IPART is reviewing the effectiveness and efficiency of the NSW Home building compensation fund

IPART
Independent Pricing and Regulatory Tribunal
New South Wales

The NSW Government has asked IPART to review the effectiveness and efficiency of the NSW Home building compensation fund (HBCF) in protecting homeowners currently covered by the scheme.

In NSW, builders must purchase insurance when they enter into a residential building contract for more than $20,000 of work. Homeowners are able to make an insurance claim for incomplete or defective work if they are no longer able to seek redress from their builder. Multi-dwellings over three storeys are exempted from the scheme.

Following the exit of private insurance providers in the 2000s, the NSW Government insurer, icare, is the only supplier of Home building insurance in NSW. It has a forecast deficit of around $650m (as at June 2019) because for the last decade, premiums have been set lower than the amount required to cover the cost of the claims.

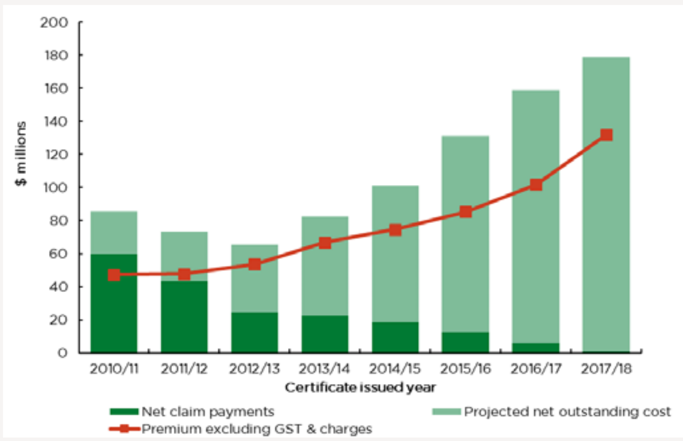
In 2018 major reforms commenced to help improve the financial viability of the scheme. From August 2019, premiums have been set at break-even levels for all building types except multi-dwellings (which are expected to reach break-even levels by 2021). This means that the premiums paid on these policies will cover the costs of future claims. But because consumers have up to 10 years to make a claim (for major defects that occur within six months of completion) on old policies that were not set at break-even levels, the scheme will make a loss for years to come, which will be funded by taxpayers.

In 2018, the market was also re-opened to competition after the NSW Government became the monopoly supplier in 2010. SIRA, as the scheme regulator, has set the minimum standards (for example a minimum $340,000 of cover), but it is open to providers to offer alternative indemnity products with additional features.

Over time, providing choice to builders should provide innovative and more cost-effective products. Homeowners would benefit as insurers offer additional protections and/or builders pass on lower costs. However, private providers have not yet entered the market.

In this chart, the extent that the total costs (green bars) are higher than the premiums (red line) shows the forecast level of taxpayer subsidy for policies in that year.

The chart also shows that once a policy is written the liability remains outstanding for many years, 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 was still over $20m. 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 $85m.



SIRA, Home building compensation scheme report, June 2018, p 34.

What will IPART be looking at?

The purpose of the Home building compensation fund is to protect homeowners faced with incomplete and or defective building work carried out by a builder if they can no longer seek redress from their builder. It is just one part of the consumer protection regime for NSW homeowners - which also includes measures to prevent defects occurring in the first place, and other avenues to address defects once they have occurred, such as dispute resolution mechanisms.

Within this broader regulatory framework, we will look at how well the fund achieves its intended outcomes (effectiveness) and whether it is able to achieve those objectives at a lower cost (efficiency), for the homeowners currently covered under the scheme. This includes investigating whether the current scheme design could be improved, including whether the scheme could further mitigate risks of builders becoming insolvent, and whether there are impediments to private sector participation in providing insurance. We are also interested in whether there are alternative indemnity products that would provide greater value to homeowners and builders.

Measures to address defects once they have occurred

Three storeys or less

More than three storeys

Warranties

From completion:

2 years for minor defects

6 years for major defects

Dispute resolution

Fair Trading

NCAT (for claims less than $500,000)

District Court

(>$500,000, <$750,000)

Supreme Court

(>$750,000)

Home Building Compensation Fund

IPART's review

Strata Building Bonds and Inspections Scheme

Preventing defects from occuring in the first instance

Building standards

Licensing

Certification

New measures are being developed to ensure buildings meet building standards:

New rules to ensure that building designs comply with the Building Code of Australia, and that builders construct buildings according to these plans.
Design and Building Practitioners Bill
Building and Development Certifiers Act and Regulations

A tool to identify high-risk builders and developers. The NSW Building Commissioner has proposed using this information to determine whether it will audit building sites before an occupation certificate is issued.

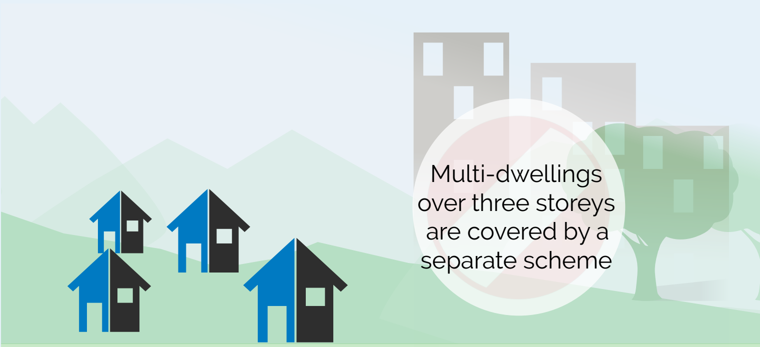
The NSW Government's key focus of further reform is to prevent homeowners from having to face defects in the first instance.

The effectiveness and the efficiency of the scheme will be impacted by the broader regulatory framework. New measures being developed to ensure building standards are met should reduce the number of defects faced by homeowners, and the claims on the scheme.

We are seeking to make recommendations on the scheme that would:

- Result in a choice of products that improve outcomes for homeowners and builders,
- Improve administrative processes,
- Encourage confidence in the market for construction of residential dwellings, and
- Increase the financial viability of the scheme.

Building work in NSW has a two year warranty for minor defects, and a six year warranty for major defects. Where a job is defective or incomplete, there are dispute resolution mechanisms to seek recourse from the builder. For buildings three storeys or less, if a builder becomes insolvent, dies, disappears, or has its licence suspended because it does not comply with a money order by a tribunal or court, homeowners can apply for compensation up to $340,000[1] from the Home building compensation fund.



Builders (excluding owner-builders) are required to buy insurance for each residential building project exceeding $20,000. The insurer regularly assesses the risk profile of each residential builder, and sets limits on the value and number of projects they can undertake each year.

Because the fund is a last-resort safety net, only a small number of homeowners make claims. However, the fund plays a broader role in providing oversight of builders in the residential sector.

0.5%

There are around 350 claims each year, compared to 65,000 new insurance policies issued. This approximates to a claim rate of about 0.5%.

1 This is the maximum claim offered by the NSW Government insurer, icare. Private insurers could enter the market and offer more, but they must provide coverage for at least $340,000.

HAVE YOUR SAY

We are seeking feedback on our Issues Paper by 1 June 2020:

What would encourage private providers to enter the market?

Are there unnecessary administrative burdens and barriers for builders?

How could the scheme further reduce defects and insolvency?

Are there any impediments to providers offering better value alternative indemnity products to homeowners?

What would improve the experience for homeowners making a claim on the fund?

What features of schemes in other places should be adopted in NSW?

April 2020	September 2020	November 2020
Issues Paper	Draft Report	Final Report

How the scheme works

Purchasing insurance

Builders must submit an application for eligibility to a broker

Brokers obtain eligibility for builders from insurer

Builders purchase insurance for each building project through a broker

SIRA assesses premiums and eligibility criteria of the insurer to ensure they comply with the scheme guidelines

Builders must provide the homeowner with the certificate of insurance before they can commence work

The **insurer** places limits on the number and value of jobs that can be completed by a builder

icare

icare is the NSW Government insurer. Private providers can also offer cover, but there are currently none in the market

The State Insurance Regulatory Authority (SIRA) is the scheme regulator

The **homeowner** notifies the insurer that their building is defective or incomplete

The **homeowner** can make a claim to the insurer once the builder becomes insolvent, dies, or disappears

Taxpayers subsidise the cost of the claims made to icare for premiums set below cost

The **homeowner** can make a claim to the insurer if the builder does not comply with an NCAT order

icare usually engages another builder to fix the defects. In some circumstances icare provides a payout to the homeowner

The **homeowner** lodges a complaint with NSW Fair Trading to resolve a building dispute with the builder if it is still trading

NSW GOVERNMENT Fair Trading

If there is no resolution, the **homeowner** can lodge a claim with NCAT

NCAT NSW Civil & Administrative Tribuna

Making a claim

What are the key issues?

No private providers offer home building compensation

Private providers have not been able to compete while icare's premiums have been subsidised

Since it began providing insurance in 2010, the NSW Government has subsidised the cost of premiums and currently makes a loss on the scheme. It is only since August 2019 that premiums have been set at break-even levels (except for multi-dwellings up to three storeys, which expect to reach break-even levels next year). This should reduce financial impediments to private entry.

Government regulations are prescriptive and may increase costs through duplication

Home building compensation is mandatory in NSW and SIRA regulates home building insurance and alternative indemnity products, and providers. Providers carrying on an 'insurance business' must also meet APRA's licencing requirements. Stakeholders have suggested that these regulations may be overly prescriptive and prevent private providers from offering innovative products that meet customers' needs, including non-insurance products. In the UK, where home building insurance is not mandatory, there is variation in the products that are offered.

Providing home owners a choice of products could deliver better outcomes. For example 'first-resort' products could be offered that allow homeowners to make a claim for defective work while the builder is still trading

Such products may be more expensive, but it could provide more value to customers. For example, if a defect were to arise, the provider would pursue the builder for rectification works, and if required enter into dispute resolution and court processes. To manage its risk, the provider might also have additional processes in place to ensure poor-quality builders aren't undertaking work, such as monitoring the progress of the building.

With a product such as this, consumers might be more likely to raise disputes if there is a low cost of doing so. However, the provider can still require the consumer to take reasonable steps to resolve any dispute before it accepts a claim. In Queensland's first-resort scheme, the insurer (Queensland Building and Construction Commission (QBCC)) requires homeowners to enter its dispute resolution process before the claim is considered.

We are keen to hear from stakeholders about the current barriers to new products and what changes are required to see more products developed that provide the same or greater protection to homeowners at lower cost.

One option we will consider is 'regulatory sandboxing' to adapt SIRA's regulations to allow providers to negotiate testing environments for new business models or products that are constrained outside of existing regulations.

For more information on regulatory sandboxing, see chapter 2 of our Issues Paper.

Home building insurance has a long pay-off period and small customer base

Home building insurance is less attractive than other insurance products insurers could sell, because of its long warranty period and small number of customers. Insurers must wait up to 10 years before any potential liabilities for defects expire compared to one year for products like home and contents insurance.

The process for determining builder eligibility can be onerous

Because homeowners can only claim if their builder is insolvent (or has died or disappeared), insurers focus on controlling the risk of insolvency. This task requires a detailed review of builders' financial accounts and may be influenced by a builder's broader life circumstances. Private providers have expressed interest previously in offering alternative products to reduce the administrative burdens of examining builder eligibility. Instead, they would inspect homes while under construction to detect and remedy defects upfront.

Insurers cannot reduce the cost of claims by excluding high risk builders

SIRA's eligibility guidelines prohibit insurers from excluding high-risk **builders**. While insurers may limit their offering to a low risk **category**, eg, single-dwelling residential builds only, they must make insurance available to <u>all</u> builders in that category.

HAVE YOUR SAY

We want to know:

1. What changes to the scheme would encourage the supply of new, innovative products - both different types of insurance and non-insurance products?

2. Should private providers be allowed to mitigate risk by limiting insurance to high risk builders, or other methods?

3. To what extent do the requirements of the Home Building Act 1989 duplicate the Insurance Act 1973 and increase costs of entry for private insurers?

4. What additional information would be helpful to homeowners in selecting a builder?

5. How could the claims process be made more efficient?

Premiums are increasing

Insurance must be purchased by the builder for each project, but these costs are ultimately passed onto homeowners. Because premiums are transitioning to break-even levels (both overall and for different building categories) they have increased significantly since 2017. For a new single dwelling, the premium has increased by almost 50% from around 0.8% of the property value to 1.1% (including GST and stamp duty). For new apartments under three storeys, premiums will increase by around 130% by 2021 - from 2.1% to 4.8%.

$2,000

The average premium is around $2,000 for a new single dwelling (around 1.1% of a $230,000 project, including stamp duty and GST - but not brokers fee which vary from broker to broker).

Premiums currently range from around 0.4% of the total value of the build for single storey alterations and swimming pools to 2.7% for apartments up to three storeys.

There are three main costs of providing home building insurance

- The cost of meeting homeowners claims
- The operating costs (eligibility assessments, claims management, underwriting and overheads)
- An economic return on investment, where the expected return to shareholders (or owners) for their capital invested in the business, is commensurate with the risks in providing home building insurance.

How do we ensure that a safety net is provided to homeowners at least cost?

Could insolvency risks be managed more effectively?

The scheme only provides compensation to homeowners who can no longer seek a remedy from their builder, and so one of the key ways of reducing the costs of the fund is to reduce the probability that builders become insolvent. To manage this risk, the insurer caps the number and value of projects they are able to work on at any one time. If they wish to take on more complex work, builders are required to participate in a mentoring and review program. The insurer also sets premiums to reflect the risk of particular building types and builders.

Information on builder progress payments, critical stage inspections and issuance of compliance certificates might help in further identifying builder insolvency risk. Such information could indicate whether a builder is experiencing cash flow problems or has increasing liabilities arising from construction work. For example, critical stage inspections for a builder's projects could identify if works increasingly do not comply with development consents and legislative requirements (leading to future problems).

We have been asked to investigate whether this information could be used by insurers to reduce costs. For example, an insurer could use this information to reduce a builder's open job limits through the eligibility process. Alternatively, builders could be required to enter into a program (such as the buildig contract review program) where there is additional supervision if building issues are continually identified through critical stage inspections. Such a program could also help builders to better manage any cashflow problems identified through information on builder progress payments.

Builder eligibility

The insurer sets the type of building work (eg, construction of a new single dwelling) and caps the value and number of projects it is willing to provide insurance for at any one time. This "eligibility assessment" is based on a detailed analysis of their work and financial history. Managing the pace of work that a business can handle financially can be an important part of managing insolvency risk. It may also provide an incentive for builders to have a strong financial position in order to grow their businesses.

Building contract review program

In addition, new builders or those seeking to take on larger or more complex projects compared with their past experience can be required to participate in a building contract review program as part of their eligibility. It is a mentoring and review program that can help mitigate insolvency risk by assisting builders in budgeting their projects appropriately, providing performance reviews and helping to ensure that projects are running on time and according to budget.

Risk-based premiums

Builders will also be charged a lower premium if they have a lower-risk profile (past claims data indicates that sole traders have lower insolvency risk compared with companies). icare provides a discount of up to 30% on the 'base premium' (which takes into account the property type (single-dwelling, multi-dwelling), and the degree of structural change (new build, renovation, alteration). Conversely it adds a loading of up to 30% is added to higher-risk builders.

For more information on how insurers manage risk, see chapter 3 of our Issues Paper.

Could the scheme be run more efficiently?

Generally, where there is only one provider operating in a market, we would conduct an efficiency study to determine whether the operator's costs are efficient. This usually involves a detailed examination of its capital and operating costs, and return on and of capital, and may include benchmarking other providers or industries.

However, as the market for home building compensation insurance is open to competition, we would expect that if excessive profits were being earned and/or the insurer in inefficient, this would attract new entrants. icare's premiums have only recently reached break-even levels (except for multi-dwellings, which are still below cost) and no private providers have yet entered the market.

In addition, icare outsources most of its key functions to private providers, including eligibility assessments, claims management and underwriting. These functions are procured through a competitive tender process, therefore it is likely that icare is paying market prices for these services.

We note that when SIRA assesses icare's premiums, it examines whether the the premiums are likely to reflect the cost of the scheme.

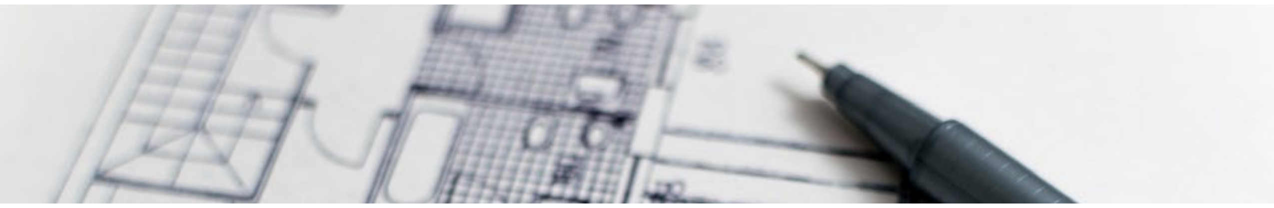
Given these factors, our preliminary view is that the merits of an efficiency study of icare's Home building compensation fund would not outweigh the costs at this stage.

We want to know:

6. What incentives should the scheme have for builders to undertake good risk management and encourage good business practices?

7. How could enhanced information collection be used to further mitigate builders' insolvency risk?

8. Is an efficiency study of icare's economic costs necessary?



There are administrative costs to builders in obtaining cover

Before a builder can commence residential building work exceeding $20,000 on buildings three storeys or less, they must undergo an eligibility process. This is a significant administrative task for builders, who must provide detailed information including work and financial (including personal assets and liabilities and previous insolvencies).

The insurer uses the information provided by the builder in the eligibility process to cap the value and number of projects that a builder can undertake, in order to manage the risk that they will go insolvent. This can also slow the pace that a builder can grow, reducing the profit that they are otherwise able to earn.

We want to know:

9. Do you consider the current eligibility assessment process should be simplified?

10. Could this be done without subjecting the Home building compensation fund to greater risk?

11. Are there any other unnecessary regulatory or administrative burdens and barriers to entry for builders that should be reviewed?

Multi-dwellings greater than three storeys are covered by a separate scheme

It has not been financially sustainable to provide protections under the scheme for all homeowners. Changes were made in the early 2000s so that homeowners can only access compensation if the defect becomes evident within two years of the building work being completed for a minor defect, and six years for a major defect (down from seven years). Multi-dwellings over three storeys were also excluded from the scheme.

Our terms of reference has only asked us to look at the effectiveness and efficiency of the scheme in protecting homeowners currently covered. Expanding the scheme has been considered in previous reviews.

In 2012, when the Goverment considered whether the scheme should be expanded to high-rise buildings. It considered that the risk involved in high-rise works are materially different to those of individuals who are building a home. As a result, expanding the scheme would likely increase premiums, and building costs for consumers. In addition, high-rise developers would need to meet very strict criteria to be eligible for cover, which could reduce competition in the industry, further driving up costs. Instead, NSW Government introduced the Strata building bonds and inspections scheme to provide pr0tections for these high rise apartments.

The current focus of the NSW Government is introducing reforms to help prevent homeowners from facing defects in the first instance. This includes working on new legislation that would ensure that building designs comply with the Building Code of Australia, and that builders construct buildings according to these plans. It appointed a Building Commissioner in 2019. One of his priorities is developing a 'ratings' tool to identify high-risk builders and developers. This would assist homeowners undertaking due diligence in selecting a builder. The NSW Building Commissioner has also proposed using this information to determine whether it will audit building sites before an occupation certificate is issued.

The strata building bonds and inspections scheme applies to residential buildings over three storeys

The developer of high-rise buildings is required to pay a bond of 2% of the contract value, which is held in a trust. It is used to pay for the costs of rectifying any defects identified by an independent building inspector between 15 months and 18 months after the completion of the building work. This is substantially less than the coverage period provided by the Home building compensation fund, which is up to six years for major defects.

Any building rectification works should be completed within three years, and the unspent bond is refunded to developers. However, in some cases the bond amount is less than the value of the rectification works required.