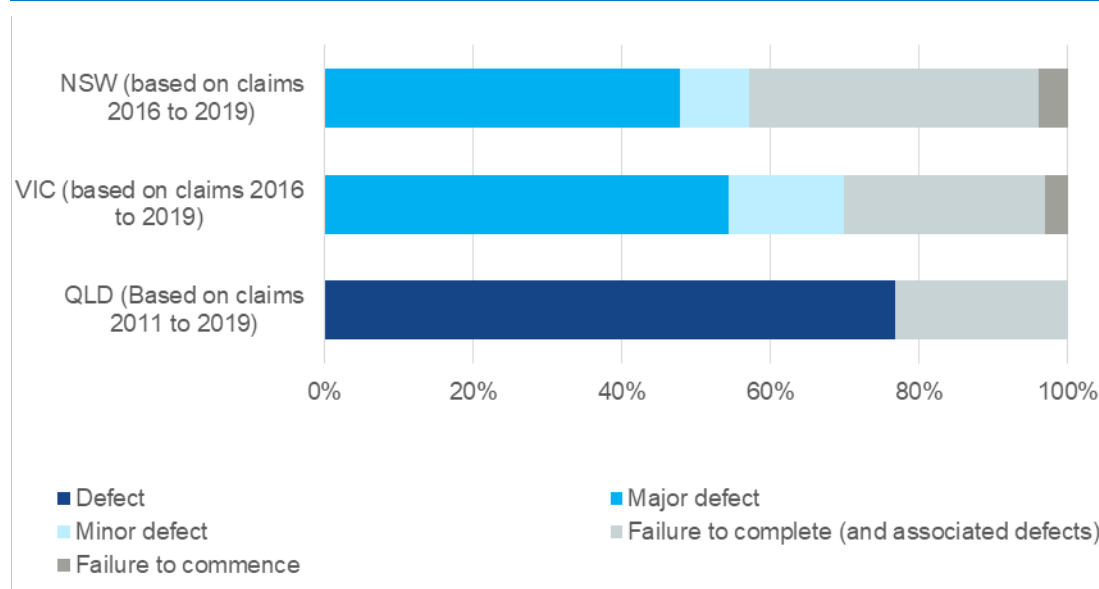
Figure 4.5 Average claims costs per dwelling – NSW compared to Victoria and Queensland



Note: The data was not available on a comparable basis across all years, or dollars. The information is displayed based on the availability of data. The NSW 2011 to 2019 average is based on claims made with icare only. The 2016 to 2019 averages in NSW do not include claims on multi-dwellings in NSW (construction types C02, C03, C08), because costs have been reported on a per policy, rather than a per dwelling (or certificate) basis. We have sought further information for our final report. Adjustments have been made to the Queensland data to exclude claims relating to contracts less than \$20,000. To calculate these averages, each claim is only counted once per dwelling. NSW claims with both a major and minor defect have been allocated to a major defect claim, and all claims with a non-completion component have been allocated to non-completion claims category (even if the cost of the rectifying defects is a larger portion of the claim).

Data source: Based on information provided by icare, June 2018; *SIRA, Dec 2018 - Home building compensation report Dec 2018 Data Tables*, accessed 10 September 2020. Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020; *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, Correspondence with Taylor Fry, 24 July 2020; correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

Figure 4.6 Claims by type – NSW compared to Victoria and Queensland



Note: The data was not available on a comparable basis between categories, or across years. Each claim is only counted once per dwelling. NSW claims with both a major and minor defect have been allocated to a major defect claim, and all claims with a non-completion component have been allocated to non-completion claims category (even if the cost of the rectifying defects is a larger portion of the claim).

Data source: Based on information provided by icare, June 2018; information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020; [Domestic building insurance scheme performance reports from 2010-11 to 2018-19](#), Correspondence with Taylor Fry, 24 July 2020; correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

There are a number of factors that explain some of the difference between the average claim costs in NSW and other states, including:

- ▼ Different levels of coverage. In particular, NSW has a higher maximum claims amount of \$340,000 (up from \$300,000 in July 2014), the maximum claims value in Queensland is \$200,000 for each claim type (pre-completion/post-completion), and all policies issued before July 2014 in Victoria also have a maximum claims cost of \$200,000.⁶²
- ▼ Homeowners in NSW can recover any legal costs they have been incurred that are owed from the builder (this accounts for about 1% of all claims costs)⁶³
- ▼ Building costs are likely to be higher than in other states, leading to higher cost rectification works. Figure 4.6 shows that the average contract cost of a new dwelling in NSW is around 20% to 30% higher than in Queensland.

⁶² VMIA, [Domestic Building Insurance – What's covered?](#); accessed 10 September 2020.

⁶³ Based on information provided by icare, June 2018.

Figure 4.7 Average contract value for new constructions in Queensland and NSW



Data source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 20.

After we adjusted for these factors,⁶⁴ claims costs in NSW are still 60 to 80% higher than Victoria and Queensland, or \$30,000 to \$40,000. This could reflect more severe defects in NSW, reflecting weaknesses in the broader regulatory environment. As discussed in Chapter 3, Taylor Fry considered that defects could become more severe in NSW compared to Queensland because of the time taken to resolve disputes.⁶⁵ For example, water-proofing issues, which make up a high proportion of claims, are likely to worsen over time. As discussed in Chapter 3, one of the benefits of Queensland's first-resort scheme is that claims can occur while a builder is still trading if the early dispute mechanisms are unsuccessful. This can mean defects are being rectified more quickly.

It is also possible that the higher claims cost could also reflect higher rectification works in NSW as a result of icare's claims management processes. This process involves icare seeking quotes from shortlisted builders that have registered their interest to undertake the repair work. Generally at least three quotes are preferred.⁶⁶ However, further evidence is required to understand whether this is a factor.

As discussed in more detail in Chapter 7, we are recommending that price regulation is required for icare because it is a monopoly provider. As part of this process, the price regulator should review whether the current arrangements for rectifying works are resulting in efficient outcomes.

⁶⁴ We subtracted legal costs, reduced costs directly related to building rectification by 20%, and then capped all claims at \$200,000.

⁶⁵ Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 41.

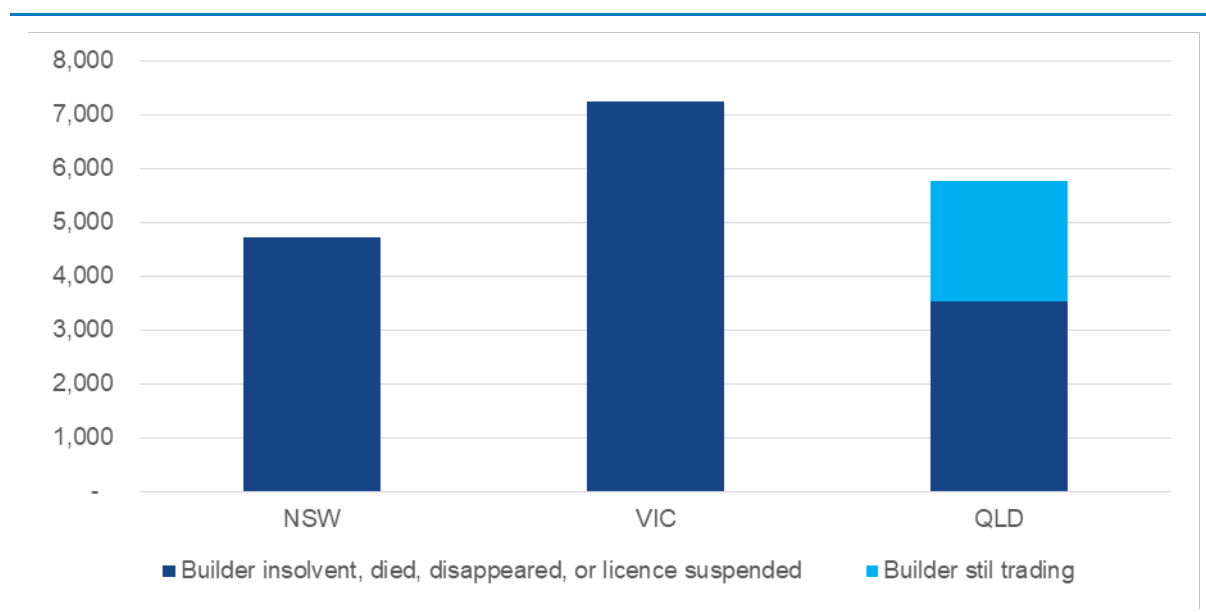
⁶⁶ Information provided by icare, 21 May 2020.

4.3.1 NSW has fewer claims than other states

The total costs of claims that is required to be recovered from premiums reflects not only the average claims rate, but also the number of expected claims. All else being equal, a higher claims rate will require higher premiums.

We found that the number of claims in NSW is not a factor in explaining higher claims costs. Figure 4.8 shows that NSW has significantly fewer claims than other states.

Figure 4.8 Claims numbers 2010-11 to 2018-19 – NSW compared to Victoria and Queensland



Note: The split of claims for Queensland into claims where the builder is trading and not trading is based on 26 months of data. NSW claims for 2018-19 is estimated based on half a year of data.

Data source: SIRA, *Dec 2018 - Home building compensation report Dec 2018_Data Tables*, accessed 10 September 2020; ESC, *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

4.4 icare's costs for operating the HBCF

As noted in the previous section, the costs of operating the HBCF make up around 20% of total costs (Figure 4.4), or around \$33 million. The key costs include claims management, and builder eligibility assessments (together making up around 55% of costs).⁶⁷ These functions have been outsourced. icare's outsourced services have been competitively tendered and so should reflect the market price of delivering these services (Box 4.2).⁶⁸

However there may also be efficiencies in having some of the functions administered centrally if it improves the flow of information. In particular, if the claims management experience is well understood, it can be used to inform risk factors, and incorporated into eligibility and premium models.

⁶⁷ The remainder is made up of service fees to icare (\$8.8 million), SIRA levies (\$5.7 million) and expenses associated with system upgrades (\$1.0 million); icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 15.

⁶⁸ Note that as part of this review, IPART has not audited icare's procurement processes.

VMIA, the Government insurer in Victoria, made significant savings when it brought the claims management function in-house in 2017, with premiums falling by around 25%.⁶⁹ As noted by a stakeholder to our review, prior to this, the auditor general had found that using intermediaries to deliver the insurance service cost an additional \$21 million between July 2011 and July 2015 compared to a model where VMIA insourced the delivery, including removing brokers.⁷⁰

Box 4.2 How icare has managed its expenses

icare's procurement of the builder eligibility assessments and claims management were delivered under an open competitive tender process. Four response were received for eligibility services, and seven for claims services.

The actuarial services tender was closed to the pool of suppliers qualified under the NSW Pre-Qual scheme for Actuarial Services. Three quotes were received.

In each case we understand that probity advisors were appointed, procurement conduct plans and conflict of interest registers were in place, and the e-tender portal was used.

Source: Correspondence with icare, 31 August 2020.

We also considered how the operating costs of the NSW HBCF compares to the Queensland home warranty scheme (Table 4.1). There are several differences between expenses incurred in each scheme. In particular, the Queensland scheme does not include the equivalent of icare's eligibility risk management role which accounts for 36% of icare's operating costs.⁷¹ A similar function is instead undertaken by the licencing function and so these costs are not recovered by premiums. However, it includes other operating costs, such as dispute resolution services that are not captured by the NSW scheme. In NSW, these costs are incurred by NSW Fair Trading and NCAT. The Queensland scheme also has a larger function in relation to debt recovery because some claims are made in relation to businesses that are still solvent and so costs can be recovered from these businesses.⁷²

Despite these significant differences, the total expense costs of the NSW and Queensland schemes are very similar (\$33.3 million in NSW compared to \$34.5 million in Queensland).⁷³

⁶⁹ Victorian Managed Insurance Authority, *Annual Report 2017-18*; p 6, accessed 10 September 2020.

⁷⁰ Anonymous submission to IPART Issues Paper, May 2020; Victorian Auditor General, *Victoria's Consumer Protection Framework for Building Construction*, May 2015, p 70, accessed 10 September 2020.

⁷¹ icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 15.

⁷² Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, pp 44-45.

⁷³ *Ibid.*

Table 4.1 Expenses collected through premiums in NSW and Queensland

	NSW icare HBCF	Queensland QBCC Home Warranty insurance
Expenses include:	<ul style="list-style-type: none"> ▼ Claims management ▼ Eligibility risk management ▼ Service fees to icare ▼ SIRA levies ▼ Expenses associated with system upgrades 	<ul style="list-style-type: none"> ▼ Claims Management ▼ Reinsurance costs ▼ Debt Recovery ▼ Underwriting ▼ Dispute Resolution (in relation to claims)
Expenses (\$)	\$33.3	\$34.5
Expenses as % of 2019 contract value	0.2%	0.3%

Source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 45.

4.5 The use of brokers should be voluntary under the scheme

It is currently mandatory for builders to use brokers to apply to become eligible for HBC, and also to purchase certificates of insurance. Figure 4.4 shows that brokerage costs are estimated to add around 15% to premium costs. These costs are not incurred by builders in Queensland because there are no brokers under the scheme.⁷⁴ In Victoria, brokers are optional. After selecting an insurance distributor, they can manage and buy the insurance themselves.⁷⁵

The Law Society submitted that with a single provider, it may be appropriate to query the role that brokers play in the current scheme.⁷⁶ icare submitted that use of a distributor could be a discretionary election by the builder, based on their size and sophistication, allowing builders to use accountants instead if they required assistance (as occurs in Queensland). It submitted that it already has the technology for direct builder engagement, eligibility assessment, underwriting risk control and reporting, insurance policy processing and issuing, and premium collection which would enable a transition to an optional distribution model that would deliver increased consumer value.⁷⁷

We have also heard that when eligibility issues arise, builders must deal with the broker, who then deal with icare to resolve the issue. Some builders felt that this prolonged the resolution, and they weren't sure if the correct information was being conveyed between all parties. They considered that the experience and outcomes could have been improved if they were able to communicate directly with icare regarding these issues.

Brokers are currently the customer interface between builders and icare. Their main role is to assist builders through the eligibility process, which involves the submission of complex financial information tailored to the requirements of the scheme. However the value that brokers provide in purchasing the certificates themselves is likely to be limited.

⁷⁴ *Ibid*, p 23.

⁷⁵ VMIA, *VMIA Domestic Building Insurance*, [Video VMIA Domestic Building Insurance](#), June 2017.

⁷⁶ Law society submission to IPART Issues Paper, June 2020, p 5.

⁷⁷ icare submission to IPART Issues Paper, June 2020, p 19.

To help reduce the costs of the HBCF in NSW to builders and homeowners in NSW, our draft recommendation is that the use of brokers become voluntary under the scheme. It is likely that many builders would still choose to use brokerage services, and so they would still incur these costs. However, providing builders with more options around how they manage their obligations under the HBCF provides a greater incentive for brokers to demonstrate value for money, and exposes them to competition from other business professionals, placing downward pressure on their fees, and also allows builders to avoid these costs entirely. In addition, where eligibility issues do arise, both builders and icare are likely to better understand the issues involved where they are able to communicate directly.

We note that the savings made from brokerage fees might be partially offset by slight increases to icare's costs as a result of having to deal with builders directly.

4.6 More information on premiums for individual builders could lead to cost savings

icare provides a [premium calculator](#) on its website to provide information to builders and homeowners about the costs of HBC. The calculator shows the base rate premium for the specified construction and location, but individual builders attract a loading or a discount on the base premium rate of up to +/-30%, depending on risk factors such as age of their business, and their business structure (ie, company, sole trader, or partnership).

Our draft recommendation is that the calculator display premium rates specific to each builder. This would help homeowners better manage their insurance costs prior to choosing a builder. Currently a builder must disclose the estimated costs of HBC cover after quote has been provided for the work but before the contract is signed, but in practice this is too late.

Displaying the premiums for a builder would also provide homeowners with additional information to understand the insolvency risks associated with their choice of builder.

5 Removing regulatory barriers to entry for alternative indemnity providers

In 2018, the NSW Government implemented changes to Part 6B of the *Home Building Act 1989* to allow private entry into the HBC scheme. The changes allowed for both insurers (licensed by APRA) and alternative indemnity product (AIP) providers (non-insurers regulated by SIRA only) to enter the scheme. The Government's intentions were to encourage competition, product innovation and choice by allowing for alternative indemnity products, such as fidelity fund schemes and specialised insurance arrangements.

Despite these changes, no private providers have entered the market. Two private providers have applied to SIRA for a licence to become an AIP provider, but SIRA has not granted any licences.⁷⁸

Our terms of reference asks us to consider the impediments to private sector participation in providing insurance through the home building compensation (HBC) scheme.

This chapter considers whether regulatory barriers prevent insurers or AIP providers entering the market. It considers whether legislative or other changes are required to give effect to the Government's intentions of the 2018 reforms to allow non-APRA regulated providers to offer HBC contracts. It considers the impact that any recommended changes would have on consumer protection under the scheme.

5.1 We have found that there are regulatory barriers to entry for non-APRA licensed AIP providers

Under the provisions of the *Home Building Act 1989* (HB Act) it is very unlikely that a non-insurer could meet the legislative requirements to become a licensed AIP provider.

An AIP provider will almost always be carrying on an insurance business and so would need to be authorised by APRA under Part III of the *Insurance Act 1973* (Insurance Act). This is because it is likely that an AIP constitutes a contract of insurance unless the provider has *discretion* whether or not to pay a claim in full or part. But a discretionary indemnity product would not satisfy section 104A of the HB Act, which requires an AIP to provide insurance-equivalent protection against loss.

To give effect to its original intention to open the scheme to non-insurers, our draft recommendation is that the Government amends the HB Act and Regulation to allow non-insurers to offer products that do not have insurance-equivalent protections.

⁷⁸ One of these applicants was SecureBuild, which withdrew its application after it was not able to obtain a licence as a general insurer from APRA and had its application for an exemption from the *Insurance Act 1973* rejected.

It is evident that there are non-insurers that are interested in entering the market. Making these changes would allow them to do so, which could result in improved product choice and lower costs for homeowners, through increased competition. However, it may reduce homeowner certainty about claims, compared to an insurance product. We have considered measures that the Government could take to mitigate this:

- ▼ Limit a discretionary fidelity fund scheme to selected, low-risk construction types. For example, swimming pools. We understand that this type of industry-specific product has been developed for workers compensation products.
- ▼ Amend the HB Act and Regulation to provide guidance on how AIP providers could make discretionary decisions on a claim, and how relevant authorities, including SIRA and NCAT, would review this if a homeowner was to appeal the provider's decision.

The changes currently underway to reduce the incidence of defects in the residential building market will take some years to translate to lower risk in the HBC market. Until then, the HBC market is unlikely to attract a lot of interest from private insurers. In the meantime, the market would benefit from having niche providers offering some builders a choice to compete with icare's insurance product.

IPART draft finding

- 5 There are regulatory barriers inhibiting entry for private providers. In particular, it is unlikely that fidelity funds that are not regulated by the Australian Prudential Regulation Authority (APRA) could offer HBC cover in NSW under the current drafting of the legislation.

Draft recommendation

- 8 The NSW Government amends section 104A of the *Home Building Act 1989* and associated Regulation to allow alternative indemnity providers to offer a discretionary (non-insurance) product.

5.2 What stakeholders said in response to our Issues Paper

We received submissions on entry barriers from icare, SecureBuild, the Risk Specialist Group, HIA and others. We held follow up discussions with stakeholders to discuss their issues, including SecureBuild's unsuccessful application for an AIP licence (see Box 5.1).

SecureBuild expressed the view that the current legislation does not allow non-insurers to offer HBC products in the market.⁷⁹ HIA stated that:

Fidelity Funds are not APRA approved, regulated, or compliant they are able to operate with lower operating costs than licensed insurers. Superficially, this suggests that they will be able to offer lower premiums. This situation presents yet another barrier to entry to private insurers.⁸⁰

⁷⁹ SecureBuild, Submission to IPART Issues Paper, May 2020, p 3.

⁸⁰ HIA, Submission to IPART Issues Paper, May 2020, p 6.

We met with SIRA and APRA to discuss their interpretations of the regulatory arrangements for AIP providers and insurers. While SIRA does not have a role in advising applicants on the nature of their proposed product, it expressed the view that it would be legally possible to structure an AIP that will not constitute an ‘insurance business’ under the Insurance Act. However, it did not provide an example of a product that would meet the criteria.

We also received a number of submissions from builders and industry associations, which expressed dissatisfaction with the current monopoly insurer and considered that competition in the market could provide better service and product choice.

Box 5.1 SecureBuild’s experience applying to become an AIP provider in NSW

In 2018, SecureBuild sought to enter the HBC market as an AIP provider in the form of a fidelity fund, as provided for by Part 6B of the HB Act. It applied to SIRA for a licence to become an AIP provider. SecureBuild engaged independent legal advice that, despite the intent of Part 6B of the HB Act, alternative indemnity products constituted insurance business by way of a contract of insurance between parties.

It withdrew its application to SIRA because it would also need to be licensed by APRA as a general insurer.

SecureBuild then applied to APRA for determination under section 7 of the *Insurance Act 1973* that it should be exempt from the provisions of Part 3 of the Act (concerning authorisation to carry on an insurance business). While SecureBuild did not fit within any of the exemption categories specified in the Act and regulations, it argued that its insurance business would be regulated by SIRA, meet SIRA’s prudential requirements and together with the Home Building Insurers Guarantee Fund (HBGF), would be more than sufficient to protect policy holder interests (ie, named beneficiaries under contracts issued by SecureBuild).

APRA rejected SecureBuild’s application because it was not satisfied that there was a special case for an exemption on the basis that ‘no amount of oversight by SIRA will suffice to protect policyholders unless SecureBuild is required to hold eligible capital of an amount which is adjusted in accordance with the scale, nature and inherent risks associated with its proposed insurance business.’ APRA was not satisfied that the requirements imposed by SIRA were of an equivalent kind to those that apply to insurers authorised under the *Insurance Act 1973*. APRA noted that while the NSW Government could establish a fund to partially meet any shortfall in capital that may be required in the event that SecureBuild held insufficient funds to cover claims, the NSW Government did not have such a fund at the time.

Source: SecureBuild, Submission to IPART Issues Paper, May 2020; Correspondence between APRA and SecureBuild, tendered to IPART, May 2020.

5.3 What is an insurance product?

'Insurance' is not defined under the Insurance Act,⁸¹ 'but its meaning has been considered by case law'.⁸² This makes it somewhat of a grey area, but generally, a contract of insurance demonstrates the following three elements:

- ▼ The contract must provide that the insured will become entitled to something on the occurrence of some event, which entitlement reflects an obligation on the insurer to give some benefit to the insured
- ▼ The event must be one which involves some element of uncertainty
- ▼ The insured must have an insurable interest in the subject matter of the contract.

APRA does not advise businesses about whether their proposed product is insurance. They must seek independent legal advice. If a product is determined to be insurance, the product provider must obtain a licence from APRA to supply the product.

5.4 What makes an alternative indemnity product an insurance product?

Under Part 6B, Section 104 of the HB Act, an AIP is defined as:

- ▼ a fidelity fund scheme; or
- ▼ a specialised insurance arrangement; or
- ▼ any other insurance product or arrangement prescribed by the Regulations for the purposes of this Act.

Currently, the *Home Building Regulation 2014* (Regulation) does not prescribe any other insurance product or arrangement so, for the purposes of the HB Act, a non-insurance AIP could be a fidelity fund only.

⁸¹ The Insurance Act refers to the conduct of 'insurance business' rather than the provision of contracts of insurance. Section 3 of the Act includes a circular definition of insurance business as 'the business of undertaking liability, by way of insurance (including re-insurance) in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event and includes any business incidental to insurance business as so defined...' The Insurance Act specifies a number of products that are not insurance business for the purpose of the Insurance Act. These include products like life insurance and health insurance, which are not relevant to the HBC market.

⁸² See the working definition of a contract of insurance set out by Channel J in *Prudential Insurance Company v Commissioners of Inland Revenue* [1904] 2KV 658 @663-664. This working definition has been followed in a number of Australian cases including by the Full Federal Court in *Todd v Alterra @ Lloyds Limited* [2016] 330ALR 454, and *Medical Defence Union Limited v Department of Trade* [1980] CH 82.

5.4.1 The HB Act requires an AIP to offer insurance-equivalent protection to policy holders

Whether a fidelity fund would be approved in NSW would depend on whether it met the regulatory requirements in section 104A of the HB Act. Section 104A states:

- (1) The Authority may approve the use of an alternative indemnity product to provide cover for loss of a kind that is required to be covered by an insurance contract under Part 6 for at least the period for which any such cover is required to be provided.
- (2) The Authority must not approve an alternative indemnity product unless it is satisfied that the product will provide cover for loss of that kind.
- (3) An approval may be unconditional or subject to conditions.

This is consistent with the purpose of the legislation which is to provide consumer protection for homeowners if their builder cannot complete or fix works on their home. The Minister's second reading speech for the amendments that introduced the concept of an alternative indemnity product stated that:

The cover offered by these products [fidelity funds] will need to meet or exceed the minimum cover requirements of the legislation in the same way as insurance.⁸³

This means that the HB Act does not permit a fidelity fund to refuse to pay a claim at its discretion. This is also apparent from the Regulations, which limit the grounds on which a fidelity fund provider may refuse to pay a claim and those grounds do not (and could not) include a refusal to pay by exercising a discretion. Accordingly, a discretionary scheme cannot meet the current requirements of the HB Act, and a fidelity fund could only obtain a licence to provide an AIP under the scheme if an APRA-licensed insurer was offering it.

5.4.2 Fidelity funds in other jurisdictions are discretionary funds

There are two fidelity funds that offer home building warranty products in other Australian jurisdictions: Master Builders operates funds in the Northern Territory and ACT as not-for-profit trust funds (Box 5.2).

Both of these are discretionary funds. In the NT, section 39(i) of the *Building (RBI and Fidelity Fund Schemes) Regulations 2012* provides that the scheme's trust deed must require a certificate issued under the scheme to specify that the following matters are in the discretion of the trustees in relation to a claim made under the certificate:

- ▼ whether the claimant is a beneficiary under the certificate, and
- ▼ if the claimant is a beneficiary – the amount of the payment to the beneficiary out of the assets of the scheme and the terms and conditions on which payment is to be made.

Section 54DA of the *Building Act 1993 (NT)* provides that the approval criteria for a fidelity fund scheme are to be prescribed by regulation. Although it also states that the approval criteria must include certain requirements, none of the specified requirements relate to the amount of cover.

⁸³ Legislative Council Hansard, 20 June 2017, p 2. See [Legislative Council Hansard – 20 June 2017 – Proof](#), accessed 16 September 2020.

In the ACT, under section 4(d)(4) of the *Building (Approval criteria) Determination 2002*, the trust deed must state that each of the following matters is at the discretion of the trustees when a request is made by an owner:

- ▼ whether any payment is to be paid to the owner from the assets of the fidelity fund scheme
- ▼ the amount of any such payment to be paid to the owner, and
- ▼ the terms and conditions on which any payment to the owner is to be paid by the trustees from the assets of the fidelity fund scheme.

Section 99 of the *Building Act 2004 (ACT)* provides that the Minister may determine the approval criteria for an approved fidelity fund scheme. Again, although it also states that the approval criteria must include certain requirements none of the specified requirements relate to the amount of cover.

This means that these fidelity funds would maintain an element of discretion on the amount to pay out on an eligible claim.

A discretionary scheme for indemnity is not a contract of insurance, because it does not provide an obligation for the insurer to give some entitlement to the insured on occurrence of an event. This is the case even if the discretion is must be exercised reasonably.

Box 5.2 Master Builders fidelity funds in the ACT and NT

The Master Builders Association is an industry body representing key building construction sectors, including residential, commercial, engineering and civil construction.

The Master Builder's Fidelity Fund was established in the ACT in 2002 and operates under requirements as set out in the ACT's *Building Act 2004* and is managed by an independent Board of Trustees. To be eligible to become a member of the fund, builders must meet specified financial benchmarks in its application.

It is mandatory for licensed builders to obtain either residential building work insurance or a fidelity fund certificate from the fidelity fund scheme before commencing building work over \$12,000. The fidelity fund certificate must provide cover for up to \$85,000 and remains valid for five years after completion (or occupation of the project).

In 2013, the NT Government replaced its home building certification fund with a fidelity fund, administered by the Master Builders Fidelity Fund, an independent not-for-profit trust for the benefit NT homeowners. The fund takes contributions from builders at a set rate and provides cover of 20% of the contract price up to \$200,000 if a builder dies, disappears, loses registration or goes bankrupt. It covers structural defects for six years and non-structural defects for one year. This covers the cost of changing contracts, amending building permits and any other increases in costs associated with materials and labour.

The Master Builders Fidelity Fund is the sole form of home warranty insurance available to home owners in the NT and is mandatory, although it is open to entry by other private providers. When it commenced, the NT government provided a \$750,000 interest-bearing loan and a guarantee regarding any claims that exceeded the balance of the fund. Both the loan and the guarantee required the Treasurer's approval under the NT's *Financial Management Act 1995*.

Source: See MBA (ACT), [Fidelity Fund](#) and NT [Fidelity Fund](#), accessed 8 September 2020.

5.5 The *Insurance Act 1973* sets high prudential standards for general insurers

Following the corporate collapse of insurance firm HIH, APRA strengthened its prudential standards for general insurers to reduce the likelihood of failure in the general insurance sector. In particular, APRA now requires insurers to hold high levels of capital to prevent under-capitalisation.⁸⁴

For non-insurance businesses that want to offer a niche product in a small market like the NSW HBC market, it is not economic to hold the required levels of capital. In addition to capital requirements, an application to obtain a licence from APRA as a general insurer requires payment of a \$110,000 fee and may take at least 12 months to approve.⁸⁵ This is a high entry cost for non-insurance businesses.

There is scope to seek a licence exemption from APRA, but businesses must meet specific criteria. Currently, there are few exemptions to the Insurance Act of this kind.⁸⁶ Businesses could apply for consideration by APRA as a special case, as SecureBuild did. However, APRA rejected SecureBuild's application for exemption because it did not consider SIRA's prudential requirements sufficient to prevent material detriment to policy holders and that SIRA had not operationalised the HBGF in NSW.

5.6 Why should non-insurers be allowed to provide alternative indemnity products?

The Government's original intentions to open up the HBC market to non-insurers were to increase competition, consumer choice and promote competitive and sustainable pricing. It envisaged that these providers would operate similarly to the fidelity funds operating in the ACT and NT, and that SIRA would regulate them on an equal footing to insurers.

This is important because the HBC market is currently unlikely to attract strong interest from private insurers, because it is currently a high risk environment. There may be greater interest from private insurers when changes to the regulation and governance of the residential construction market currently underway translate to a lower severity of defects.

In the meantime, the market would benefit from having smaller providers offering a choice of products to compete with icare's insurance product. Given that there have been two AIP licence applications to SIRA, there appears to be interest from the private sector to provide these products in the market.

However, unless the Government makes changes to the HB Act and Regulation to allow discretionary payments, the market would be limited to APRA-regulated insurers only.

⁸⁴ See Treasury, [The HIH claims support scheme, aftermath of the hih collapse](#), Economic Roundup 1, 2015, accessed 8 September 2020.

⁸⁵ See [APRA's licensing process FAQ](#) and [APRA lodging an application](#), accessed 8 September 2020.

⁸⁶ Eg, The Export Finance and Insurance Corporation established by the *Export Finance and Insurance Corporation Act 1991*; Coal Mines Insurance Pty Limited, a company incorporated in New South Wales; The Motor Vehicle Insurance Trust constituted under the *Motor Vehicle (Third Party Insurance) Act 1943* of Western Australia. There are also exemptions for government insurers, described in the legislation as a "a body, not being a company, established or constituted under a law of the Commonwealth or of a State or Territory that is required under a law of the Commonwealth or of a State or Territory to carry on any business of insurance or to undertake liability under a contract of insurance."

These changes would trade off with the level of consumer protection for homeowners, which would have less certainty about the outcome of their claim.

To mitigate any dilution of consumer protection that may result from a discretionary fund, there are a couple of measures the Government could consider.

- ▼ **Limit a discretionary fidelity fund scheme to low-risk building segments.** For example, build categories like swimming pool are historically low risk claim items. An industry-based fidelity fund could be established to cover the unique characteristics of that sub-market. We understand that this type of industry specific product has been developed for workers compensation products.
- ▼ **Rules governing how discretion would apply.** The Government could prescribe the circumstances in which a fund may exercise its discretion. This would provide greater transparency for homeowners.
- ▼ **Review powers for SIRA, NCAT and other relevant authorities.** The Government may need to give SIRA, NCAT or other courts, where the matter exceeds NCAT's jurisdictional limits, powers to review a claim decision where a provider has exercised its discretion to reduce payment on an eligible claim. While authorities have limited powers to review the claims administrator's handling of claims decisions, there is no guidance on how it would determine whether an AIP has been reasonable in its application of discretion.

On balance, we consider that the benefits from having competitors in the market would outweigh any detriment that may stem from reduced certainty about claims payments.

6 Does the regulatory framework increase the costs of entry into the HBC market?

Part 6C of the *Home Building Act 1989* (HB Act) requires businesses to obtain a licence from SIRA to become either an insurer or an alternative indemnity product (AIP) provider to underwrite home building liabilities and manage claims in the HBC scheme. Applicants must meet SIRA's requirements for capacity, capability and processes to be legally authorised to carry out HBC business in NSW.

This licence places obligations on the provider to comply with the HBC legislative framework, including the HB Act and regulations, and any HBC guidelines made under it. SIRA has issued a number of guidelines setting out the conduct and reporting requirements for licenced insurers and AIP providers. These include guidelines on prudential management, determination of eligibility, premiums or contributions, and claims management.

SIRA's licensing regime applies in addition to Commonwealth regulations for insurers. Section 12 of the *Insurance Act 1973* requires businesses wanting to carry on an insurance business in Australia to be licensed by APRA. APRA does not regulate non-insurer providers, such as fidelity funds.

In our Issues Paper, we asked stakeholders whether regulatory duplication and prescription increased the costs of entry into the NSW HBC market for insurers and AIP providers. This chapter discusses the issues stakeholders raised, our analysis of the effectiveness of the licensing and regulatory framework for insurers and AIP providers and our recommendations to reduce entry costs and increase competition and choice in the market.

6.1 The regulatory framework discourages new entry

We consider that a less prescriptive approach to the regulation of private insurers and providers would promote greater competition in the HBC market and still deliver adequate consumer protection.

The current regulatory framework applies to both icare and any new entrants. icare currently has a monopoly on the market and requires a prescriptive regulatory approach to ensure efficient outcomes for builders and homeowners. However, applying the same regulatory approach to new entrants is unnecessarily restrictive. New entrants do not have the same influence on the market and have commercial incentives to provide products and services to meet homeowners' needs. Otherwise, builders and homeowners would remain with, or go back to, the incumbent provider.

Stakeholders have told us that some elements of the current regulatory framework discourage new entry, by duplicating Commonwealth regulations and restricting how insurers or providers manage their risk. Applying a more flexible regime to new insurers and providers would encourage market entry by lowering the costs to insurers and providers of entering and operating in the market.

In particular, in relation to insurers, we have found that requiring them to apply for a licence to provide HBC products duplicates APRA's prudential regulation. This increases costs of entry and does not provide additional protection for homeowners. Other jurisdictions that have a competitive home building insurance market, such as Victoria and the ACT do not require home building insurers to hold a separate state-based licence (see Box 6.1).

Licence requirements are set out in the HB Act and Regulation. Within the limits of those requirements, SIRA has some administrative discretion when weighing up the importance of those matters. It is our draft recommendation that SIRA simplifies its licensing process by deeming insurers to have met the prudential requirements if they are licensed as a general insurer by APRA. SIRA should maintain its current licensing of non-insurer providers because APRA has no role in regulating fidelity funds.

It is also our draft recommendation that the Government reduce regulatory obligations on both private insurers and AIP providers. In particular, they should not have to submit eligibility and premiums filings to SIRA for assessment. Instead, they should be guided by high level principles, rather than enforceable standards, similar to the General Insurance Code of Practice. SIRA should report annually on private insurers and providers' performance against those principles as part of its current annual reporting.

The current insurance guidelines for eligibility, premiums and claims handling impose a degree of regulation on price setting and market practices that is more relevant to regulating a monopoly entity with substantial market power. In the short-to-medium term, icare is likely to remain the default provider for a majority of the market. This is largely because the market is small, and the product is low value and has a long payoff period. As such, the insurance guidelines should continue to apply to icare (as well as additional draft recommendations we have made to improve transparency and customer service). However, new entrants should have greater flexibility to determine what HBC liabilities they underwrite and how they price their risk.

Lastly, a new entrant cannot offer a separate construction period or warranty period product, because icare (the only insurer in the market) does not offer these products separately. Our draft recommendation is that icare be required to make separate cost-reflective construction period and warranty period products available so that a new entrant could specialise in one product only.

We consider that these changes would decrease the costs of entry into the NSW HBC market, making it more commercially viable for new entrants to provide product choice for builders and homeowners.

IPART draft findings

- 6 That the HBC licensing framework unnecessarily duplicates APRA's role in the prudential supervision of insurers, increasing costs of entry to the scheme for insurers.
- 7 That the regulatory framework deters entry by unnecessarily restricting how private insurers and providers compete in the market.
- 8 HBC is a 'long-tailed product', which means providers must hold capital to cover liabilities for up to 10 years, discouraging providers from entering the market.

Draft recommendations

- 9 That SIRA simplifies its licence application process for insurers to recognise that APRA's prudential standards apply, removing the need for a duplicate assessment. This could reduce licence fees payable by insurers.
- 10 That the NSW Government:
 - limits the application of sections 103BD to 103BG of the *Home Building Act 1989* that regulate premium pricing to the default market incumbent, icare
 - removes the requirement for SIRA to approve private insurers and providers' eligibility and claims models, in favour of a market monitoring arrangement where SIRA reports on market participants' performance against high-level principles.

This should be reviewed in five years or earlier if the market composition has changed considerably.

- 11 That the NSW Government requires icare to make available separate cost-reflective construction period and warranty period products so that a new entrant could provide construction period cover only.

Box 6.1 Other jurisdictions do not require home building warranty insurers to be licensed

NSW is the only state that requires insurers to hold an additional state-based licence to offer HBC products.

In Victoria, the domestic building insurance market is open to private insurers. They do not have to apply for a specific licence to offer insurance (other than a licence to conduct insurance business as required by APRA).

In the ACT, the market for residential building insurance is open to insurers and fidelity funds. Under the ACT *Building Act 2004*, an authorised insurer means a body corporate authorised to carry on insurance business under the *Insurance Act 1973*.^a However, the Planning and Land Authority must approve a fidelity fund scheme. The Act sets out criteria for approving such schemes.^b

In South Australia, building contractors must take out an insurance policy that complies with the requirements of the *Building Work Contractors Act 1995*. QBE is the sole distributor operating in SA.^c It is not required to take out a specific licence to provide this product.

In WA, the Minister must approve an insurer or fund to provide building indemnity insurance.^d Similarly, in the NT, the Minister must approve an insurer or fidelity fund provider, based on criteria set out in the *Building Act 1993* and associated regulations.^e

a ACT Government, *Building Act 2004*, Dictionary.

b ACT Government, *Building Act 2004*, s99.

c HIA insurance, [Changes to SA Building indemnity insurance premium](#), accessed 2 September 2020.

d WA Government, [Home indemnity insurance](#), accessed 2 September 2020.

e NT Building Act 1993, s54CA and Division 4.

6.2 Should businesses require a licence to offer HBC products?

Under section 105A of the HB Act, it is an offence for a business to provide HBC insurance or enter into a contract or arrangement to provide AIP cover unless it is a licensed insurer or AIP provider. A prospective insurer or AIP provider must apply to SIRA for such a licence.

A licence is a common instrument used by governments to regulate commercial activity. It authorises a business to carry out its functions in a specified market, and allows the regulator to set conditions and limitations, without the need to amend legislative instruments.

An effective licensing framework should be:

- ▼ The most reasonable option to address ongoing regulatory needs when compared with other options
- ▼ Appropriately designed to provide the minimum necessary coverage, reporting requirements, conduct rules and mandatory attributes
- ▼ Administered effectively and efficiently.

Licences can increase barriers to entry if:

- ▼ The licence application process is unnecessarily costly or restrictive
- ▼ The licence conditions impose an unnecessary regulatory or administrative burden on licensees.

6.2.1 What stakeholders said in response to our Issues Paper

In our Issues Paper, we asked whether stakeholders considered that the requirements of the HB Act duplicated those of the *Insurance Act 1973* (Insurance Act). HIA stated that ‘there should not be a need for SIRA to regulate this product. APRA has the overriding task of regulating the insurance industry and to then have a state body is simply a double up.’⁸⁷

SIRA did not consider that its licence framework was duplicative of APRA’s, and considered that they served different purposes. It stated that the dual-licensing requirements are also a feature of both of the other insurance schemes that SIRA regulates, being: Compulsory Third Party (CTP) and workers compensation insurance.⁸⁸

The Risk Specialist Group stated that it did not consider that there was direct duplication of requirements between the HB Act and the Insurance Act.⁸⁹ It stated that the Insurance Act sets out the requirements and obligations of an insurer including its compliance requirements with licensing, APRA prudential standards and monitoring and the roles of appointed actuaries and auditors. The HB Act prescribes the type of contracts that require insurance and the period and limits of liability. However, the costs of compliance for private insurers were already extensive.⁹⁰

6.2.2 The licence framework for insurers duplicates APRA’s prudential requirements

Section 105C of the HB Act states that an application for a licence to be a licensed insurer under the HBC scheme may be made by any corporation that carries on insurance business within the meaning of the Insurance Act. Part 6C, Section 105F of the HB Act lists matters to which SIRA may have regard in approving a licence application, including any applicable insurance guidelines.

SIRA publishes guidelines on the prudential standards that it assesses licence applicants against. The guidelines aim to ensure licence holders maintain long-term financial viability, prudent claims reserving policies and sufficient financial resources at all times to meet their liabilities under the Act. SIRA ensures this by assessing an applicant’s capacity, capability and processes against the standards (see Box 6.2). SIRA bases its prudential standards on APRA’s General Insurance Prudential Standards (GPS).

⁸⁷ HIA, Submission to IPART Issues Paper, May 2020, p 15.

⁸⁸ Discussions with IPART, June 2020.

⁸⁹ Risk Specialist Group, Submission to IPART Issues Paper, May 2020, p 8.

⁹⁰ Ibid.

Box 6.2 SIRA's licensing process for insurers

SIRA assesses insurers against a number of criteria, including:

1. The suitability of the applicant
2. The paid-up share capital and reserves of the applicant
3. The constitution of the applicant (if any)
4. The re-insurance arrangements of the applicant
5. The efficiency of the insurance scheme generally
6. Any applicable Insurance Guidelines
7. Any other matters that SIRA thinks fit.

Applicants must provide a number of documents to demonstrate how they meet these criteria including:

- ▼ A business case that establishes its capability to apply for a licence to provide HBC and demonstrates reasonable plausibility and viability of its proposal
- ▼ A three-year business plan and risk management and control framework
- ▼ An eligibility model
- ▼ A claims management model
- ▼ Premium filings to be submitted for the nominated product categories
- ▼ Complaint handling and review processes.

To assess an applicant's prudential capacity, SIRA requires an insurer applicant to provide:

- ▼ Evidence of APRA's authority or, if in the process of applying for an authority to carry on an insurance business, advice on the status of an applicant's negotiations with APRA and copies of any correspondence to/from APRA regarding the application
- ▼ Details of any other general insurance authorities held by related companies, if applicable
- ▼ Copies of the last two calculated minimum capital requirement multiples, as required and defined by APRA
- ▼ Copies of the last three audited annual returns lodged with APRA, together with auditor's certificates
- ▼ Copies of the latest returns lodged with APRA, if these are for a period after the latest annual return lodged under the requirement above
- ▼ Evidence of meeting SIRA's HBC Prudential Guidelines standards and requirements.

In addition to providing the documents outlined, applicants must also provide a letter authorising APRA and ASIC to release information pertaining to the applicant to SIRA.

Source: SIRA, [Licensee application guidelines – Home building compensation regulation](#), January 2018. accessed 16 September 2020.

APRA's prudential regulation of insurers would meet the requirements of the HB Act

APRA's prudential framework for general insurers covers capital requirements, financial position, governance, risk management and any other relevant requirements.

Following the collapse of HIH in 2001, the HIH Royal Commission recommended a number of reforms to improve the prudential, legal and regulatory regime governing the general insurance industry in Australia.⁹¹ These included increasing the minimum entry-level capital requirements for general insurers and enabling APRA to make prudential standards for general insurance. APRA also strengthened its supervisory approach and practices.⁹² This included introducing new prudential standards to address under-reserving by insurers, enhanced disclosure by actuaries as to methods used for calculating outstanding claims and improving the 'fit and proper' test for company directors.⁹³

APRA takes at least 12 months to assess an application to become a general insurer. APRA requires licensed insurers to submit quarterly returns and audited returns annually to monitor compliance. Insurers must also submit individual claim and policy information.

Given that the insurer applicant must provide a letter of authorisation for SIRA to obtain any required evidence of an insurer's prudential status with APRA or ASIC, we consider that it is unnecessary duplication for applicants to provide the same information directly to SIRA.

However, SIRA should maintain its prudential regulation of non-insurer providers, because they are not licensed by APRA.

Duplication of APRA's prudential regulation increases the costs of entry for insurers

SIRA charges insurers a fee of \$50,000 (ex-GST) to grant a licence.⁹⁴ SIRA advised us that the licence fee covers the administrative and legal costs of assessing an applicant's eligibility.

Removing the requirement for SIRA to assess insurer applicants against the same standards as APRA does to obtain a licence to carry on an insurance business, would reduce SIRA's assessment costs, without reducing homeowner protection. This should mean that SIRA could lower its licence application fee, and administration costs to insurers would also fall.

6.3 Does the regulatory framework discourage entry through unnecessary prescription?

In undertaking their HBC business, licensed insurers and AIP providers must comply with the requirements of the HB Act, Regulation and relevant insurance guidelines published by SIRA.

Division 4 of the HB Act requires SIRA to issue insurance guidelines on:

⁹¹ Department of the Parliamentary Library, [Report of the Royal Commission into HIH Insurance](#), May 2003, accessed 8 September 2020.

⁹² Australian Government, Treasury, [Aftermath of the HIH collapse](#), Economic Roundup, 1, 2015, accessed 8 September 2020.

⁹³ Ibid.

⁹⁴ See [SIRA, How to apply for a licence, Home building compensation insurance](#), accessed 16 September 2020.

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- ▼ The requirements for approval of an insurance product or AIP
 - ▼ The determination of premiums or contributions
 - ▼ Market practices and claims handling procedures
 - ▼ Prudential standards and their application to insurers and providers
 - ▼ Eligibility requirements for obtaining cover and underwriting of products and compliance with eligibility requirements.

Insurers and providers must submit premiums (or contributions), eligibility models and claims models that comply with the guidelines to SIRA for approval each year. SIRA assesses compliance of these against the principles and requirements in its guidelines, the HB Act and HB Regulation before deciding whether to approve them.

6.3.1 What stakeholders said in response to our Issues Paper

In our Issues Paper, we asked stakeholders:

- ▼ What changes to the scheme would encourage the supply of new, innovative products (both insurance and non-insurance)
- ▼ Whether providers should be allowed to mitigate risk by limiting their insurance offering to selected low-risk builders only, or other methods?

Stakeholders raised concerns that prescribing eligibility in a heavy-handed way would deter new entrants and product innovation. Stakeholders had mixed views about whether providers should be able to insure only selected low-risk builders.

Some stakeholders argued that insurers and providers should be allowed to refuse HBC cover to certain high-risk contractors because:

- ▼ It is the only way for a private insurer or provider to operate profitably in a market with significant losses and a Government incumbent.⁹⁵
- ▼ It is a standard feature in many insurance markets where insurers are able to choose to whom they will provide insurance (and hence bear the responsibility of their decision).⁹⁶

However, others stated that:

- ▼ Having insurers 'pick and choose' the organisations they insure in prior scheme iterations contributed to significant difficulty in obtaining cover and increased the cost of cover to consumers.⁹⁷
- ▼ This will polarize the market and carry the risk that the State will have to carry the balance of that market. The market should retain the ability to spread the risk to enable a more even distribution of premium amounts that might otherwise be too spread out and overly penalize new builders.⁹⁸

⁹⁵ NIBA, Submission to Issues Paper, May 2020, p 6.

⁹⁶ Ibid.

⁹⁷ Risk Specialist Group, Submission to Issues Paper, May 2020, p 8.

⁹⁸ Master Builders Association of NSW, Submission to Issues Paper, May 2020, p 1.

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- ▼ Where insurers compete for the more desirable business of less risky builders, a price ‘race to the bottom’ could be created. Continued competition that drives down the price in the market eventually makes it unsustainable in which to operate, due to the mismatched timeframes of liability recognition, revenue recognition and market volatility. This creates a potential risk of significant pricing volatility as risk is repriced.⁹⁹

6.3.2 The eligibility guidelines discourage entry

SIRA’s eligibility guidelines set minimum standards that insurers and AIP providers must incorporate into their eligibility assessments. Licensed insurers and AIP providers must submit an eligibility model to SIRA that shows how they will go about assessing contractor eligibility to do residential building work under the HBC scheme. The eligibility model must set out the assessment criteria, application procedures, service standards, forms, available website information and complaints and dispute management processes that the licensee will use when assessing builder eligibility for their HBC product.

In 2017, SIRA sought stakeholder feedback on its eligibility and premium standards (Box 6.3). Many stakeholders considered that insurers and providers should have the flexibility to set their own eligibility criteria and risk-based premiums. However, some were concerned that providers may compromise standards to attract greater market share, to the detriment of home owners.

One reason that SIRA may have received mixed stakeholder feedback is that the current guidelines apply equally to icare, as well as any new entrant. Because of its ongoing dominant market position, icare requires a more prescriptive regulatory approach to ensure competitive outcomes for contractors and homeowners. However, any new private insurers and providers would have commercial incentives to manage risk and price products to gain market share. Applying the same regulation to a private insurer or provider with a small market share imposes unnecessary regulatory costs.

⁹⁹ icare, Submission to Issues Paper, May 2020, p 15.

We have examined some of the key problems below.

Box 6.3 SIRA's eligibility and premium standards review – stakeholder feedback

In 2017, SIRA consulted on key features of the HBC scheme, including eligibility and premium standards. Most stakeholders supported SIRA setting minimum standards, but had mixed views about whether the application of these should be more prescriptive, or whether providers should have more flexibility to determine builder eligibility according to their own risk management principles.

- ▼ The Small Business Commissioner stated that: providers should have flexibility to set their own standards as long as they meet certain principles. The pricing of 'high risk' contractors paying a loading of up to 30% on top of the premium would allow contractors additional scope [to provide services under the scheme], whilst ensuring a higher balance of funds to cover the excess risk.
- ▼ HIA stated that in order to be attractive to the private market HBC providers should be given the flexibility to set their own eligibility criteria. Those set by SIRA must be limited to a minimum set of requirements and set a flexible approach. HBC providers can and should manage their own risk criteria, to encourage a competitive market. The process for determining builder eligibility and appropriate risk-based premiums is time consuming and detailed, compared to what is required for other insurance products. Further, the premium principles should be used as a guide and not applied in a way that is unduly prescriptive or inflexible.
- ▼ SecureBuild considered that SIRA's eligibility and premium guidelines should not be overly prescriptive because:
 - It forces HBC providers to offer homogenous products, restricting innovation
 - It could act as a barrier to entry for new entrants
 - Insurers and AIP providers are in a better position to determine how to manage risks
 - It opens SIRA up to criticism or litigation if eligibility leads to poor outcomes.
- ▼ Building Partners stated that HBC providers should retain flexibility to set their own standards but SIRA should prescribe the principles and standards expected
- ▼ SPASA supported HBC providers being given flexibility to set their own standards within certain prescribed limits to issue an eligibility profile, if they can demonstrate they can meet certain stipulated and transparent principles.
- ▼ The Law Society stated that the minimum standard of eligibility should be uniform. The cost of insurance coverage is passed on from the builder/contractor to the homeowner. It is important for consumers to have the same protection that would flow from uniform eligibility criteria.
- ▼ Western Sydney Community Legal Centre considered that HBC providers may compromise standards with a view to attracting more insurance. It considered that first resort-type products, as well as other new and innovative products, should not require an eligibility profile and should be given flexibility to set their own standards as long as they meet certain principles.

Source: See [SIRA HBC eligibility and premium guidelines consultation submissions](#), accessed 16 September 2020.

The eligibility guidelines do not allow an insurer or provider to insure low-risk builders

An insurer or provider cannot adopt an eligibility model that provides cover to a small pool of what it judges to be the lowest risk builders only. For example, a provider cannot have an eligibility model that denies HBC cover to all new builders on the basis that they have no prior building experience.

Principle 6 of the eligibility guidelines states:

SIRA will consider the combined effect of the eligibility models for all licence holders on the building industry. It is important that the eligibility models (when viewed together) offer access to cover on terms that can be met by a sufficient range of contractors to supply a competitive, sustainable and viable market for residential building and trade services. The eligibility criteria must not unduly limit eligibility to the degree that only a small segment of contractors would be able to access building cover contracts. Eligibility models must provide reasonable access for new contractors entering the market. Examples of unacceptable criteria include limiting eligibility only to contractors that have previously entered into building cover contracts, or requiring contractors to have long continuous trading histories.¹⁰⁰

The intent of this principle is to ensure that overall 'eligibility supports a strong and viable residential building industry'. SIRA considers that allowing providers and insurers to target what they judge to be a small group of low-risk contractors only would result in the incumbent retaining a greater proportion of high-risk contractors, potentially putting more pressure on its premiums.

Instead, the regulatory framework allows providers to price and mitigate their risks by:

- ▼ Requiring builders with low working capital to inject capital into their business so that they are able to withstand greater shocks to their business
- ▼ Providing builders with a lower job limit to mitigate their exposure if the builder were to go insolvent
- ▼ Charging a higher premium (up to 50% more than their base premium)
- ▼ Requiring new builders to enter into a mentoring program to assist the builder in managing its building contracts (ie, ensuring that the contract is priced correctly with sufficient margins and managing cashflow from projects etc).

In addition, providers may refuse to grant eligibility under certain circumstances, in accordance with their eligibility models. For example, if business financial measures indicate a high probability that a builder is trading whilst insolvent or there are current winding-up petitions by creditors. They may also engage in risk mitigation practices outside of the scheme, for example, conducting their own site inspections and stopping progress payments if work is not to standard.

¹⁰⁰ SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, Principle 6.

SIRA allows providers to offer HBC cover to specific types of contractors only (eg, swimming-pool builders or builders of single-dwelling residences) via a licence condition imposed on a new insurer/provider. Such a condition can be imposed under Section 105I(d) of the HB Act:

(d) specifying the persons, or classes of persons, to whom the licence holder may provide insurance or cover by means of alternative indemnity products,”

However, the insurer/provider would need to make HBC available to all contractors that have eligibility under that category, subject to its risk-mitigation options above.

Allowing new entrants to restrict eligibility would not substantially affect market sustainability

icare has stated that if private providers were allowed to determine their own eligibility standards it could lead to unsustainable business practices. That is, they could allow higher job limits (or lower premiums) than a builder's level of risk would determine. This may lead to higher claim payouts in future and losses that cause providers to leave the market, leaving the Government to bear all the market risk.

Market sustainability problems can arise in a workably competitive market, where private providers hold considerable market share. For example, in 2001, when HIIH collapsed, it had 30 to 40% share of the HBC market. With HIIH no longer in the market, higher risk builders suddenly faced significant price increases or were unable to purchase insurance.

There are various reasons why icare is likely to remain the default incumbent insurer in the medium-term. The market is small with long payoff periods, average claims are relatively high, and premiums below breakeven levels for some construction types. The experience in Victoria, where the home warranty market has remained open to competition for the last decade, is that there are a small number of private insurers targeting low-risk and niche construction segments, such as pool builders (see Box 6.4). These private providers account for less than 20% of the market.

As such, it is unlikely that allowing new entrants greater flexibility to determine eligibility and select which contractors they offer HBC cover would have a substantial impact on the sustainability of the overall market. While icare's remains the incumbent, it would not affect a contractor's ability to obtain insurance. It would also not affect other contractors' premiums, because they are priced largely on the individual contractor's perceived risk.

In addition, competition in the market for low-risk contractors would give icare's an incentive to compete for those contracts, improving the product offering for these builders.

Box 6.4 Other competitive home building insurance markets do not prescribe eligibility standards

In Victoria's domestic building insurance market, which has always been open to competition, there is no obligation for private providers to incorporate minimum eligibility principles or standards. Private providers are not precluded from choosing to insure builders that they deem are low-risk only.

One of the Victorian providers, AssetInsure, has stated previously that it is only targeting what it considers to be good, experienced builders and will not provide home warranty insurance to new builders.^a

The entry of these providers has not prevented VMIA, the government-operated market incumbent, from setting breakeven premiums, and operating on a viable basis. As shown in Chapter 4, for a market of a similar size and structure, premiums are around a third of the NSW rate. Private providers make up a small proportion of the market – too small to have an impact on overall sustainability.

^a [Assetinsure FAQs](#), accessed 16 September 2020.

6.3.3 Price regulation of private insurers and providers is unnecessary

Sections 103BD to 103BG of the HB Act regulate premium pricing for all licensed insurers. An insurer must file the premium or set of premiums that it proposes to charge to SIRA for approval each year.

SIRA publishes guidelines about premiums that specify the manner in which premiums are to be determined and the factors to be taken into account when determining premiums. They require the insurer to provide evidence of how it has calculated the premium, including setting out risk factors providers must address.

SIRA publishes similar guidelines for how providers must calculate contributions for approval by SIRA.

Governments commonly use price regulation to restrict abuse of monopoly power where:

- ▼ There is a single producer in the market, because monopolistic supply is entrenched, or goods can be supplied most cheaply by one producer
- ▼ The market exhibits certain characteristics that allow some participants to acquire and exploit a high level of influence over prices.

While these characteristics are relevant to icare as a monopoly or default incumbent provider, new entrants are unlikely to exhibit influence over prices. If they did, they would lose market share to icare or other providers. It is in their commercial interest to set premiums at a competitive level.

One relevant concern that stakeholders have raised is the ability of providers to set prices too low in an effort to win customers without duly considering the appropriate return on risk. While some insurers may offer cheaper premiums to win market share initially, this pricing behaviour would not be sustained in the longer-term under APRA's prudential framework for general insurers.

APRA determines how much capital an insurer must hold in reserve to pay claims, which informs the premium an insurer can charge. An insurer that consistently under-prices its premiums would risk losing its licence to carry on an insurance business, because it does not hold adequate capital reserves to meet its liabilities.

Similarly, SIRA's licensing framework for AIP providers ensures that providers have adequate capital reserves to meet their liabilities.

Our draft recommendation is that new entrants are exempt from the requirements of the HB Act that regulate pricing of premiums.

6.4 Are there barriers to insurers and providers offering 'split' products?

icare provides one HBC cover product that has a maximum claim amount of \$340,000 for both:

- ▼ Construction period cover, and associated defects during construction
- ▼ Warranty period cover, for the risks of defects after completion.

If a homeowner does not use the maximum amount of \$340,000 for a non-completion claim, then they are able to use the residual amount towards any defect claims.

Recent changes to the scheme allow providers to offer different products for each coverage period, but each must provide at least \$340,000 of cover. Providers can choose to offer one or both types of cover, but a builder must have coverage for both periods.

The changes to allow providers to offer the HBC coverage periods as separate products is important because many providers aren't interested in providing 'long-tail' products that can give rise to liabilities more than ten years after they are issued. Separating the product encourages new entry by allowing providers to enter the market and offer construction period cover only.¹⁰¹ icare's claims data shows that the majority of non-completion claims are finalised within 3 years after a certificate is purchased for a project (although some can take up to five years to resolve).¹⁰²

However, we consider there are still barriers to providers offering separate products in line with their preferred area of exposure. A new entrant cannot offer a separate construction period or warranty period product, because icare (the only other insurer in the market) does not provide the remaining cover as a separate product.

¹⁰¹ We note that in other countries such as New Zealand there are providers that offer a warranty period cover only, and so we recommend that icare should also be required to offer a construction period product as well as a warranty product. The review of the reasonableness of icare's price for these separate products should be undertaken by SIRA, as part of its current role in reviewing icare's premium filings.

¹⁰² We have received a submission from an individual that they are still dealing with their builder for non-completion for a build that commenced in 2015 and was expected to be completed within 8 months.

6.4.1 What stakeholders said in response to our Issues Paper

NIBA submitted that the current [icare] product should be replaced with separate insolvency and defect products, so that each risk can be underwritten and priced according to the nature of the cover provided.¹⁰³

The HIA stated:

While the Home Building Amendment (Compensation Reform) Act 2017 (the 2017 Act) provides for split product cover, the regulations require that each of these two separate products must be for a minimum insurance cover of \$340,000. This poses a significant barrier to entry. Private insurers interested in offering split products are to have capital reserves of \$680,000, compared to the combined product at \$340,000 offered by iCare.¹⁰⁴

The Risk Specialist Group stated:

A multi-product model would allow insurers to focus on their preferred area of exposure. However, it would be unlikely to provide better value than existing products and add further administrative burden and cost.¹⁰⁵

6.4.2 The additional costs of offering HBC products separately are unlikely to be significant

We agree that icare should be required to make separate cost-reflective construction period and warranty period products available. To ensure equivalent protection for homeowners who take out split coverage products, the NSW Government should retain the current coverage limits of \$340,000 for each product. However, to reduce administrative costs and for simplicity, we consider that icare should also be able to continue to offer the combined product with a combined coverage of \$340,000.

It may be more costly for providers to offer products separately compared to offering a combined product, but we do not consider any additional costs would be significant.

Overhead costs that need to be recovered from each policy might be slightly higher, compared with icare, which is able to spread its overheads over two products (both non-completion and defects). However, if the provider already provides home warranty insurance in another jurisdiction, it may be able to leverage its existing systems to minimise the overhead costs being recovered from HBC policies.

We do not consider that the \$340,000 minimum that applies to both products would drive significant additional costs to insurers, compared to a combined cap of \$340,000. This is because claims are rarely made for both periods of cover. Under a non-completion claim, any associated defects are also rectified. Therefore there is a low likelihood that a substantial defects claim is also required for previous works under the same HBC policy.¹⁰⁶

¹⁰³ NIBA, Submission to Issues Paper, May 2020, p 5.

¹⁰⁴ HIA, Submission to Issues Paper, June 2020, p 5.

¹⁰⁵ Risk Specialist Group, Submission to Issues Paper, May 2020, p 6.

¹⁰⁶ If new works to complete the project exceed \$20,000 then a new HBCF policy must be purchased for those works. Homeowners are then able to seek up to \$340,000 for either non-completion or subsequent defects claims for those new works.

icare's claims data shows that of the roughly 1,200 finalised claims since 2015 there have been about 10 claims for non-completion (mostly under \$200,000) that also had subsequent defects claims which ranged from \$20,000 to \$60,000.¹⁰⁷

We also considered whether there would be claimants that are unable to make further defects claims under icare's HBCF policy, but they would be able to make a claim if defects were later identified if they had two separate policies. Around 70 non-completion claims (with associated defects) reached the limit of \$340,000. In contrast, about 80% of non-completion claims were less than \$275,000 and about 70% were less than \$200,000. Claimants would not be prevented from making a further defect claim up to the combined \$340,000 cap in relation to the same work.

¹⁰⁷ However, we only have claims data for the 5 year period from 2015, and so further claims may be finalised and also arise in subsequent years.

7 Increasing SIRA's regulatory oversight of icare

Currently, icare is a monopoly provider of mandatory HBCF cover. Without other providers in the HBCF market, icare does not face competitive pressure to either improve its services and/or deliver its services efficiently – as it does not risk losing customers.

In Chapter 5 we address potential barriers to entry to facilitate new entrants into the market to compete with icare. However, in the short to medium term it is likely that icare will continue to be the only provider of HBCF cover in NSW.

This chapter discusses our draft recommendation that icare should be subject to independent price regulation. We are also recommending that SIRA increases its regulatory oversight of icare by reviewing and determining icare's builder eligibility model and claims handling process to reflect the outcomes that would reasonably be expected to prevail in a competitive market.

We do not consider that the same regulatory oversight by SIRA is required for new entrants. This is because they will face competitive pressure from icare to provide better services to attract builders to their product offering.

In response to stakeholders' specific concerns about icare's builder eligibility assessment we address issues raised and provide draft recommendations in Chapter 8.

7.1 icare's HBCF does not face competitive pressure to improve its services

In a competitive market, there would be pressure on providers to either improve services and/or deliver services efficiently:

- ▼ Builder eligibility – providers would be incentivised to only ask for information that is necessary (or critical) in determining a builder's eligibility, provide transparency to builders in how the information was used to determine their eligibility and resolve issues in a timely manner.
- ▼ Claims handling – providers would also be incentivised to assess and finalise claims in a timely manner, as homeowners would likely prefer builders that have HBCF cover with a provider that manages claims in a timely manner.
- ▼ Premiums – providers would charge premiums that reflect the reasonable cost of providing HBCF cover (ie, recover the reasonable expected cost of claims and the efficient costs of builder eligibility assessments, claims handling expenses, actuarial pricing and valuation services expenses, and overheads).

It would also be reasonable to expect providers to review their processes periodically and engage with their customers (builders and homeowners) to improve their services.

However, stakeholders have indicated that a variety of aspects of icare's services are not consistent with these outcomes. Without other providers in the HBCF market, icare does not face competitive pressures to improve its services as it does not risk losing customers.

A common theme has been builders finding icare's eligibility assessment too onerous and lacking in transparency, particularly how the information provided is actually used to determine an eligibility and any applicable conditions (such as injecting capital into their business).¹⁰⁸ Stakeholders also indicated that there can be considerable variability in the time taken to resolve eligibility issues.¹⁰⁹ We note that similar concerns were raised in previous consultation undertaken by SIRA in 2017 when establishing its current eligibility guideline (see below for further detail on the eligibility guideline).¹¹⁰ Specific issues raised by stakeholders concerning icare's eligibility assessment are discussed in more detail in Chapter 8.

Stakeholders also submitted that there is a lack of transparency over icare's premium changes:

- ▼ that it was difficult to reconcile icare's intention to reduce premiums for a range of building classes with its reported deficit of \$636 million for the 2018-19 financial year¹¹¹
- ▼ pricing is not consistent with risk eg, prior to August 2019 the insurance price of duplexes was three times the current price¹¹²
- ▼ pricing of dual occupancy granny flats is inconsistent, causing confusion to builders and consumers.¹¹³

7.2 icare's HBCF requires further regulatory oversight

In 2017, reforms were undertaken to open the home building compensation market to competition. SIRA consulted on guidelines for how providers should price premiums, assess builder eligibility and undertake claims handling.¹¹⁴

The current guidelines were established in 2018 and generally set out the principles that providers are to adopt, factors that may be considered or must be adopted, and the minimum standards that providers should have in place in offering services (see Box 7.1).

Providers are required to submit premium, eligibility model and claims handling filings to SIRA annually.¹¹⁵ SIRA decides whether it will reject them or not, based on whether they comply with the guidelines but does not publicly disclose its assessment of filings.¹¹⁶

¹⁰⁸ HIA submission to IPART Issues Paper June 2020, p 18; NIBA submission to IPART Issues Paper, June 2020, p 7; Landscape association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, p 3.

¹⁰⁹ Stakeholder meeting 17 June 2020; stakeholder meeting 30 July 2020.

¹¹⁰ SIRA, [Home building eligibility consultation summary](#)

¹¹¹ NIBA submission to IPART Issues Paper, June 2020, pp 3-4.

¹¹² Risk Specialist Group submission to IPART Issues Paper, May 2020, p 1.

¹¹³ Risk Specialist Group submission to IPART Issues Paper, May 2020, p 1.

¹¹⁴ SIRA also consulted on guidelines for how providers are to adopt good business practices and have the capacity to offer suitable products and services. SIRA, [Draft home building compensation business plan guidelines](#)

¹¹⁵ Unless SIRA authorises an extension of the current filing period. SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, p 10; SIRA, *Home building compensation (premium) insurance guidelines*, January 2018, p 11.

¹¹⁶ Eg, SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, pp 10-11.

Box 7.1 SIRA's premium, eligibility and claims handling guidelines

SIRA's premium, eligibility and claims handling guidelines generally contain the following items:

Principles that providers must adhere to

- ▼ For premiums, they are to be fair and reflective of risk, not excessive or inadequate, not unreasonably volatile etc.
- ▼ For eligibility assessments, the criteria adopted in assessments are to be fair and reflective of risk, transparent, assessed reasonably, provides stability and is not unreasonably volatile etc.
- ▼ For claims handling, claims are to be processed efficiently in a timely manner; information provided to be claimants should be clear, accurate and expressed in plain language; claims and complaints procedures should be made available in an accessible format; and consistent service standards should be provided along with consistent decision making that is supported by evidence.

Factors that providers may consider or must adopt at a minimum

- ▼ For premiums, providers may consider the contract value, construction type, location of premises and contractor risk factors approved by SIRA.
- ▼ For eligibility assessments, providers must consider at a minimum net tangible assets of the builder, their net profit position, annual turnover, industry specific indicators, management structure, qualifications, business capacity, arrangements to support supervision of building work and quality assurance, trading history, existing exposure and existing eligibility (and conditions) imposed by other licence holders.

Minimum service standard levels

- ▼ For premiums, providers must have a process in place where a builder may appeal aspects of their premium determination. This must include at a minimum contact details for appeals and reviews within the provider, and timeframes for lodging and resolving disputes.
- ▼ For builder eligibility, eligibility reviews must be done within 30 business days. If the provider deems it necessary to revise/restrict or cancel an eligibility then at least 30 business days' notice must be provided (10 business days for suspensions), and there must be a process in place where builders may appeal aspects of their eligibility determination, similar to disputes relating to premium determinations.
- ▼ For claims handling, the provider must decide within 30 business days whether the claim will be accepted (or whether further information is required). Within 10 business days of accepting a claim, the provider must engage a service provider to inspect the property. The service provider must also have processes in place where a claimant may seek an internal review of the provider's claim decision.

Source: SIRA, *Home building compensation (premium) insurance guidelines*, January 2018; SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018; SIRA, *Home building compensation (claims handling) insurance guidelines*, January 2018;

SIRA's guidelines generally contain criteria that are broad to allow flexibility for providers to adopt different approaches. As such, they do not apply competitive pressure on providers to either improve their services and/or deliver services efficiently.

Given that icare is a monopoly provider of mandatory HBCF cover and faces no competition and does not risk losing customers, our draft recommendation is that icare should be subject to independent price regulation. SIRA currently has a role to review premiums so this could be expanded to require it to determine premiums that are sufficient and not excessive, and reflect the efficient cost of expected claims and expenses. SIRA would also undertake a public consultation process.

Alternatively, for assessing icare's HBCF premiums, given IPART's capability and current role in determining maximum prices for various monopoly providers, we could be requested to determine icare's maximum HBCF premiums.

In addition, we are also recommending that SIRA should increase its regulatory oversight of icare. SIRA should undertake a review to determine icare's builder eligibility model, and claims handling process to reflect the outcomes that would reasonably be expected to prevail in a competitive market.

icare should be required to propose premiums, builder eligibility assessment model and claims handling process.

In its determinations, SIRA should assess:

- ▼ icare's proposed builder eligibility model – whether icare's builder eligibility model is reasonably what a commercial provider would adopt in a competitive market eg,
 - that it can be substantiated by examining the financial position of previous builder insolvencies under the HBCF (and that icare only seeks information from builders that impact the eligibility outcome),
 - explains how builders' information has been used to determine their eligibility and individual builder loadings/discounts for use in setting risk-adjusted premiums,
 - explains how the information provided has led to any conditions such as injecting financial capital in their business, and
 - resolves eligibility disputes in a timely manner.
- ▼ icare's proposed claims handling process – whether icare's processes for establishing the actual claim payments is efficient, and manages and finalises claims in a timely manner.

We also recommend that SIRA establishes appropriate Key Performance Indicators (KPIs) against which it can measure icare's performance in resolving eligibility issues and finalising claims in a timely manner¹¹⁷

¹¹⁷ ESC, *Domestic Building Insurance Premium Validation Review*, April 2019, p iv.

Draft recommendation

- 12 An independent regulator determines icare's premiums for the HBCF to ensure they reflect efficient costs. SIRA's role, as the scheme regulator, could be expanded to provide it with determination powers. Alternatively, IPART, as the NSW pricing regulator, could be given the on-going role of determining icare's HBCF premiums.
- 13 SIRA increases its regulatory oversight of icare by reviewing and determining icare's builder eligibility model and claims handling processes.
- 14 SIRA establishes appropriate KPIs against which it can measure and publicly report on icare's performance in resolving eligibility issues and finalising claims in a timely manner.

8 Builder eligibility assessments

Insolvency risks are primarily managed through the builder eligibility process. Builders are required to obtain eligibility from their provider before purchasing HBCF cover from them. The eligibility process allows the provider to manage its risks by:

- ▼ limiting the value and number of individual projects that the builder can have under construction at any time (also referred to as the 'open job limit')
- ▼ limiting the maximum contract value for any individual project, and
- ▼ imposing conditions, such as injecting additional capital into their business.

Providers of HBC cover are not required to provide eligibility to all builders and may refuse eligibility if the builder is deemed to be too high risk (eg, was involved in prior insolvencies in the past five years due to financial mismanagement).

This chapter outlines this eligibility process in detail, and considers whether more information is required to further mitigate builders' insolvency risk, for example, information collection in relation to builder progress payments, critical stage inspections, and issuance of compliance certificates or other measures. It also considers whether the scheme's incentives for building industry participants to undertake good risk management and encourage good business practices.

8.1 icare's approach to assessing eligibility is risk based

icare's approach to assessing builder eligibility involves assessing a builder's financial (for example, adjusted net assets, gross margins and working capital) and non-financial information (including a builder's previous experience, work history and whether there is any adverse information such as claims notifications) (see Box 8.1 below for further information). Its approach is mainly aimed at investigating the factors that are likely to lead to builder insolvency, which accounts for over 90% of HBCF claims.¹¹⁸

About 19,200 builders currently have eligibility with icare and about 2,000 of these builders (or 10%)¹¹⁹ who have relatively higher open job limits¹²⁰ or undertake projects deemed to be higher risk (such as the construction of multi-dwellings less than 4 storeys), have their eligibility reviewed at least once each year. The remaining builders are reviewed on a risk-basis only, for example, if any adverse information is received about the builder through mercantile alerts such as non-payment of subcontractors or suppliers.¹²¹

¹¹⁸ icare submission to IPART Issues Paper, May 2020, Figure A1.2 Last resort, p 35.

¹¹⁹ icare, *Response to IPART section 22 data request*, June 2020; icare, Submission to Issues Paper, May 2020, p 9.

¹²⁰ Generally builders that have an open job limit greater than \$3 million. icare, *HBCF Eligibility Manual*, March 2020, pp 19-20.

¹²¹ icare submission to IPART Issues Paper, May 2020, p 9; icare, *HBCF Eligibility Manual*, March 2020, pp 29, 52.

We considered whether icare should collect more information to further mitigate insolvency risk. Some further risk factors associated with insolvency include:

- ▼ Delays in a builder receiving progress payments could result in cash flow problems for their business
- ▼ Issues arising from projects identified through critical stage inspections or delays in receiving compliance certificates, could signify that a builder has liabilities relating to those projects. This could affect the builder's financial position and increase their risk of insolvency.

In response to our Issues Paper there were mixed views about the effectiveness of these measures. Some considered information on these measures could be helpful.¹²² Whilst others questioned whether enhanced information collection would materially reduce insolvency risk. Stakeholders also cautioned against the imposition of onsite inspections to assess a builder's capability as it could add to costs and introduce significant complexity as to what is adequate or appropriate supervision to ensure that building work complies with plans and specifications and is of an appropriate standard. Submissions also noted that measures to improve residential building quality and compliance are currently in the process of being implemented in NSW.¹²³ Stakeholders also submitted that the current requirements were already onerous.¹²⁴

icare's approach to assessing builder eligibility is risk-based:

- ▼ where regular reviews are focussed on builders that pose greater risk to the HBCF (generally builders that do more than \$3 million of residential building work at any time or undertake work deemed to be higher risk¹²⁵), and
- ▼ information sought is generally informed by HBCF claims experience.

We consider that improvements could be made by icare providing greater transparency in its assessments and how it has determined eligibility outcomes, including individual builder loading/discounts used in risk-adjusted premiums. Also, icare should review its dispute resolution processes to resolve eligibility issues in a more streamlined and timely manner.

We also consider that icare (and any other potential providers in future) should be responsible for managing its own risks and not have measures prescribed. Hence, icare should be permitted to examine and decide whether enhanced information collection in relation to builder progress payments, critical stage inspections and issuance of compliance certificates are effective in mitigating insolvency risk. Any measures icare adopts should be substantiated (eg, evidenced by analysis of HBCF claims history).

¹²² HIA submission to IPART Issues Paper, June 2020, p 17.

¹²³ MBA NSW submission to IPART Issues Paper, June 2020, p 2; HIA submission to IPART Issues Paper, June 2020, p 17. Law society submission to IPART Issues Paper, June 2020, p 4.

¹²⁴ HIA submission to IPART Issues Paper, June 2020, p 18. NIBA submission to IPART Issues Paper, June 2020, p 7; Landscape Association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, pp 3-8.

¹²⁵ Eg, construction of multi-units less than 3 storeys or renovation/alterations work on multi-units.

Box 8.1 icare's eligibility assessment

icare's eligibility assessment determines a builder's eligibility profile which identifies:

- ▼ Open job limit – total value and number of jobs permitted at any time
- ▼ Construction profile – the maximum contract amount for any job
- ▼ Eligibility conditions – if applicable, such as contributing more capital to the business or new builders entering into a review/mentoring program such as the Building Contract Review Program.

A builder nominates their open job limit and icare requires the following information to assess/review a builder's eligibility:

Financial information

- ▼ Adjusted net tangible assets (ANTA) – The amount of cash or assets that can readily be turned into cash, that a business has to withstand normal business disruptions or shocks. A minimum threshold of at least 3% of a builder's annual turnover is required.
- ▼ Gearing – Targets no more than 70%. If higher, can suggest that a builder may have difficulty in accessing additional working capital through external funding if need be.
- ▼ Gross margins – Inadequate gross margins has been identified as the primary cause of cashflow deficiency. Demonstrated weakness due to under-pricing may require the builder to enter into a Building Contract Review Program as a condition of eligibility.
- ▼ Expense days coverage – icare considers the benchmark to be at least 30 days (ability of a business to sustain normal overheads from retained equity).
- ▼ Current working capital – icare examines emerging trends to ascertain the builder's liquidity, ongoing viability and ability to undertake and complete projects.

Non-financial information

- ▼ Any adverse previous business history – Previously insolvencies within the past 5 years is considered and can be grounds to deny a builder eligibility, unless the builder can provide evidence that the causes of insolvency were not due to mismanagement. In such cases, builders are required to have ANTA of at least 10% in their business.
- ▼ Current claims notification/NCAT/court order – The number of notifications, and matters being referred to the Tribunal may be an indication that the builder is in difficulty. If non-complied NCAT/court orders arise then it may be grounds to suspend the builder's eligibility.

In order for icare to determine the above information, builders are typically required to provide a project pipeline forecast for the next 12 months, details of any franchise arrangements, current statement of personal assets and liabilities, details of any claims/NCAT/court actions above \$50,000, tax returns, aged debtors/creditors listing, work in progress summaries, ATO integrated client account statements and details on any external funding facilities. Larger builders (open job limits greater than \$3 million) may also be required to submit business operational plans, work in progress valuation statements and detailed breakdown of related party loan balances and transactions.

Under icare's eligibility manual, builders are to be notified of a review at least 40 business days prior to the review date, and if all the information has been received then the eligibility assessment/review with any conditions is required to be completed within 10 business days. The eligibility assessment is then required to be finalised within 40 business days. Builders are also able to view their eligibility profiles online to see their next eligibility review date.

Source: icare, *HBCF eligibility manual*, March 2020

8.2 icare should provide greater transparency in its eligibility assessments

Stakeholders submitted that a substantial amount of financial information is required and it is unclear how the information is used to determine a builder's eligibility profile and why capital is required to be injected into their business.¹²⁶ A common theme was that icare has a one size fits all approach to assessing eligibility, and does not take into account the individual circumstances of a builder's business.¹²⁷ Stakeholders also said that icare's restrictions on a builder's open job limit impedes growth opportunities for a business.¹²⁸

icare's approach to assessing eligibility is outlined in its HBCF eligibility manual. However, the manual does not explain how each of the information requested is actually used to determine a builder's eligibility. Although, it does explain that it uses a Builder Eligibility Assessment Tool (BEAT) that incorporates all the information provided by builders to generate an analysis of a builder's financials (including calculation of accounting ratios such as net tangible assets) and outputs risk warnings for consideration by the Eligibility Risk Manager¹²⁹ when deciding on a builder's eligibility.¹³⁰ icare states that only in exceptional circumstances should the automatic result provided by the BEAT be over-ridden by the Eligibility Risk Manager (eg, if additional information is provided by the builder in support of their financial position).¹³¹

We found that without knowing how the information provided by builders is used in the BEAT, it is difficult to understand how a builder's eligibility assessment has been determined, including the builder's individual loading/discount and why certain conditions have been imposed. We note that icare does not submit its BEAT to SIRA as part of its eligibility model filing.

Our draft recommendation is that icare should provide more information about its eligibility assessment. This is because in a competitive market, it would be reasonable to expect that if builders find that a provider has an assessment process where it is not explaining its eligibility decisions sufficiently and/or is perceived to be seeking information unnecessarily, then it is likely that builders would switch to an alternate provider, given the significant impact that eligibility can have on their business. This would be supported by our draft recommendation in Chapter 7, that SIRA review and determine icare's builder eligibility assessment to reflect what would be reasonably expected from a commercial provider operating in a competitive HBCF market.

Greater transparency would give builders stronger incentives to undertake good risk management and encourage good business practices as it would assist builders in better managing their business and reducing their own risk of insolvency. It would also assist those builders seeking to increase their open job limits or wanting to reduce the need to have more frequent reviews of their eligibility.

¹²⁶ HIA submission to IPART Issues Paper, June 2020, p 18; NIBA submission to IPART Issues Paper, June 2020, p 7; The Landscape Association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, p 3.

¹²⁷ SPASA submission to IPART Issues Paper, June 2020, p 4.

¹²⁸ Landscape Association submission to IPART Issues Paper, June 2020, p 1.

¹²⁹ icare outsources its builder eligibility assessments to [CorporateScorecard](#) (accessed 10 September 2020).

¹³⁰ icare, *HBCF Eligibility Manual*, March 2020, p 12.

¹³¹ icare, *HBCF Eligibility Manual*, March 2020, p 49.

8.2.1 Individual builder loading/discount used in risk-adjusted premiums

icare also uses the information provided in eligibility assessments in calculating risk-adjusted premiums for individual builders. When builders purchase a certificate of insurance for a particular project, icare applies its decision on the builder's individual loading/discount (of up to +/-30%) on to the base premium applicable to the project (see Box 8.2 below for further details).¹³²

In its submission, icare explained that the basis of the factors used in setting individual builder loadings/discounts and its current eligibility assessment process was from work undertaken by the then Department of Finance, Services and Innovation's Data Analytics Centre (DAC) in 2016. icare advised that the DAC reported that the model it developed had an 84% accuracy in predicting the likelihood of builder insolvency.¹³³

Over the course of the review, some stakeholders queried how their individual loading/discount had been determined. For example, we heard of an instance where the Eligibility Risk Manager informed them that they would be getting a discount, but then icare subsequently notified them that they would be receiving a loading instead (the stakeholder was still pursuing the reasons for the change).¹³⁴

We found that whilst icare's information on the factors used to determine an individual builder's loading/discount is clear in terms of the rationale for its inclusion (ie, based on HBCF claims experience) it is not clear how the factors are weighted to determine the actual percentage loading/discount (and which factors are more significant). It is also not clear how effective the other financial information (eg, gearing, expense days coverage and current working capital¹³⁵) sought in the eligibility assessment are in mitigating insolvency risk, if they are not used in calculating a builder's individual loading/discount for risk-adjusted premiums.

Our draft recommendation is that icare should provide greater transparency in how information provided is used to determine an individual builders' loading/discounts. Further, icare should periodically update the work undertaken by the DAC in 2016 to examine whether the current factors used to predict builder insolvency are still effective and remain relevant.

We do not consider there to be significant issues in disclosing to builders how the information provided has been used to determine an eligibility profile.

¹³² icare, *What risk factors impact on your HBCF premiums? – Fact Sheet*, June 2020, p 1. SIRA's premium guideline allows providers to apply an individual builder loading/discount of up to +/-50% (SIRA, Home building compensation (premium) insurance guidelines, January 2018, p 11).

¹³³ icare submission to IPART Issues Paper, May 2020, pp 8-9.

¹³⁴ Stakeholder meeting, 14 August 2020.

¹³⁵ icare, *HBCF Eligibility Manual*, March 2020, pp 34-39.

Draft recommendation

- 15 icare provides greater transparency in how it undertakes its eligibility assessments and how it determines individual builder loading/discounts used in risk-adjusted premiums
- 16 icare:
- Provides information in plain language in the Builder Eligibility/Change application form or the Builder Self Service Portal¹³⁶, why particular information is sought and how it would be used in determining a builder's eligibility.
 - Provides information in plain language on how the information provided by builders was used to determine their eligibility profile and their individual loading/discount, including any conditions of eligibility.
 - Makes clear any adjustments that have been made to take into account any industry specific circumstances eg, the adjustment for a pool builder in determining their eligibility to account for 'sleeper pools'.¹³⁷
 - Periodically updates the work undertaken by the Data Analytics Centre in 2016, to examine whether the factors previously identified and currently used, continue to be significant in predicting builder insolvency, and if there is scope to reduce the amount of information sought without necessarily increasing risk.

¹³⁶ The Builder Self Service Portal allows builders to input their financial information, purchase certificates of insurance, view their open job limits and view when their next eligibility review is scheduled.

¹³⁷ SPASA submitted that icare's eligibility assessment does not consider the unique circumstances of the pool building industry eg, 'sleeper pools' - where a pool project is initially commenced at the beginning of a new house project but can only be completed once the house is finished. SPASA submitted that the pool project stays on the pool builder's open job limit during the entire period precluding the builder from taking on additional work, to the detriment of their business. However, we note that icare's eligibility manual explains that 'sleeper pools' are taken into account when determining a pool builder's eligibility and thus pool builders are allowed to undertake significantly more projects at any time compared to other builders. For example, a medium builder constructing new homes can undertake 8 to 29 jobs at any time compared to a medium pool builder that can undertake 50 to 99 jobs at any time. SPASA submission to IPART Issues Paper, June 2020, p 3.

Box 8.2 icare's individual builder loadings for risk-adjusted premiums

A builders' individual loading or discount rate is determined using the information provided as part of the eligibility assessment. It uses characteristics that have shown to either increase or decrease the likelihood of insolvency based on HBCF claims data. The following factors are considered by icare:

- ▼ Entity licence period and business structure (ie, sole trader, partnership, company) – icare HBCF's claims experience is that claims are significantly less likely where entities operate as sole traders (or partnerships) and the longer they have held their licence. Hence companies generally attract a loading whilst sole traders and partnerships attract a discount.
- ▼ Adjusted net tangible assets (ANTA) – claims data shows that the higher levels of retained ANTA as a percentage of forecast revenue, the lower the frequency of insolvency. Builders that choose to have a higher ANTA than the minimum of 3% will attract a discount, and a loading otherwise.
- ▼ Net profit before tax or taxable income – claims experience shows that entities that have generated strong net margins for each of the past three trading years have a lower likelihood of claims, and hence attract a discount. Entities that have generated losses in each of the past three years will attract a loading.
- ▼ Adverse history – where there is a significant and recent history of the builder being linked to failed entities which have generated HBCF claims or any other characteristics that are identified as imposing a substantial risk to icare HBCF, will attract a loading.
- ▼ Review not current – for those builders subject to annual reviews, if a scheduled review is 30 days overdue as a result of the builder not providing the information required then a loading will be applied
- ▼ Building Contract Review Program and audited accounts – participation in the program attracts a discount and so does audited accounts which increases icare HBCF's confidence in the information submitted.

Source: icare, Risk factors impacting HBCF premiums, June 2020.

8.3 icare should resolve eligibility issues in a more streamlined and timely manner

icare has a complaint and dispute handling procedure that includes processes for dealing with issues raised by builders about their eligibility.

Based on stakeholder discussions and submissions, some examples of issues raised are:

- ▼ not understanding why a restriction has been placed on a builder's eligibility,
- ▼ querying why a certain amount of capital is required to be injected into the business, and
- ▼ not receiving information on why an individual risk loading/discount differs from what was previously advised.

Generally the procedure for a builder to obtain a resolution is:

- ▼ in the first instance, contact the Eligibility Risk Manager (Corporate Scorecard) through their broker to have the matter resolved
- ▼ if the builder is not satisfied with the outcome then the issue is referred to icare HBCF for further consideration (Corporate Scorecard may also decide to refer the matter to icare HBCF for resolution), and then
- ▼ icare HBCF's decision on the matter is final and binding.¹³⁸

At any time, builders can also contact SIRA for a regulatory compliance review to investigate potential breaches of the Home Building Act, the Regulation or the Insurance Guidelines.¹³⁹ However, a regulatory compliance review is not a mechanism of appeal to review the merits of a particular builder's eligibility, and does not overturn icare's eligibility decision. It is focused on whether the procedures outlined in the Act have been followed.

Based on stakeholder feedback and submissions, we found that there can be significant variation in the timeframes in which issues are resolved, with some matters being responded to expediently (if a local member of parliament is involved) and others taking many weeks. In icare's complaints and disputes handling procedures, depending on the matter and who is involved, there can be significant variability in response times regarding eligibility:

- ▼ enquiries from HBCF, SIRA or NSW Fair Trading are to be responded within 2 business days for general requests, and within 4 business hours for urgent enquiries eg if there is Ministerial involvement.¹⁴⁰
- ▼ issues raised directly by builders can take up to 7 weeks, if they are not satisfied with the outcome provided by Corporate Scorecard and the matter is referred to icare HBCF.¹⁴¹

¹³⁸ icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, pp 21-23.

¹³⁹ icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, p 25.

¹⁴⁰ icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, Table 3, p 8.

¹⁴¹ Under icare's HBCF complaint and dispute handling procedures, the Eligibility Risk Manager is to have its own underwriting committee and convene within 10 business days of receipt of a complaint. Its determination is then to be advised to the builder within 5 business days of the committee having considered the complaint. If the builder is dissatisfied with the outcome, the matter is to be escalated to icare HBCF by the Eligibility Risk Manager within 3 business days. Complaints or disputes referred to HBCF should generally have HBCF's determination communicated to the Eligibility Risk Manager and the Builder's Distributor within 15 business days. This can take a total of 33 business days or about 7 weeks. icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, section 7.3 and 7.4, pp 21-23.

Where the outcome of an eligibility review is for the builder's eligibility profile to be modified, the new building limits apply immediately if the new terms are unfavourable to the builder. The builder is then provided with at least 20 business days to meet any new conditions (such as additional capital).

While it is appropriate to impose restrictions/conditions on a builder's eligibility if their circumstances suggest that they are likely to be a significant risk to the HBCF, we have heard that in some cases they have been unreasonably imposed (as they were eventually lifted after several weeks of discussions without requiring the builder to inject financial capital or meet any other eligibility conditions). While such situations may be infrequent, they can adversely impact a builder's business resulting in them being unable to contract new work covered under the HBCF for some considerable time.

Our draft recommendation is that icare should review its dispute resolution processes to resolve issues in a more streamlined and timely manner. This is what we expect would reasonably prevail in a competitive market as builders are likely to choose providers that address eligibility issues expediently, given the potential impact on their business can be significant. In addition, if it allows builders to better understand how the information provided has been used and why it has led to a certain eligibility profile outcome, then over time we expect there to be less need for builders to raise issues.

Draft recommendation

- 17 icare reviews its dispute resolution processes to resolve eligibility issues in a more streamlined and timely manner

9 HBCF product specifications

We received submissions from stakeholders about a number of issues concerning the scope and requirements of the HBC product, including whether HBC cover could be made voluntary for certain construction types. In this chapter we highlight the issues raised.

We also note stakeholder submissions on owner-builder work being excluded from HBC cover (owner-builder work is outside the scope of our terms of reference given that we have been asked to review protections for consumers currently covered under the scheme).

9.1 Making HBCF cover easier to understand

Stakeholders have submitted concerns about certain requirements of the HBCF and how it applies to particular aspects of residential building works and home building contracts. These include:

- ▼ for contracts that require HBCF cover, whether items such as soft-scape landscape works and pool equipment can be excluded from HBC requirements
- ▼ how to allow for variations in the cost of HBCF in contracts, if the exact contract price is not known at the time the contract is signed
- ▼ whether head contractors can require subcontractors to also purchase HBCF cover for subcontracted residential works exceeding \$20,000, and
- ▼ whether HBCF cover is required for alterations and renovations for multi-units above 3 storeys.

Our draft recommendation is that SIRA produces guidance for the building industry (eg, via a fact sheet) that explains the requirements for the issues raised.

9.1.1 Items in building contracts potentially not requiring HBCF cover

The Landscape Association and the Swimming Pool and Spa Association (SPASA) identified items of work that should be excluded from HBCF cover.¹⁴² The Landscape Association considered that soft-scape works should be excluded from the scheme, because they do not represent a risk that needs to be covered by the HBCF.¹⁴³ It submitted that soft-scape works are complete once installed, can be taken over at any stage by a new contractor, and do not have any lingering warranty insurance. It noted that they can represent a substantial proportion of the overall contract price for residential works. Hence, these items should be excluded from the calculation related to eligibility for HBC insurance, maximum caps on the value of works a contractor can carry out and in the \$20,000 threshold per contract over which HBCF insurance is required.

¹⁴² SPASA submission to IPART Issues Paper, June 2020, p 3; Landscape association submission to IPART Issues Paper, June 2020, pp 1-2.

¹⁴³ Landscape association submission to IPART Issues Paper, June 2020, pp 1-2.

Similarly, the Swimming Pool and Spa Association (SPASA) submitted that swimming pool and spa equipment (which can account for 10%-15% on average for a basic pool) are already covered by manufacturers' own statutory warranties and so should be removed from the requirement to obtain HBCF cover.¹⁴⁴

Our draft recommendation is that SIRA provides guidance to the building industry on whether soft-scape landscaping works and swimming pool and spa equipment require HBCF cover, and how these items should be treated in building contracts that require HBCF cover. For example, whether builders are able to:

- ▼ Have two separate contracts with homeowners - one that includes items that require HBCF cover if it exceeds \$20,000, and another separate contract that includes all items that do not require HBCF cover.
- ▼ Have a single building contract with homeowners but within the single contract clearly identifying separately the items that require HBCF cover. The items that require HBCF cover, their total amount, and any applicable HBCF cover would be presented separately in the same contract from the items that do not require HBCF cover.

Under either of the above approaches, it would be important for homeowners to understand the implications of items being allocated incorrectly, either under the wrong contract or under the wrong section (if a single contract option is adopted) - homeowners may not have sufficient HBCF cover as a result.

9.1.2 Requirement to include the cost of HBCF cover in contracts

SPASA noted that under section 7(2)(f1) of the Home Building Act, contractors are required to include in their contracts with homeowners, the cost of HBCF cover if applicable.¹⁴⁵ It submitted that pool builders enter into pool contracts frequently (25 to 50 contracts per year for small builders and over 300 projects per year for very large pool builders) and that the details of a pool specification are negotiated and settled with a consumer quickly. Given how quickly a pool contract can be agreed upon (a pool builder may sign up four out of every ten customers they visit daily) it is not feasible or practicable for HBCF quotes to be obtained prior to and at every visit.

It also submitted that there appears to be an inconsistency in the Home Building Act where section 7(2)(e) requires a contract to contain the contract price if known, but section 7(2)(f1) requires that the contract must contain the cost of HBCF cover, irrespective of whether the contract price is known or not.¹⁴⁶

Our understanding is that builders are allowed to include an estimate of the cost of HBCF and that variations to this estimate are allowed and that this should be made explicit in contracts. We note that the 'NSW Fair Trading Home building contract template for work valued over \$20,000' includes an example clause that builders can include in contracts to allow them to recover any differences (between the estimated HBCF cost and the actual cost).¹⁴⁷

¹⁴⁴ SPASA submission to IPART Issues Paper, June 2020, p 3.

¹⁴⁵ SPASA submission to IPART Issues Paper, June 2020, pp 7-8.

¹⁴⁶ SPASA submission to IPART Issues Paper, June 2020, p 8.

¹⁴⁷ NSW Government, [Home building contract for work over \\$20,000](#), clause 13 variations, p 14.

To assist builders in estimating the cost of HBCF readily, icare has an online premium calculator where builders are able to input the construction type, contract sum, postcode of works and the individual builders' loading/discount.¹⁴⁸

9.1.3 Only head contractors are required to purchase HBCF cover

The National Electrical and Communications Association (NECA) submitted that head contractors often require subcontractors to also purchase HBCF cover, for subcontracted residential building works that exceed \$20,000.¹⁴⁹ It stated that there is a lack of clarity in the market about whether or not a lead contractor can require subcontractors to also purchase HBCF.

NECA submitted that HBCF cover should be the sole responsibility of the head contractor and that subcontractors should not also be required to purchase HBCF cover.¹⁵⁰ It submitted that such an approach would be in line with contractual agreements, as subcontractors are liable to the head contractor who is then liable to the homeowner.

Under the requirements, HBCF cover is the sole responsibility of the head contractor.¹⁵¹ Subcontractors are not required to purchase HBCF cover irrespective of the value of the subcontracted residential works.

9.1.4 Requiring HBCF cover for renovations and alterations for multi-units above three storeys

In discussions, some stakeholders indicated that there is a lack of clarity over whether HBCF cover is required for renovations and alterations done in multi-units above three storeys.

Only the construction of multi-units above three storeys is exempt from requiring HBCF cover.¹⁵² Hence, renovations and alterations undertaken in multi-units (irrespective of the number of storeys) would require HBCF cover if exceeding \$20,000.

Draft recommendation

- 18 SIRA produces guidance for the building industry that addresses the following questions:
- For contracts that require HBCF cover, whether items such as soft-scape landscape works and pool equipment can be excluded from HBC requirements
 - How to allow for variations in the cost of HBCF in contracts, if the exact contract price is not known at the time the contract is signed
 - Whether head contractors can require subcontractors to also purchase HBCF cover for subcontracted residential works exceeding \$20,000
 - Whether HBCF cover is required for alterations and renovations for multi-units above three storeys.

¹⁴⁸ icare, [HBCF premium calculator](#), accessed 1 September 2020.

¹⁴⁹ NECA submission to IPART Issues Paper, June 2020, p 3.

¹⁵⁰ NECA submission to IPART Issues Paper, June 2020, p 3.

¹⁵¹ *Home Building Act 1989*, sections 98(1) and 92.

¹⁵² *Home Building Regulation 2014*, cl 56.

9.2 Swimming pool and spa works should continue to be covered by mandatory HBCF cover

SPASA submitted that home warranty insurance should be made voluntary for the swimming pool and spa industry.¹⁵³ It suggested that the current HBCF was not suitable for its construction type given icare's eligibility process requirements. In particular:

- ▼ it is too onerous on smaller builders (in terms of the frequency, cost and resourcing of the reviews for smaller builders),
- ▼ it is a burden on new entrants as they are required to meet icare's capital requirements, and
- ▼ it does not factor in unique circumstances particular to its industry such as 'sleeper pools'.¹⁵⁴

We address SPASA's concerns about icare's eligibility process requirements in Chapter 7 and Chapter 8.

We consider that mandatory HBCF cover should continue for swimming pools and spa works:

- ▼ Whilst consumers should be undertaking due diligence before engaging a particular pool/landscaping builder there can be substantial information asymmetry about the quality of work that the builder undertakes. Further, it is difficult for a consumer to assess the risk that the builder would not be able to rectify any defects due to insolvency.
- ▼ It can provide valuable consumer protection for a potentially significant purchase that is related to the residential home, when there is no other recourse available because the builder has died, disappeared, gone insolvent or had their licence suspended – eg, average claims for stand-alone pool works was about \$22,000 on average over the past 5 years.¹⁵⁵

9.3 Owner-builder work is exempt from mandatory HBCF cover

A number of stakeholders submitted that homes built by owner-builders should be covered under mandatory HBCF cover.¹⁵⁶ They indicated that consumers who purchase owner-built homes have reduced protections as a result.

In 2015, the NSW Government made owner-built homes ineligible to obtain home warranty insurance under the HBCF. It stated that "this is to focus home warranty insurance on the licensed building sector, and to make clear distinction between homes that are built by qualified licensed builders and those built by owner-builders".¹⁵⁷

¹⁵³ SPASA submission to IPART Issues Paper, June 2020, p 8.

¹⁵⁴ SPASA submission to IPART Issues Paper, June 2020, pp 3-4.

¹⁵⁵ In nominal dollars; icare, *Response to IPART section 22 data request*, June 2020.

¹⁵⁶ BuildSafe Insurance Brokers submission to IPART's draft Terms of Reference, December 2019; Australian Owner Builders submission to IPART's draft Terms of Reference, December 2019.

¹⁵⁷ Home amendment bill 2014, [second reading, discussing owner-builders being ineligible to take out home HBCF cover](#), accessed 14 September 2020, pp 4-5.

The NSW Government also implemented measures to protect consumers purchasing owner-built homes. It requires that contracts for the sale of all properties, on which owner-builder work has been carried out in the 6 years preceding the sale, must include a consumer warning that the work has been undertaken by an owner-builder and that the owner-builder is not providing statutory insurance.¹⁵⁸

Our terms of reference requires us to investigate the effectiveness and efficiency of the HBCF in protecting consumers currently covered under the scheme. Owner-builder work is exempt from the HBC requirements and so is outside the scope of our terms of reference.

In response to stakeholder submissions, we note that:

- ▼ The NSW Government has implemented consumer protection measures so that consumers are aware if they are purchasing an owner-built home which does not have HBCF cover.
- ▼ As part of obtaining an owner-builder permit, owner-builders are aware that if they build their home or undertake work themselves and not engage a qualified licensed builder, then they have no statutory home warranty insurance.¹⁵⁹
- ▼ The HBCF current deficit of \$637 million and so including owner-builder cover would subject it to greater risk.¹⁶⁰ Where performance reporting of owner-builder insurance is available, it shows that owner-builders pose greater risk compared with licensed builders. For example, in Victoria where owner-builder insurance is mandatory, they pay higher premiums (\$4.50 per \$1,000 of project value) compared to licensed builders (\$3.00 per \$1,000 of project value).¹⁶¹
- ▼ Owner-builders have the option of purchasing home warranty insurance voluntarily from private providers eg, BuildSafe and AOBIS.¹⁶²

¹⁵⁸ Home amendment bill 2014, [second reading, discussing owner-builders being ineligible to take out home HBCF cover](#), accessed 14 September 2020, pp 4-5.

¹⁵⁹ NSW Fair Trading, [Becoming an owner-builder](#), accessed 10 September 2020.

¹⁶⁰ icare, *Annual Report 2018-19*, p 59.

¹⁶¹ ESC, *Victoria's domestic building insurance scheme – performance report 2018-19*, November 2019, pp 31-32, The most common reason for claims on owner-builder policies in Victoria is disappearance of the previous owner (it is reported that it is difficult for the owners of a property to track down the original owner-builder to rectify any faults) (ESC, *Victoria's domestic building insurance scheme*, November 2019, p 33).

¹⁶² Buildsafe, [Owner builder home warranty insurance NSW](#), accessed 14 September 2020; AOBIS, [Owner builder warranty insurance in NSW](#), accessed 14 September 2020.