Independent Pricing and Regulatory Tribunal
New South Wales

Review of the efficiency and effectiveness of the

NSW HOME BUILDING COMPENSATION FUND

Issues paper

April 2020

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 1 June 2020.**

We would prefer to receive them electronically via our online submission form <www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission>.

You can also send comments by post.

Postal address:

Review of the effectiveness and efficiency of the NSW Home Building Fund

Independent Pricing and Regulatory Tribunal
PO Box K35 Haymarket Post Shop,
Sydney, NSW 1240

Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website <www.ipart.nsw.gov.au> 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 at the end of this report.

We may choose not to publish a submission - for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. However, it could be disclosed under the Government Information (Public Access) Act 2009 (NSW) or the Independent Pricing and Regulatory Tribunal Act 1992 (NSW), or where otherwise required by law.

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

Overview

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

	Warranties	Dispute resolution	
Three storeys or less	From completion: 2 years for minor defects 6 years for major defects	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**
More than three storeys			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.

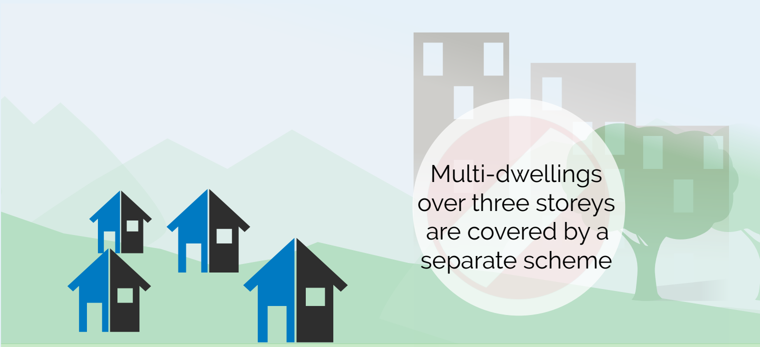
The NSW Government's key focus of further reform is to prevent homeowners from having to face defects in the first instance.

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

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

Builders purchase insurance for each building project through a broker

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.

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.

We want to know:

HAVE YOUR SAY

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.

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.

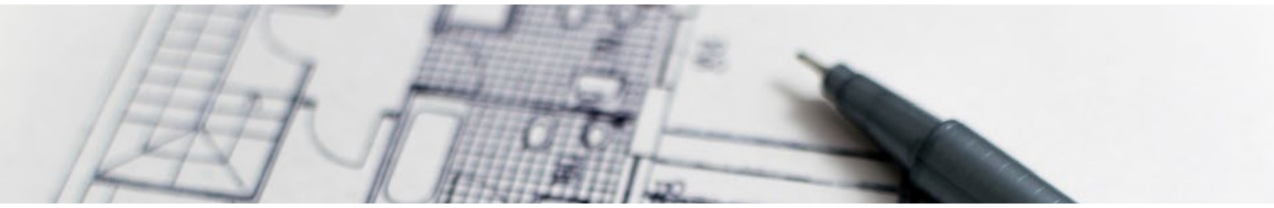
Given these factors, our preliminary view is that the merits of an efficiency study of icare's Home building compensation fund would not outweigh the costs at this stage.

We want to know: HAVE YOUR SAY

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: HAVE YOUR SAY

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.

How this report is structured

The rest of this issues paper provides more information on this review.

- **Chapter 2** discusses potential impediments to private insurers and alternative indemnity providers entering the market in more detail.
- **Chapter 3** further explains how the Home building compensation fund could further reduce defects and insolvency.
- **Appendix A** is a copy of our terms of reference for the review.
- **Appendix B** provides more general information on the fund.
- **Appendix C** outlines how the fund has changed over time.
- **Appendix D** provides further details on SIRA's how building eligibility is assessed and premiums are set.
- **Appendix E** sets out icare's claims process for homeowners.
- **Appendix F** compares home building insurance schemes across different Australian jurisdictions, and the UK.

2 What changes to the scheme would encourage private providers to enter the market?

In 2018, the NSW Government implemented legislative changes to the *Home Building Act 1989* (NSW) (Home Building Act) to enable private sector providers to apply to State Insurance Regulatory Authority (SIRA) to become licensed HBC providers.[1] Having more private providers of HBC products would give builders more choice and provide better value products for homeowners.

The Government implemented a number of complementary reforms to support private providers participating in the scheme, including further separating the regulatory and operational roles of SIRA and icare; strengthening SIRA's regulatory oversight of HBC providers; introducing risk-based premiums and ending guaranteed broker commissions in a move towards achieving break-even premiums by 2021.[2] Since then, there have been no new entrants and icare remains the sole provider on behalf of the Government.

This Chapter examines what conditions are required to encourage private sector participation, any barriers that may be preventing private providers from entering the HBC market, and asks for stakeholder feedback on these issues.

2.1 What conditions would encourage private entry into the HBC market?

Providers have an incentive to enter a market where they determine that they can make a profitable return. Offering innovative new products would allow them to gain market share by providing better value products (either different types of insurance or alternative indemnity products) to builders and homeowners.

However, there may be legal, technological, information or financial barriers that increase their upfront costs of entry. For example, these barriers to entry may include:

- **Below-cost pricing.** If the incumbent is charging prices that are not cost-reflective, it may discourage new entrants, because they cannot earn an efficient return on investment.
- **Economies of scale**. It may be difficult for a new entrant to win enough market share to make a viable return on investment, especially if there are substantial start-up costs.
- **Government legislation or regulations**, which prohibit or restrict new entrants, by placing licensing requirements or other legislative restrictions, which new entrants find cumbersome to negotiate

1 See https://www.sira.nsw.gov.au/fraud-and-regulation/reforms/home-building-compensation-scheme-reforms, accessed 25 March 2020.

2 See Appendix C and Appendix D.

- **Technology or information advantages**, which incumbent providers may have, because they have already established and implemented systems to manage relevant business processes. Where the incumbent is a Government provider they may have acquired systems from the Government, which is an advantage if the Government does not make the same systems available to new entrants.

As part of our review, we will examine to what extent there are barriers that prevent or discourage entry into the HBC scheme, and recommend any changes that would improve the market conditions to attract new entrants.

We are keen to hear from stakeholders about the current barriers to offering new, innovative products and what other changes would be required to see more products developed. For example, providers of other types of insurance have used new technology to increase the range and types of products offered, providing customers a greater choice to meet their needs and risk profiles.

2.2 Are there any financial or market barriers preventing private entry?

Financial and market barriers prevent new entrants from earning an appropriate return on investment. This may be because the incumbent provider is pricing products below cost, or the new entrant cannot attract enough customers to earn an appropriate return on investment. In our preliminary analysis and consultation with stakeholders, we have identified some potential financial and market barriers that may be deterring private providers.

> Premiums are now at break-even levels for all building categories, except multi-dwellings up to three storeys, but providers can wait up to 10 years before funds are free of liabilities for claims

2.2.1 Icare's premiums reflect the expected cost of claims for most dwellings

Historically, the HBCF has been subsidised by the Government. Since 2010, when the Government became the sole provider of HBC insurance, the subsidy made HBC insurance premiums more affordable by topping up the difference between revenue from premiums and the expected cost of paying out claims on those policies.

In 2017, the Government announced its intention to gradually increase premiums to establish 'break-even' pricing by 2021[3]. From August 2019, premiums have been set at break-even rates, except for multi-dwellings up to three storeys which require the highest increases.[4] To alleviate the impact on multi-dwelling (up to three storeys) building activity, the Government intends to move their premiums to break-even rates through four increases across 2019-20 and 2020-21.

3 See https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/#gref, accessed 25 March 2020.

4 Ibid. Multi-dwelling construction types will move to break-even premium rates through four rate increases across Financial Year 2019-2020 and Financial Year 2020-2021 to alleviate the impact to building activities.

In addition to improving the financial sustainability of the scheme, the effect of these changes means that new entrants could currently compete on price with icare HBCF for new policies, with the exception of multi-dwellings (up to three storeys). However, icare HBCF would still be liable for losses for up to 10 years on policies written prior to the break-even premium changes.

It has only been a few months since icare HBCF achieved break-even premiums on single-dwelling construction types. We are keen to hear from stakeholders whether this would encourage entry by new private providers.

2.2.2 Payoff periods are much longer than insurance products in other industries

HBC insurance has a much longer payoff period than other insurance products. Policy holders have a warranty period of six years for major defects, and may extend this if they notify the provider of the loss before pursuing the builder through other means. This means providers could wait up to 10 years before the statutory warranty period lapses and revenue from premiums is no longer at risk from claims for home building losses. By comparison, home and contents insurance providers generally only wait one year before the policy lapses and revenue earned through premiums is no longer subject to claims.

We are keen to hear from stakeholders and in particular insurers and other private providers on options to mitigate the impact of the longer payoff periods. For example would it be feasible and what, if any, additional regulations would be required for providers to offer different payment structures, which spreads premiums over a longer time period.

2.2.3 The pool of HBC insurance customers is small compared to other insurance products

In comparison to other insurance products, the HBC market is small. New entrants may not be able to win enough market share to make it financially viable. Unlike other insurance products like car and home and contents insurance, which renew their premiums each year HBC insurance is a one-off payment for a single project, for which coverage lasts up to 10 years. There is no incentive for providers to compete for policies already written, because there are no ongoing premiums, only the risk that they may have to pay a claim on it. It is also uncertain what impact future premium increases would have on the market.

2.3 Do Government regulations or legislation deter private entry into the HBC market?

In 2018, the Government implemented legislative changes to allow private entry into the HBC market. Currently, SIRA is responsible for regulating insurance and alternative indemnity products (alternative products) under the Home Building Act. HBC providers must be licensed by SIRA to underwrite home building liabilities and manage claims in the HBC scheme. SIRA provides comprehensive guidelines to licence holders about how they must assess builder eligibility. In addition, insurance providers must be licenced by the Australian Prudential and Regulation Authority (APRA).[5]

5 See https://www.apra.gov.au/licensing-guidelines-for-general-insurers, accessed 7 April 2020.

In our preliminary consultations, stakeholders have suggested that these regulations may be overly prescriptive and prevent private providers from offering innovative products that meet customers' needs, including products that may not be strictly insurance products.

We propose to consider what changes would be required to allow entry into the scheme on a trial base to facilitate innovative products to be offered that provide the same or greater protections at lower cost. One option we will consider is using regulatory sandboxes to encourage new providers to enter the scheme, by raising regulatory barriers with SIRA to allow innovators to negotiate testing environments for new business models or products that are constrained by or outside of existing regulations.

Box 2.1 Regulatory Sandbox[a]

A regulatory sandbox is a risk-controlled, time limited testing environment that enables:

- A business to reduce uncertainty and manage regulatory risks during the testing stage of its innovative product or business model
- A regulator to test adaptive regulatory responses to disruption in the market.

a See https://www.innovation.nsw.gov.au/regulatorysandboxes, accessed 7 April 2020.

In the UK it is not mandatory for builders to purchase home building insurance for residential construction work.[6] This means there is substantial variation in the cover provided between different products.[7]

Even though it is not mandatory in the UK, developers[8] almost always purchase home building insurance for their new builds.[9] This is because when providing mortgages for new homes, banks require that the homes have home building insurance - hence, it might be difficult for developers to subsequently sell new homes if home building insurance has not been purchased for it. Further information on the UK market is provided in Appendix F.

IPART seeks comments on the following

1 What changes to the scheme would encourage the supply of new innovative products – both different types of insurance and alternative products?

6 UK Ministry of Housing, Communities & Local Government, *Redress for purchasers of new build homes and the new homes ombudsman – a technical consultation*, June 2019, pp 10-11.

7 UK Ministry of Housing, Communities & Local Government, *Redress for purchasers of new build homes and the new homes ombudsman – a technical consultation*, June 2019, pp 9-10.

8 The developer may also be the builder. If they are not, then it is in the interest of the developer to ensure that home building insurance is taken out for the new build and that their builder complies with the requirements of the insurer when constructing – this is so that the developer does not face difficulties in selling the new home once completed.

9 Home owners can also optionally purchase home building insurance for renovations eg https://renovationinsurancebrokers.co.uk/knowledge-base/structural-warranty/, accessed 25 March 2020.

2.3.1 HBC providers cannot mitigate their risk by providing insurance to low-risk builders only

The HBC (eligibility) insurance guidelines (Guidelines) prohibit HBC providers from only offering insurance to low-risk builders and consistently excluding high-risk builders. Principle 6 of the Guidelines states:

> 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.[10]

This is to ensure that eligibility supports a strong and viable residential building industry. If private providers can exclude higher-risk builders, it leaves the Government as the sole provider of HBC insurance for these builders.

SIRA may allow, via licence condition, the offer of HBC cover to builders in specific market segments that may be lower risk, eg, swimming pool builders or single-dwelling residential builders.[11] However, the provider would have to make that category of insurance available to all builders wanting to undertake that type of work, including those who may be at higher risk of default. To manage its risks, HBC providers can limit the number and total value of projects that the builder can undertake at any point in time,[12] or add a loading of up to 50% to the premium.[13]

Limiting the ability of an insurer to exclude individuals is not uncommon in other insurance sectors, such as private health insurance. The extent to which insurers in other sectors are able to charge individual risk-based premiums varies. Private health insurers are unable to do so for equity reasons, but car insurance providers offer to exclude younger drivers in exchange for a lower premium, or if they agree to install an electronic tracker in their car, which feeds data back to the insurer on the safety of their driving habits.[14]

Stakeholders have indicated that if the Government was the 'provider of last resort' of HBC insurance for high risk builders, it would bear a disproportionate load of the risk and potential claims. However, it could charge higher premiums to offset this risk. This could be an incentive for builders to engage in good business practices.

IPART seeks comments on the following

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

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10 SIRA, *Home building compensation (eligibility) insurance guidelines*, Principle 6, p 6.

11 Section 105I(d) of the Home Building Act states "Without limiting the generality of section 105H, the conditions to which a licence under this Part may be subject, or to which the Self Insurance Corporation [icare] may be subject, include conditions—…(d) specifying the persons, or classes of persons, to whom the licence holder may provide insurance or cover by means of alternative indemnity products."

12 SIRA, *Home building compensation (eligibility) insurance guidelines*, Principle 6, p 8.

13 SIRA, *Home building compensation (premium) insurance guidelines*, p 11.

14 See https://mozo.com.au/insurance/car-insurance/articles/save-on-premiums-by-driving-safely-with-ubicar-insurance, accessed 1 April 2020.

Home building compensation insurers cannot limit eligibility to only builders and contractors deemed to be low risk

2.3.2 Private HBC insurers must be licensed to provide insurance products by the Australian Prudential and Regulation Authority (APRA)

As part of the Government's 2018 reforms to the scheme, the Government made changes to the Home Building Act to allow *alternative indemnity product providers* (as well as private insurers) to apply to SIRA to enter the HBC market in NSW.[15] In principle, this would encourage competition in the market by allowing builders to access a broader range of HBC products, including:

- A fidelity fund scheme[16] (where the beneficiaries are the person on whose behalf the building work is done, the purchaser of the land, or the successor in title)
- A specialised insurance arrangement
- Any other insurance product or arrangement prescribed by the regulations.[17]

Under the Commonwealth Government's *Insurance Act 1973* (the Insurance Act), insurance providers also require a licence from APRA, giving them the authority to conduct any business that may be classed as an 'insurance business' in Australia.[18] Part 3 of the Insurance Act defines 'insurance business' as:

> The business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event.[19]

The incumbent provider, icare, is regulated by both APRA and SIRA.

HBC providers must obtain a licence to carry on an insurance business from the Australian Prudential Regulation Authority, as well as the State Insurance and Regulatory Authority in NSW

APRA has a standard process that it follows in assessing licence applications to ensure providers meet the necessary prudential requirements to run an insurance business. This protects customers and promotes financial stability by making minimising the risk of losses to beneficiaries.

15 *Home Building Act 1989*, s104B
16 A fidelity fund is made up of contributions by persons who can then draw on the fund if a claim is made. An example is the Solicitor's Mutual Indemnity Fund (SMIF) to which all solicitors are required to contribute. The purpose of the SMIF is to pay the difference between an indemnity provided by an insurer to an individual solicitor and the amount of the claim made against the solicitor.
17 *Home Building Act 1989*, s104.
18 Some exclusions apply, such as life insurance, health insurance and funeral services, which are governed by other legislation.
19 *Insurance Act 1973*, Part 3.

This licence application process can cost providers a $110,000 fee upfront and can take up to 18 months before APRA grants a licence to a provider (See Box 2.2). While these conditions apply equally to all providers, it may deter potential alternative product providers from developing innovative HBC products for the market.

There is a mechanism under the Insurance Act that appears to allow APRA to exempt entities from its licensing requirements. APRA may, in writing, determine that Part 3 of the Insurance Act does not apply to a particular person or category of person.[20]

Box 2.2 APRA's licensing process for potential insurance businesses

APRA can only receive applications from corporations or Lloyd's underwriters[a] to carry out insurance business, not partnerships or unincorporated entities. A business wishing to offer an insurance product in any market needs to go through the following process:

1. **Contact APRA**: Prior to applying, potential insurers are encouraged to contact APRA to ensure they understand the licensing process, APRA's expectations and what documentation they require.
2. **Lodge an application**: The application must include details of the company's ownership, board and management, three-year business plan, financial resources including level of capital or operational risk financial requirement, and risk and information management frameworks. The application fee for general insurance is $110,000.
3. **Assessment**: APRA reviews the application and may ask for additional information and conduct meetings to review operations on-site. APRA assesses the application to determine whether the business will be financially sound, manage risks effectively, meet fit and proper expectations, have a sound risk culture and not pose a risk to financial safety or stability of the financial system. The assessment process may take three to 18 months. APRA may impose conditions on licences.
4. **Post-licensing**: Licensed entities must provide ongoing information to show how they are meeting APRA's prudential standards. This includes annual and quarterly reporting of relevant information and lodging audited yearly statutory accounts. They must pay an annual supervisory levy.

a See https://www.apra.gov.au/underwriting-lloyds-australia, accessed 13 March 2020.

Source: See https://www.apra.gov.au/apras-licensing-process, accessed 13 March 2020.

2.3.3 SIRA requires private HBC providers to meet requirements for capacity and capability to be granted a licence to carry out HBC business in NSW

SIRA also issues licences to prospective HBC applicants in accordance with the Home Building Act and Regulation and its own guidelines. It assesses applicants against a number of criteria, similar to APRA's criteria, including:

- the suitability of the applicant
- the paid-up share capital and reserves of the applicant
- the constitution of the applicant (if any)

20 *Insurance Act 1973*, Part 3, s 7.

- the re-insurance arrangements of the applicant
- the efficiency of the insurance scheme generally
- any applicable Insurance Guidelines, and
- any other matters that SIRA thinks fit.[21]

A licence fee of $50,000-$60,000 is payable depending on whether applicants are an insurer or other business.[22]

SIRA requires licence holders to follow its eligibility guidelines, which prescribe principles and requirements that HBC providers must implement when assessing builder eligibility.

IPART seeks comments on the following

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?

2.4 Are there any technology or information barriers preventing private entry in the HBC market?

SIRA's eligibility guidelines require private licence applicants to have information and accounting systems that are adequate for maintaining records and reporting to SIRA in the required manner from the commencement of operations.[23] These systems must ensure compliance with all laws, regulations, guidelines, rules and licence conditions. However, there is no requirement for providers to have any specific systems.

Currently, the incumbent provider, icare, contracts with external providers to deliver many of its core HBC functions including:

- Actuarial valuation and premium pricing advice
- Underwriting (assessing builder eligibility)
- Claims management.

Outsourcing these functions may mean that icare is unlikely to have an incumbent advantage over a new entrant. Private participants would have similar access to procure similar services, or provide their own in-house.

However, given that icare HBCF has been the sole provider of HBC insurance since 2010, it may have gathered information about risk factors from its claims history that new entrants would not have. New entrants may be at a disadvantage for setting risk-based premiums.

21 SIRA, *Licensee application guidelines - Home building compensation regulation*, p 4.
22 SIRA, *Licensee application guidelines - Home building compensation regulation*, p 16.
23 SIRA, *Licensee application guidelines - Home building compensation regulation*, p 7.

2.5 Are there any other deterrents to private participation in the HBC market?

While not strictly barriers to entry, there may be other factors that discourage new entrants into the HBC 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.** A provider assesses a builder's eligibility by examining their financial performance, equity exposed to building operations, technical capability and history, past performance and experience of principals and managers, and previous adverse associations. It can take up to 40 days to finalise an eligibility assessment.[24]
- **HBC providers have little control over the circumstances that are most likely to cause builder insolvency**. Because the HBCF is a 'last resort' scheme, the primary risk that the provider needs to assess is the risk that a builder will be unable to rectify building defects should they occur within the statutory period due to death, insolvency, etc. Some drivers of insolvency relate to business decisions such as debt, capital and corporate structure, which the insurer can assess. However, we have heard from stakeholders that for many smaller businesses, a change in life circumstances can impact on business performance.[25]

24 Icare, *HBCF Eligibility Manual*, March 2020, p 69.
25 IPART discussions with icare, February 2020.

3 How could the scheme further reduce defects and insolvency?

In assessing the effectiveness and efficiency of the HBCF in protecting consumers who are currently covered by the scheme, we have been asked 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.

The key points of interaction between builders and licensed providers are when builders obtain eligibility and when builders purchase certificates of insurance, specific to the work they intend to undertake. Hence, we focus on builder eligibility and premium pricing as two areas where the scheme could impact the behaviour of building industry participants.

In the sections below, we discuss whether the scheme's regulatory framework and/or icare HBCF's processes[26] could be improved to further incentivise building industry participants to undertake good risk management and further mitigate insolvency risk.

3.1 Incentives to undertake good risk management and encourage good business practices

The regulatory framework for assessing builder eligibility and premium pricing (for the certificates of insurance) are set out in SIRA's guidelines which were established in 2018. They contain criteria that licensed providers must comply with at a minimum (further detail is provided in Appendix D).

- SIRA Home building compensation (eligibility) insurance guidelines – Sets out the principles for eligibility criteria eg, that they are to be fair and reflective of risk, transparent, should allow builders to be assessed reasonably, should provide incentives for risk management and good business practices, should support a strong and viable building industry, and should support a viable home building compensation fund. It also sets the minimum financial matters (eg, assets of the builder, profit position and annual turnover) and non-financial matters (eg, management structure, qualifications, business capacity and trading history) that must be considered.

  The guidelines also set out procedural matters such as, eligibility reviews must be undertaken within 30 days, and that builders should be provided with at least 30 days' notice if the licensed provider deems it necessary to restrict or revise a builder's eligibility.

26 As currently the only provider of HBC insurance in NSW.

- SIRA Home building compensation (premium) insurance guidelines – Sets out the principles for premium pricing eg, they are to be fair and reflective of risk, should not be excessive or inadequate, should not be unreasonably volatile, and should provide incentives for risk management and good business practices. The guidelines also require the risk factors that licensed providers use to set premiums eg, contract value, construction type, location of premise, and specific contractor risk factors such as business structure, to be approved by SIRA.

One of the principles in both SIRA's eligibility and premium guidelines is to provide incentives for risk management and good business practices.

- In the eligibility guideline it states:

> Contractor eligibility should provide incentives for contractors to undertake effective risk management with the objective being to reduce both the likelihood and severity of potential future claims through sound business practices, arrangements to support building work supervision and quality assurance, and financial backing. Similarly, eligibility criteria should not drive adverse business practices or place undue restriction on business trading structures.[27]

- In the premium guideline it states that:

> Premiums should provide incentives for contractors to improve business practices thereby reducing both the likelihood and severity of potential future claims. Licensed providers may offer contractors discounts or load premiums based on the licensed provider's risk management practices. Discounts and loadings must conform with principles one, two and three and should be designed, to the extent possible, to generate incentives to reduce the level of risk. At the same time, perverse incentives or incentives that might compromise the scheme must be avoided [28]

We note that icare HBCF's eligibility assessment and premium pricing process[29] (see Appendix D for further detail) complies with SIRA's principle for providing incentives for risk management and good business practices in the following ways:

- Builder eligibility - Provides incentives for builders to maintain their financial capacity and ensure the ongoing financial viability of their business as it may be difficult to obtain eligibility again in future. This can reduce the likelihood of potential future claims (arising from builders going insolvent) and also the potential severity of future claims (particularly for larger businesses[30]).
  - icare HBCF examines a builder's financial capacity (equity in the business, financial performance), technical capacity (building licence conditions) and previous building experience. This determines what type of construction the builder would be able to seek insurance for, including the amount of work that they are able to take on at any one time ('open job limits') – this helps to ensure

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27 SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, p 6.

28 SIRA, *Home building compensation (premium) insurance guidelines*, January 2018, p 6.

29 icare HBCF's approach to assessing eligibility is set out in its eligibility manual with the actual assessment outsourced to a third party provider – Corporate Scorecard (icare HBCF's Eligibility Risk Manager). The manual is reviewed and updated regularly and also incorporates learnings from claims data. icare HBCF requires builders to obtain eligibility through approved HBCF brokers, who ensure that complete and accurate information is submitted to the Eligibility Risk Manager. Brokers may charge a fee for their service. Previously, a 15% commission was included in the insurance premiums but this was removed as part of the 2017 reforms (moved to a fee for service model). https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/what-we-do/ accessed 13 March 2020

30 The severity of total potential claims from a smaller business going insolvent is likely to be lower than the severity of total potential claims arising from a larger business going insolvent, as a smaller business would undertake less projects in comparison.

that builders are taking on work that they're experienced in and have the financial capacity to do so. In examining a builder's history, being involved[31] in businesses that have been insolvent in the past five years is one of the grounds to be denied eligibility.

- Premium pricing - Provides incentives for builders to adopt good risk management and sound business practices which can attract a discount (up to 30%) on their premium. This may improve their competitiveness when tendering for contracts, and may reduce the likelihood and severity of future claims. Although, it may be unclear how effective this incentive is for builders as they are likely to pass the cost of premiums onto home owners. However, premium payments are being made into the HBCF that reflect different builders' risk which assists in the financial viability of the scheme.
  - icare HBCF initially calculates a base premium that is based on the contract value, construction type (eg, new single dwelling or renovation), and location (whether it is in a metropolitan or regional area)[32]. It then applies a discount/loading (up to ± 30%) based on specific builder characteristics. For example, past claims data has shown that builders that operate as a sole trader (compared with entities) and those that have more (net) assets relative to forecast revenue (eg, greater than 3%) have a lower likelihood of insolvency, hence attract a discount.

The incentives above are focussed on reducing the likelihood and severity of future claims through reducing insolvency risk. Additionally, the likelihood and severity of future claims could be reduced through improved quality of work so that despite a builder becoming insolvent[33] the risk of a claim eventuating and its potential severity may be reduced. Minimising the risk of defects occurring in the first place is also an approach to reducing the likelihood and severity of future claims. This is because there are two conditions that both need to be satisfied before a claim is triggered: a defect being identified within the relevant insurance coverage period[34], and the builder going insolvent.[35]

Under the principles in the eligibility guidelines, it states that eligibility conditions should *provide incentives* for builders to undertake effective risk management to reduce both the *likelihoo*d and *severity of potential future claims* through sound business practices, and *arrangements to support building work supervision and quality assurance*.

- Currently, building work inspections to assess compliance with building standards and relevant legislation are carried out by private certifiers[36]
- icare HBCF is not involved in the actual building process and its building contract review program does not examine construction works to check compliance with building standards.

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31 A key manager, director or principal of the builder was a director or key manager of a previous business within the immediate 9 months prior to a business closure, icare HBCF Eligibility manual, March 2020, p 14.

32 The metropolitan areas are defined as Sydney, Central Coast and Newcastle. The exact postcodes are available in SIRA's guidelines. SIRA, *Home building compensation (premium) insurance guidelines*, January 2018, p 9.

33 Or having disappeared, died or had their license suspended.

34 Consumers are able to notify the licensed insurer that a defect has occurred, whilst pursuing the builder for rectification works, in order to preserve their entitlements.

35 Or having disappeared, died or had their license suspended.

36 https://www.fairtrading.nsw.gov.au/housing-and-property/building-and-renovating/preparing-to-build-and-renovate/what-certifiers-do, accessed 17 March 2020.

It may be difficult to apply effective incentives in eligibility conditions to incentivise builders to reduce the likelihood and severity of potential future claims by minimising defects (both the incidence and severity of defects), if the trigger for the insurance policy is largely based on the builder going insolvent[37] rather than the quality of their building works – if a claim is triggered, the builder is not responsible in providing compensation or rectification works. To reduce the likelihood and severity of future claims through improved quality of work it may be more effective to have greater enforcement of compliance with building standards and relevant legislation so that consumers receive a quality build from the beginning without potential defects.

In other jurisdictions such as the UK, insurers are more involved in the building process and undertake their own building checks (see Appendix F for further details).[38] These are requirements imposed by providers and we are interested to hear from stakeholders whether such an approach would provide an incentive for builders to undertake improved quality work in the first instance[39] and hence, whether it would reduce the likelihood and severity of potential future claims.

IPART seeks comment on the following:

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

– Are the current incentives sufficient for builders to undertake good risk management and encourage good business practices?

– What further incentives should be included for builders to undertake good risk management and encourage good business practices?

– What incentives should be included in eligibility conditions and/or premium pricing so that builders are incentivised to reduce the likelihood and severity of potential future claims through improved quality of work?

3.2 Measures to further mitigate builders' insolvency risk

In SIRA's guidelines and icare HBCF's processes, the measures currently in place to mitigate builders' insolvency risk are the eligibility assessments, the building contract review program[40] and premium pricing. The building contract review program is for builders that are new or are seeking to undertake more complex projects compared with their past experience. Builders are required to participate in a review program where they are provided assistance in project planning and ensuring that the project runs on time and according to budget - see Box 3.1.

37 Or if they die, disappear, or have their license suspended.
38 For example, LABC warranty https://www.labcwarranty.co.uk/blog/the-10-steps-you-need-to-take-to-get-a-structural-warranty/, accessed 19 March 2020;
39 It is likely to be cheaper for builders to undertake quality construction in the first instance, rather than having to amend their work subsequently after an inspection by the insurer.
40 The guidelines include a provision that licensed insurers may require contractors to meet additional conditions, such as participating in mentoring or review programs. SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, p 8.

Box 3.1 icare HBCF's building contract review program

The building contract review program is to assist builders that are either new to the building industry or are seeking to take on larger or more complex projects compared with their previous experience. It applies to projects that are above $50,000 and involves an authorised service provider[a]:

- reviewing contract documents to ensure that the project has been budgeted appropriately (including reasonable gross margins), and
- undertaking performance reviews, site inspections and ensuring that the project is running to budget and on time.

However, it is not a program where the authorised service provider examines the construction works to check compliance with building standards.

It is expected that builders will participate in the building contract review program at least three times before being permitted to contract for similar projects.

a A list of authorised service providers are available on the icare website below.

Source:https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/eligibility/building-contract-review-program/#gref, accessed 24 March 2020.

In terms of further measures to mitigate builder insolvency risk, such as builder progress payments, critical stage inspections[41] and issuance of compliance certificates[42] further mitigating builder insolvency risk, we note that:

- Delays in a builder receiving progress payments could result in cash flow problems for their business, which can increase the risk of insolvency.
- 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 hence increase their risk of insolvency.

Opportunities to include such information in eligibility conditions could be explored. For example, if critical stage inspections for a builder's projects regularly identify that certain works do not comply with development consents and legislative requirements, then conditions could be imposed on a builders' eligibility such as reducing their open job limits.

However, such an approach could limit the builder from undertaking new projects where a portion of the margins could be used to address issues identified from current or previous projects. This may cause the builder to go insolvent and trigger claims.

Alternatively, similar to the building contract review program, builders could be required to enter into a program where there is additional supervision if building issues identified

41 Under the Environmental Planning and Assessment Act 1979, accredited certifiers are required to carry out inspections during key stages of building work to determine compliance with legislative requirements (eg, building standards) and conditions of consent. They also take action to address non-compliant work and, if needed, report it to the appropriate authority, such as the local council. https://www.fairtrading.nsw.gov.au/trades-and-businesses/business-essentials/building-certifiers/certifier-responsibilities, accessed 13 March 2020.

42 A compliance certificate confirms that the completed building work complied with council, development and regulatory requirements. https://www.service.nsw.gov.au/transaction/apply-compliance-certificate, accessed 13 March 2020.

through inspections reach a certain threshold. Such a program could also help builders better manage any cashflow problems identified through information on builder progress payments.

IPART seeks comment on the following:

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

– How could enhanced information collection in relation to builder progress payments, critical stage inspections and issuance of compliance certificates be used to further mitigate builders' insolvency risk?

– Are licensed providers able to readily access information on builder progress payments, critical stage inspections and issuance of compliance certificates or would licensed providers be required to collect this information themselves?

– Could this information be used effectively in imposing conditions on builders' eligibility, either through reducing a builder's open job limit, or through a more light-handed approach by requiring that builders enter into a program with increased supervision?

– Are there other measures that should be implemented to mitigate builders' insolvency risk?

A Terms of reference

Effectiveness and efficiency of the Home Building Compensation Fund in NSW

The Home building compensation fund is established under the *Home Building Act 1989*. The scheme compensates homeowners if their builder is unable to complete building work or fix defects because of insolvency, death, disappearance or licence suspension for non-compliance with a money order made by a court or the tribunal in favour of the homeowner.

The scheme applies to residential building work projects over $20,000 (including GST) unless exempt, such as the construction of new houses, terraces, villas, multi-units up to three storeys in height, as well as home renovations and swimming pool building.

The scheme is regulated by the State Insurance Regulatory Authority (SIRA). The sole insurer currently offering cover under the scheme is Insurance and Care NSW (icare) on behalf of the NSW Self Insurance Corporation. Legislative amendments mean that since 2018, new providers can apply to SIRA for a licence to join the scheme.

The NSW Government is currently undertaking extensive work to reform the building and construction industry. The Building Commissioner has been appointed to lead the implementation of the reforms and advise Government on any additional reforms that may be needed to ensure better protections for homeowners and to lift building standards across NSW.

IPART review

I, Victor Dominello, Minister for Customer Service, pursuant to Section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992*, request that the Independent Pricing and Regulatory Tribunal (IPART) conduct an investigation in accordance with these 'terms of reference'.

Task

IPART should review the effectiveness and efficiency of the home building compensation fund in protecting consumers who are currently covered under the scheme.

In particular, IPART should investigate:

- the scheme's incentives for building industry participants to undertake good risk management and encourages 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 or administrative burdens and barriers to entry for building industry participants

In investigating and making recommendations on the scheme, IPART should have regard to:

a) the need for the scheme to provide an adequate level of protection to customers having regard to the other measures that are likely to contribute to the efficient and effective protection of customers

b) the need to encourage confidence in the market for construction of residential dwellings

c) the costs and benefits of any proposed changes to ensure an efficient and financially sustainable outcome

d) the coordinated approach by the NSW Government to fix the failures of the statutory warranty and home building compensation schemes

e) developments in other jurisdictions.

Procedure

IPART should undertake public consultation. IPART will consult stakeholders on the draft terms of reference and recommend final terms of reference to the Minister within six weeks of receipt of the draft.

A draft report should be publicly released for comment with a final report to be provided to the Minister for Customer Service within six months after finalisation of the terms of reference.

The Hon. Victor Michael Dominello, MP

B Overview of the Home Building Compensation Fund

Under the *Home Building Act 1989* (NSW), it is mandatory for builders to purchase insurance from the HBCF for residential building work projects over $20,000 (including GST) for the construction of new houses, terraces, villas, multi-units up to three storeys, swimming pools and home renovations. The scheme does not apply to high-rise apartments (over three storeys) and owner-builder homes.[43]

Builders are to first obtain eligibility with a licensed provider and then purchase a certificate of insurance, specific to the work being undertaken. This certificate must be provided to the homeowner before the builder commences work and accepts any money.

The HBCF compensates homeowners if their builder is unable to complete building work or fix defects because of insolvency, death, disappearance or licence suspension for non-compliance with a money order made by the NSW Civil and Administrative Tribunal or a court in favour of the homeowner. However, in the first instance homeowners are to seek compensation of non-completion of works or rectification of defects from their builder eg, using the statutory warranties available under the Home Building Act.[44]

Currently, the maximum amount covered is $340,000 and the period for claims are:

- Major defects – six years after completion of the work
- Non-major defects – two years after completion of the work[45]
- Non-completion of works – 12 months after failure to commence or cessation of the work.

Consumers can notify the provider upon becoming aware of incomplete or defective work in order to preserve their policy entitlements while pursuing the builder.

Currently, there is only one provider of home building compensation insurance in NSW – icare HBCF (which is operated by the NSW Government).[46]

Of the insurance certificates issued, a relatively small proportion have progressed to claims to date. Since 2010, about 500,000 certificates of insurance have been issued and about 2,700 claims have been made ie, about 0.5% - although, due to the 'long-tail' nature of home

43 However, for owner-builder homes the scheme does apply to contracted works undertaken by licensed trades people if the value of works is over $20,000.

44 The statutory warranty periods under the Home Building Act are six years for major defects and two years for non-major defects.

45 The insurance warranty claim periods for major and non-major defects are identical to the statutory warranty periods for major and non-major defects available under the Home Building Act.

46 Insurance and Care NSW (icare) provides the services and facilities of NSW Self Insurance Corporation (SICorp) under the *State Insurance and Care Governance Act 2015* (NSW). NSW SICorp is a statutory corporation constituted under the *NSW Self Insurance Corporation Act 2004* (NSW) and is responsible for carrying on the business of providing insurance under the HBCF under the *Home Building Act 1989* (NSW).

warranty insurance, it can take up to 10 years (given the insurance coverage period)[47] before the actual cost of a policy can be known.[48]

The scheme is regulated by the State Insurance Regulatory Authority (SIRA)[49], which also regulates workers compensation insurance and motor accidents Compulsory Third Party insurance in NSW. Its responsibilities include:

- implementing NSW Government reforms to the HBC scheme
- developing regulations and guidelines (eg, eligibility assessment guidelines, premium pricing guidelines)
- deciding whether to approve applications from private providers wanting to enter the HBC scheme, and
- reviewing the premiums that licensed providers intend to charge builders.[50]

SIRA also reports on the performance of the scheme (Box B.1) and upon request can conduct a regulatory compliance review for builders (if they are not satisfied with a decision about their eligibility for home building compensation cover) and home owners (if they are not satisfied about the way their claim was handled).[51]

Most jurisdictions in Australia have similar mandatory home warranty insurance schemes. However, in Queensland, its scheme is often referred to as a 'first resort' insurance scheme where it is possible for consumers to obtain compensation or rectification of works from the provider despite the builder not having gone insolvent.[52,53] In Tasmania it is voluntary to purchase home warranty insurance. We provide a jurisdictional comparison in Appendix F.

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47 If consumers have notified icare HBCF that there is a defect and the consumer diligently pursues the builder for rectification works, then consumers have up to 10 years after the completion of works to claim on their policy. https://www.icare.nsw.gov.au/builders-and-homeowners/homeowners/claims/ and icare HBCF, Policy of Insurance under Part 6 of the *Home Building Act 1989* (NSW), June 2018, p 2 (2.4 Maximum time limit for claims).

48 SIRA, Home building compensation report – Data tables, December 2018, Table 5 and Table 9.

49 SIRA is a statutory body and a NSW Government agency constituted under section 17 of the *State Insurance and Care Governance Act 2015.*

50 Sourced from "What is the role of the State Insurance Regulatory Authority in the HBC scheme?" – FAQs, https://www.sira.nsw.gov.au/resources-library/home-building-compensation-resources/publications/frequently-asked-questions-about-the-hbc-reforms-october-2017, accessed 10 March 2020.

51 Home owners can additionally apply for review to the NCAT or the District Court (where the amount involved exceeds the NCAT's $500,000 jurisdictional limit). https://www.sira.nsw.gov.au/disputes-and-complaints/home-building-compensation-disputes

52 In Queensland, the insurer (Queensland Building and Construction Commission, QBCC) requires homeowners to first notify the builder about defects, giving them a reasonable opportunity to provide rectification works. If the matter cannot be resolved through QBCC's dispute resolution process then the claim is considered. The QBCC will either payout the claim to the consumer or arrange for rectification works (from a separate builder). The QBCC will then recover its costs from the builder that caused the defect – if it is unable to do so, it will wear the cost https://www.qbcc.qld.gov.au/home-warranty-insurance/what-covered-how-do-i-make-claim, accessed 18 March 2020.

53 Differences between first and last resort schemes from a consumer perspective typically depend on how much effort insurers require consumers to undertake before paying out a claim. A first resort scheme can mean that consumers first notify the insurer of a defect, and then the insurer pays the claim to the consumer or arranges rectification works and then recovers the amount from the builder or wears the cost. However, such a scheme can become a last resort scheme if the insurer requires the consumer to pursue all options with the builder, and the insurer only provides compensation in the event that the consumer is unable to obtain compensation or rectification works from the builder.

Box B.1 Operation of the HBC scheme in 2017-18:

- There were about 78,440 certificate of insurance issued where new single dwellings accounted for 33%, alterations 24%, followed by renovations at 23%; multi-unit dwellings (up to three storeys) accounted for the least at 6%
- 30% of eligible builders have no projects under construction, while 5% are utilising more than 90% of their open job limit (the maximum value of works that a builder may be engaged in at any one time as set out in their eligibility conditions)
- The main trigger for claims were due to insolvencies – about 85% of claims
- Of the claims assessed since 2010, 76% have been accepted - the main reasons for rejected claims are: builder not insolvent (8%), not deemed a defect (5%), and out of time (3%)
- New single dwellings, alterations and new multi-unit dwellings (up to three storeys) accounted for the majority of claims, at 41%, 32% and 22% respectively
- Multi-unit dwellings (up to three storeys) had the highest average claim (around $50,000 per year to $150,000 per year in recent years) followed by alterations (around $50,000 per year to $100,000 per year in recent years)
- Average building contract values for new single dwellings were about $400,000 and for multi-dwellings (up to three storeys) about $275,000 per dwelling.

Source: SIRA, *Home Building Compensation scheme report*, June 2018; SIRA, *June 2018 – Home building compensation report Data Tables*, June 2018.

C Changes to the Home Building Compensation scheme over time

Home warranty insurance was first introduced in 1972 and was operated by the NSW Government. The scheme was opened to private providers in 1997, and HIH acquired a large portion of the market. However, HIH collapsed in 2001, and various reforms have been put in place since that have been aimed at maintaining the long term viability of the scheme. Many of these reduced the coverage of the scheme, although the maximum amount that can be claimed under the scheme has increased over time to reflect the increase in the cost of building works. Key changes have included:

- reducing the claim period from seven years (for all defects) to six years for structural defects and two years for non-structural defects (2002),
- moving from ‘first resort’ to ‘last resort’ scheme (2002),
- increasing the works threshold requiring insurance from $5,000 to $12,000 to $20,000 (2002 and 2012),
- exempting multi-unit buildings more than three storeys (2003), and
- removing insurance cover for owner-builders (2015).

More recently, significant reforms were implemented in 2018 so that the scheme could regain its financial sustainability and reduce its reliance on NSW Government funding, such as:

- commencing premium increases so that they would be at break-even levels by 2021
- implementing risk-based premiums so that builders’ specific characteristics (eg, business structure, level of financial capital invested in the business) could be incorporated in premium pricing, and
- removing broker commissions, which accounted for 15% of premiums.

The reforms also enabled private sector applicants to apply to SIRA to become a licensed HBC insurer or alternative product provider alongside icare HBCF. As a result SIRA is responsible for assessing premiums of licensees with the power to reject non-compliant premiums and issue guidelines with rules for assessing eligibility, premium setting and claims handling.

The various reforms over the years and key changes, including recent developments are highlighted in Figure C.1 below.

Figure C.1 Overview of key developments in home building insurance in NSW

1972 Home warranty insurance commences as a NSW Government operated first resort scheme with cover of $40,000.

1997 Opened to private insurers with all defects covered for 7 years with cover of $200,000 available for both defective and incomplete work.

2001 - 2003 As a result of the collapse of HIH Insurance (which had 30%-40% market share) and withdrawal of some insurers, reforms were undertaken to stabilise the industry in an attempt to ensure its long term viability:

- Home building insurance became a "last resort" scheme whereby consumers could only make a claim if the builder had died, disappeared or become insolvent
- Period of insurance cover was reduced from 7 years to 6 years for structural defects and 2 years for non-structural defects (the statutory warranty period was maintained at 7 years for all defects)
- Works threshold requirement for insurance was increased from $5,000 to $12,000
- Claim for non-completion of works was capped at 20% of the contract price
- In 2003, construction of multi-units above 3 storeys (and containing 2 or more dwellings) was exempted from mandatory home building insurance.

2007 - 2009

- The minimum cover provided under the scheme increased from $200,000 to $300,000 (1 March 2007)
- Fourth insurance claim trigger introduced – allows homeowners to claim on their policy if the builder's licence was suspended, by NCAT or a court, for failing to comply with a money order to compensate the homeowner (for policies issued from 19 May 2009).

2010 Following the withdrawal of all private insurers from the home building insurance market, on 1 July 2010 the NSW Self Insurance Corporation (NSW SiCorp) became the statutory monopoly provider of home building insurance.

2012

- Amendments were made to the Home Building Act to align the statutory warranty period of 7 years for all defects with the insurance cover periods of 6 years for major defects and 2 years for non-major
- Works threshold requirement for insurance was increased from $12,000 to $20,000
- The minimum cover provided under the scheme was increased from $300,000 to $340,000.

2015

- Owner-builders were exempted from mandatory home building insurance – required to include a warning that work is not insured under the home warranty insurance scheme, if sold within the statutory warranty period
- Definition of "structural defects" for the 6 year statutory warranty and insurance periods were replaced with a new concept of "major defect"
- The home warranty insurance scheme was renamed to the Home Building Compensation Fund to make clearer that the scheme was providing compensation to the consumer and that it was a "last resort" insurance product that was a safety net, rather than it being a "first resort" product where the consumer makes a claim to the insurer which then arranges payment or rectification of works from the builder.
- SIRA was established assuming the regulatory functions of Fair Trading in respect of the scheme
- icare HBCF was established to administer the Home Building Compensation Fund on behalf of NSW SiCorp

2017 - 2018

- NSW Parliament passes the Home Building Amendment (Compensation Reform) Act 2017, containing legislative elements of the NSW Government's reforms to the HBCF.
- icare HBCF commenced increasing premiums in April 2017 and introduced premium changes by implementing risk-based premiums and ending guaranteed broker commission (which were 15% of the premium) – further premium increases are expected to establish break-even premiums by 2021.
- On 1 January 2018, amendments to the Home Building Act commenced which enabled private sector participants to apply to SIRA to be a licensed home building compensation insurer, or alternative indemnity product provider.
- SIRA is empowered to undertake various functions such as assessing premiums of licensees including icare HBCF and given the power to reject non-compliant premiums; SIRA is also allowed to issue HBC insurance guidelines with rules for premiums and prudential requirements, builder eligibility, market practices and claims handling.

Source: Correspondence with SIRA, 29 January 2020.

D Builder eligibility and premium pricing

In this Appendix we provide further details on SIRA's guidelines for assessing builder eligibility and premium pricing. We also detail icare HBCF's actual processes.

D.1 SIRA guidelines – eligibility assessments and premium pricing

In 2017, SIRA undertook consultation to establish guidelines on how providers should assess builder eligibility and set premiums.[54] These guidelines[55] were established in 2018 and outline the principles that licensed providers are to adopt and minimum criteria[56] that should be used to assess builders.[57] Licensed providers are required to have manuals and adopt processes which comply with these guidelines.

We provide a summary of SIRA's principles for assessing eligibility and premium pricing in Box D.1 and Box D.2 below.

54 SIRA, Home building compensation premium guidelines – Discussion Paper, August 2017, p 4.

55 SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018; and SIRA, *Home building compensation (premium) insurance guidelines*, January 2018.

56 For example, financial requirements such as assets of the builder, annual turnover and non-financial requirements such as management structure, qualifications.

57 The guidelines also contain procedural matters eg, giving builders at least 30 days notice if the licensed insurer deems it necessary to restrict or revise a builder's eligibility etc.

Box D.1 SIRA – Home building compensation (eligibility) insurance guidelines

The primary purpose of HBC eligibility is to minimise the risk of loss to homeowners, licenced providers and the scheme. A contractor must be assessed against defined criteria in order to obtain HBC eligibility. Eligibility principles in the guidelines are:

- Eligibility criteria are fair and reflective of risk – an appropriate threshold should be set to identify unacceptable risks but not unreasonably restrict the ability of contractors to trade; contractors engaging in similar industries and business activities and hence sharing similar risk profiles should share similar eligibility characteristics and factors.
- Eligibility criteria and application are transparent – information about the licensed provider's eligibility model must be made publicly available, such as key criteria, assessment process and complaints and review process; each assessment must provide sufficient information and justification to ensure that a contractor understand the process and how their eligibility was determined.
- Eligibility is assessed reasonably – a contractor's capabilities, financial history, previous claims history, financial backing and level of external financial support should be considered; must balance a contractor's financial and non-financial risks while avoiding unreasonable inhibitions on contractors' ability to trade.
- Eligibility provides incentives for risk management and good business practices – provide incentives to reduce both the likelihood of severity of potential future claims through sound business practices, arrangements to support building work supervision and quality assurance, and financial backing; similarly, eligibility criteria should not drive adverse business practices or place undue restriction on business trading structures.
- Eligibility supports a strong and viable building industry – SIRA will consider the combined effect of the eligibility models for all licenced providers; it is important that cover is provided 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; reasonable access must be provided for new contractors entering the market; it is unacceptable to limit eligibility to only contractors that have previously entered into building cover contracts or requiring contractors to have long continuous trading histories.
- Eligibility supports a viable HBC market – SIRA will periodically assess the combined effect of eligibility models on the HBC market; if required, SIRA may consider additional regulatory options to support a viable and sustainable market such as a risk equalisation mechanism to share risks amongst licensed providers.

An eligibility model must be lodged at least once each year by each licenced provider unless SIRA allows the extension of the licenced provider's existing model. SIRA will assess whether the eligibility model complies with SIRA's guidelines and relevant legislation.

Source: SIRA, Home building compensation (eligibility) insurance guidelines, January 2018.

We provide a summary of SIRA's premium pricing principles in Box D.2 below.

Box D.2 SIRA – Home building compensation (premium) insurance guidelines

Licensed provider premiums are required to demonstrate the following principles:

- Premiums are fair and reflective of risk – should reflect contractors' level of risk; contractors that engage in similar industries, business activities and share similar risk characteristics should have similar premium rates; the licensed provider must show that its proposed target average premium rate for a particular cohort fairly reflects the expected claims cost, expenses and suitable profit margin for that cohort.
- Premiums should not be excessive or inadequate – premiums should not be excessive or inadequate; they should be affordable (relates to the impact on the NSW economy).
- Premiums should not be unreasonably volatile – should not be unreasonably volatile year on year; licensed providers must demonstrate that premium movements reflect changes in the actual or perceived level of industry and contractor risk.
- Premiums should provide incentives for risk management and good business practices – should provide incentives for contractors to improve business practices thereby reducing both the likelihood and severity of potential future claims; contractors may be offered discounts or loadings on premiums based on the licensed provider's risk management practices; discounts/loadings must conform with the first three principles above and should be designed to extent possible to generate incentives to reduce the level of risk (discount/loadings must be within ±50%.
- Premiums to be consistent with licensed provider's capital requirements – licensed providers are required to have a capital management plan and premiums must be consistent with the approved plan; in setting premiums, licensed providers must comply with NSW Government competitive neutrality principles.

The risk factors that licensed provider use (eg, contract value, construction type, location of premise, specific contractor risk factors such as business structure and adjusted net tangible assets in the business) must be approved by SIRA. SIRA will assess a licensed provider's proposed premiums against the premium guidelines and relevant legislation.

Source: SIRA, Home building compensation (premium) insurance guidelines, January 2018.

Currently, there is only one provider of home building insurance in NSW – icare HBCF. We outline below its processes for assessing eligibility and setting premiums.

D.2 icare HBCF's approach to eligibility assessments and premium pricing

Eligibility assessments

icare HBCF's approach to assessing eligibility is set out in its eligibility manual with the actual assessment outsourced to a third party provider – Corporate Scorecard (icare HBCF's Eligibility Risk Manager). The manual is reviewed and updated regularly and also incorporates learnings from claims data. icare HBCF requires builders to obtain eligibility through approved HBCF brokers[58], who ensure that complete and accurate information is submitted to the Eligibility Risk Manager.[59]

icare HBCF's approach to assessing the eligibility of builders involves examining a builder's financial performance, equity exposed to their building operations, technical capability and history. It also involves examining the past performance and experience of principals and key managers[60], along with checks to identify possible previous adverse associations.[61]

Builders are granted eligibility for a duration of 1 to 3 years at a time[62] and there are conditions imposed:

- types of construction and maximum contract price for which insurance will be provided under the scheme – generally consistent with their history, skills, building licence conditions and experience, and
- the number and total value of projects that the builder is allowed to have at any point in time ('open job limits') – determined by the financial strength of the business, personal financial position of the directors/partners together with the building expertise of the principals.

Builders are typically subject to annual eligibility reviews, with the exception of certain small builders classified as System Reviewed Small Builders[63] (builders who are approved for construction work up to $3 million, the smallest works threshold, and are not approved for construction of multi-units up to 3 storeys).[64] For these small builders, their eligibility is automatically renewed, but they may be subject to special eligibility reviews if they seek to change their builder profile to undertake more complex projects.[65]

Where builders are assessed as "high risk", their eligibility application:[66]

58 Brokers may charge a fee for their service. Previously, a 15% commission was included in the insurance premiums but this was removed as part of the 2017 reforms (moved to a fee for service model). https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/what-we-do/#gref, accessed 2 April 2020.

59 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/what-we-do/ accessed 13 March 2020.

60 Key managers include anyone who directs the critical decision making of the builder business, or is likely to exert influence based on essential experience they hold, on the business.

61 Checks of adverse associations are undertaken through ASIC, NSW Fair Trading licensing register, abr.business.gov.au and Mercantile Agency or equivalent, including a full director's history extract on each director and nominated supervisor.

62 Within the above period, builders may be subject to annual eligibility reviews. Builders are typically subject to a review before their eligibility is renewed with the exception of builders classified as System Reviewed Small Builders, who are generally not subject to annual reviews and their eligibility is automatically renewed for a further period of up to 3 years.

63 There are 6 categories of builders (new builders, system reviewed small builders, small builders, medium builders, major non project home builders and major project home builders). The System reviewed small builders have the smallest approved open job values (typically <$3 million) with major builders having the largest (typically >= $10 million).

64 However, they may do alterations and renovations on multi-units up to $1.5 million. icare HBCF, Eligibility manual, March 2020, pp 19-20 and https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/eligibility/eligibility-guidelines/

65 Icare HBCF, Eligibility manual, March 2020, p 29.

66 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/eligibility/eligibility-guidelines/#gref, accessed 2 April 2020; Icare HBCF, Eligibility manual, March 2020, pp 13-14,

- may be declined – eg, arising from business closures or insolvencies involving the directors or key managers in the past 5 years there have been losses to creditors, HBCF claims or NCAT orders, current winding-up petitions by creditors or
- have special conditions imposed – eg, increasing capital levels, providing specified levels of security, and participating in a building contract review program (BCRP) – see Box D.3 below.

Box D.3 icare HBCF's Building contract review program

The Building contract review program is to assist builders that are either new to the building industry or seeking to take on larger or more complex projects compared with their previous experience. It applies to projects that are above $50,000 and involves an authorised service provider:

- reviewing contract documents to ensure that the project has been budgeted appropriately (including reasonable gross margins)
- undertaking performance reviews, site inspections and ensuring that the project is running to budget and on time.

However, it is not a program where the authorised service providers examine the construction works to check compliance with building standards.

It is expected that builders will participate in the BCRP at least three times before being permitted to contract for similar projects.

Source:https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/eligibility/building-contract-review-program/, accessed 13 March 2020 and Icare HBCF, Eligibility manual, March 2020, p 65.

Premium pricing

Once builders have obtained eligibility, they are charged a risk-based insurance premium when they purchase a certificate of insurance[67], specific to the project they are undertaking.[68]

The premium comprises:

- a base component which uses information about the type of project (eg, construction of a dwelling or renovations)[69], the total contract value and the location of the project[70],
- a risk based loading/discount – which is based on the specific builders' characteristics (see below), and

67 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/what-we-do/, accessed 13 March 2020.

68 Builders may purchase certificates of insurance through a broker or directly from icare via their 'builder self-service portal' https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/builder-self-service-portal/, accessed 13 March 2020.

69 There are 9 different construction types that cover construction of new homes, multi-units (up to 3 storeys), alterations, renovations and swimming pools. https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/, accessed 13 March 2020.

70 Icare HBCF provides the postcodes which are deemed as 'regional' for pricing purposes and attract a 20% discount compared to metropolitan areas. Sydney, Newcastle and Central Coast are defined as 'metropolitan' and other areas as 'regional'. https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-calculator/ accessed 13 March 2020, and https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/, accessed 13 March 2020.

- a brokerage fee.[71]

The builders' individual loading or discount rate is based on HBCF insurance claims data and reflect that certain factors have a greater potential to increase or decrease the incidence of insolvency. For example:

- incorporated entities (companies) have been found to have a significantly greater frequency of claims over sole traders and partnerships – hence companies attract a loading whilst sole traders and partnerships attract a discount
- builders that have a higher adjusted net tangible assets (ANTA)[72] in the business as a percentage of forecast revenue, have a lower frequency of insolvency – hence, builders that meet or have a higher 'ANTA to forecast revenue ratio' of 3% will attract a discount whilst those that have less than 3% will attract a premium
- those that have generated strong net margins for each of the past 3 trading years have a low likelihood of insolvency and so attract a discount
- builders that participate in the BCRP also attract a discount.[73]

The base premium component ranges from 0.31% (for renovations) to 2.74% (for new multi-unit constructions up to 3 storeys) of the contract value and the individual builder's loading or discount is capped at ±30%.[74] For example, for a new single dwelling construction in Sydney with a contract value of $300,000, the base premium is currently $3,417 and then depending on the individual builder's loading, it can range from $2,392 (with a 30% discount) to $4,442 (with a 30% loading).[75] Additional service fees may be charged by a builder's broker which the builder may pass onto homeowners.

In 2017, reforms were undertaken so that premiums would be set on a risk-adjusted basis to reflect individual builder's risk and be set on a break-even basis by 2021 – see Box D.4 below. The premiums were subsidised since 2010 when the NSW Government resumed operation of the home warranty insurance scheme.

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71 Brokers may additionally charge a fee for their services.

72 ANTA – represents the net fire sale position of the business: assets less third-party liabilities. It is viewed as a buffer available to the builder to withstand normal business disruptions or shocks such as a dispute with a homeowner over a progress payment, seasonal issues such as building industry shut down errors and unfavourable variances in pricing, costs and overhead expenses. icare HBCF, HBCF eligibility manual, March 2020, p 34.

73 Icare HBCF, Risk factors impacting icare HBCF premiums, May 2019 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/#gref, accessed 12 March 2020.

74 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/, accessed 17 March 2020.

75 https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-calculator/#gref, accessed 19 March 2020.

Box D.4 Recent reforms to insurance premiums

In 2017, reforms were implemented to the HBCF so that the scheme could regain its financial stability and reduce its reliance on NSW Government funding. The premium increases are so that the scheme can meet the expected costs of future claims from new policies issued, not the potential claims cost from previously issued policies which comprise $583 million of the existing deficit of $650 million.

icare HBCF's first premium rate changes were implemented in April 2017, with subsequent increases over 2018 and 2019. Excluding multi-unit dwellings (up to 3 storeys), the resulting premium rates range from 0.38% to 1.14% of the contract works for renovations and new single dwellings, respectively.

For multi-unit dwellings the increases have resulted in the construction of multi-unit dwellings having the highest premium rate of 2.74% but these construction types will face further increases so that premiums reflect expected costs – based on claims data, multi-unit dwellings have been assessed as the highest risk. To manage the impact on building activity for these construction types, additional increases will be staged over another two year period:[a]

- Multi-unit alterations are proposed to increase by 158% so that premiums would be 3.77% of the contract value
- Multi-unit renovations are proposed to increase by 130% so that premiums would be 1.68% of the contract value
- Multi-unit constructions (up to 3 storeys) are proposed to increase by 75% so that premiums would be 4.79% of the contract value – the highest rate.[b]

Risk-based loadings/discounts were also introduced in addition to the above changes in base premiums, to reflect an individual builder's level of risk. These range from ±30% and are applied to the base premiums.

Also, as part of the reforms guaranteed commissions to brokers were removed from the premiums, which resulted in premiums reducing by 15 per cent. However, brokers are able to charge builders a fee for the services they provide.

a Subsequent increases were expected in January 2020, July 2020 and January 2021.

b These rates are for metropolitan areas. A 20% discount is applied to rural areas.

Note: The premium rates above include GST and stamp duty and are for metropolitan areas (Sydney, Newcastle and Central Coast).

Source: https://www.icare.nsw.gov.au/builders-and-homeowners/builders-and-distributors/premiums/premium-rates/#gref

E icare's HBC claims process for homeowners

Role of the homeowner

Check validity of HBC cover

Homeowners should check:

- If they have valid HBC cover for the defective work
- Who the HBC provider is (if policy written before 1 July 2010).
- That they are within the relevant claim notification period.

Notify the HBC provider of a loss

Homeowners should complete and lodge a loss notification form before commencing dispute resolution with the builder or NSW Fair Trading to protect their warranty period.

Take all possible steps to resolve dispute with builder

If the builder has not died, disappeared, or gone insolvent, homeowners should take all appropriate actions to have the builder address the defect or incomplete work. This includes lodging a complaint with NSW Fair Trading or the NSW Civil and Administrative Tribunal or the relevant court.

Complete a HBC claim form and provider supporting information]

This is a 10-page form that requests details including:

- Builder contact and licence details
- HBC insurance and certificate details
- Proof of steps taken to locate the builder
- Building contract and payments made to the builder or property purchase details (if property was purchased before defect occured)
- Description of defect and cost to rectify
- Any other proceedings ongoing.

Role of the claims manager

Claims manager assesses whether claim is valid

The claims manager decides whether the necessary conditions have been met to trigger the policy and whether any endorsements or exclusions apply.

Claims manager assesses liability under the claim

The claims manager commissions a technical report on the defect to assess the cause, references to breaches of code or standard, scope of rectification work required and cost.

Claims manager provides homeowner with a written decision

The claims manager makes a decision and provides the homeowner with written reasons for its decision.

Claim is settled

icare settles the claim by engaging a builder to rectify the defect and making progress payments on behalf of the homeowner.

Source: Icare, *HBCF Claims Information for Homeowners*, version 2.4, March 2020.

F Comparison of different schemes across jurisdictions

We provide in Table F.1 below a comparison of home warranty schemes across Australia. Most of them are similar in that they are last resort schemes (with the exception of Queensland) and do not provide cover for multi-unit apartments over 3 storeys.

Table F.1 Comparison of home building compensation schemes across Australia

	NSW	QLD	VIC	WA	SA	NT	ACT
Provider	Government (icare HBCF) Open to private insurers or alternative indemnity product providers.	Government monopoly (QBCC)	Government (VMIA) and private insurers (AssetInsure and Berkshire Hathaway Speciality Insurance) [m]	Private insurers (QBE, AOBIS) with Government reinsurance [h]	Private insurer (QBE) with Government reinsurance.	Fidelity fund scheme (Master Builders Fidelity Fund)	Fidelity fund scheme (Master Builders Fidelity Fund)
First resort or last resort	Last resort	First resort [a]	Last resort	Last resort	Last resort	Last resort	Last resort
Value of work above which insurance is required	$20,000	$3,300	$16,000	$20,000	$12,000	$12,000	$12,000
Insurance cover amount	$340,000 (covering both non-completion and defects) [b]	Prior to completion $200,000, post completion $200,000; additional cover can be purchased to increase the 'prior' and 'post' completion claims to $300,000 each	$300,000 (covering both non-completion and defects)	Up to $100,000 for non-completion or defective work. Up to $20,000 for loss of deposit.	$150,000 [g]	NT Fidelity Fund provides $200,000 for non-completion and defects	$85,000

	NSW	QLD	VIC	WA	SA	NT	ACT
Period of cover	Major defects: 6 years Non-major: 2 years Non-completion: 12 months	Structural defects: 6.5 years Non-structural: 6 months Non-completion: 2 years	Structural defect: 6 years Non-structural: 2 years	6 years	5 years	Structural defect: 6 years Non-structural: 1 year	5 years
Owner-builder coverage	Excluded but can be purchased from private providers[i]	Excluded [k] but can be purchased from private providers[l]	Included	Included[c]	Excluded[d] but can be purchased from private providers	Included[e]	Excluded [f] but can be purchased from private providers [j]
Coverage for multi-units more than 3 storeys	Excluded from 2003	Excluded 2002	Excluded from April 2002	Excluded from April 2002	Excluded from September 2002	Excluded	Excluded

a If a complaint through QBCC's dispute resolution cannot be resolved the claim is paid out (as long it meets the necessary criteria - is within the warranty period etc).

b This is currently the only product offered in NSW. However, there are provisions to provide two policies of insurance: one offering at least $340,000 cover for the construction period; and a second policy offering at least $340,000 of cover for the warranty period.

c https://www.commerce.wa.gov.au/building-and-energy/home-indemnity-insurance-owner-builders

d https://www.sa.gov.au/topics/planning-and-property/land-and-property-development/engaging-building-industry-professionals/building-indemnity-insurance, https://www.aobis.com.au/our-insurance/owner-builder-warranty-in-saqldact/

e https://nt.gov.au/property/building-and-development/build-or-renovate-your-home/residential-building-insurance/fidelity-fund-certificate

f https://www.planning.act.gov.au/build-buy-renovate/for-industry/requirements/owner-builder-responsibilities

g https://www.safa.sa.gov.au/SAicorp/building-indemnity-insurance

h https://www.commerce.wa.gov.au/building-and-energy/external-links-0

i https://www.buildsafe.com.au/owner-builders/owner-builder-home-warranty-insurance-nsw/

j https://www.aobis.com.au/our-insurance/owner-builder-warranty-in-saqldact/

k https://www.qbcc.qld.gov.au/buying-existing-home/buying-or-selling-owner-built-property

l https://www.aobis.com.au/our-insurance/owner-builder-warranty-insurance-qld/

m ESC, *Victoria's domestic building insurance scheme – performance report 2018-19*, November 2019, p vi.

Source: Correspondence with SIRA, 29 January 2020 and IPART analysis.

UK home building insurance

In the UK it is not mandatory for builders to purchase home building insurance for residential construction work.[76] This means there is substantial variation in the cover provided between different products.[77]

However, developers[78] almost always purchase home building insurance for their new builds.[79] This is because when providing mortgages for new homes, banks require that the homes have home building insurance - hence, it might be difficult for developers to subsequently sell new homes if home building insurance has not been purchased for it.

In order for insurance to be obtained on a new home, the builder is typically required to build to the insurance provider's requirements. These often exceed the minimum requirements set out in building regulations.

Home building insurance typically has a coverage period of 10 years where it is split into two periods from the time the project is completed. If defects that become evident in the first two years, the builder must rectify defects and home owners are required to pursue the builder to remedy defects.[80] During the first two years, if the builder fails to remedy the defect, then the insurer typically provides dispute resolution services.[81] If a consumer is not satisfied with the outcome or if a builder fails to remedy the defect then consumers are able to pursue the matter in court.[82] Some insurers will guarantee to rectify the defects if the builder fails to do so.[83]

For defects identified in years 3 to 10 the insurer will provide a remedy. Non-completion cover is also typically included (or can be purchased as additional cover[84]) eg for instances when builders fail to complete work due to insolvency. For example, the largest of the UK home

76 UK Ministry of Housing, Communities & Local Government, *Redress for purchasers of new build homes and the new homes ombudsman – a technical consultation*, June 2019, pp 10-11.

77 UK Ministry of Housing, Communities & Local Government, *Redress for purchasers of new build homes and the new homes ombudsman – a technical consultation*, June 2019, pp 9-10.

78 The developer may also be the builder. If they are not, then it is in the interest of the developer to ensure that home building insurance is taken out for the new build and that their builder complies with the requirements of the insurer when constructing – this is so that the developer does not face difficulties in selling the new home once completed.

79 Home owners can also optionally purchase home building insurance for renovations eg https://renovationinsurancebrokers.co.uk/knowledge-base/structural-warranty/, accessed 25 March 2020.

80 Defects can be defined as a failure to construct according to the insurer's building requirements eg, http://www.nhbc.co.uk/Homeowners/WhatdoesBuildmarkcover/, accessed 24 March 2020.

81 In accordance with the industry led-code for home warranty bodies. There are various Codes and they set out builder requirements, and the protections that insurers will provide consumers.

82 House of Commons Library, *New-build housing: construction defects – issues and solutions (England)*, August 2019, pp 13-14.

83 http://www.nhbc.co.uk/Homeowners/WhatdoesBuildmarkcover/, accessed 24 March 2020; and https://www.labcwarranty.co.uk/media/4212/labc-warranty-showhome-brochure-v8.pdf, accessed 24 March 2020.

84 LABC Warranty offers non-completion cover as an additional cover, whereas non-completion cover is included in NHBC's home building insurance. https://www.labcwarranty.co.uk/media/4197/labcw-ipid-new-quotation-nh-v12-q51d.pdf, accessed 25 March 2020;

building insurers, National home building council (NHBC) [85] provides coverage of 10% of the original purchase price (capped at £100,000 (or $200,000 AUD)).[86]

Similar to NSW, concerns around building quality and whether there is adequate consumer protection from home building insurance has been subject to numerous debates and reviews over the years in the UK. [87] A review undertaken by the Office of Fair Trading concluded that whilst home building insurance in the UK is not perfect, it is relatively robust. However other reviews have found that:

- Consumers believe that home building insurance cover more than they actually do. Many are not aware that they have to pursue builders for remedy of defects within the first two years of the home building completion.
- More defects could be avoided if insurers conducted more construction inspections, and more thorough inspections. It was found that insurers carry out construction inspections on a sampling basis only – the average home building insurance is £300 (or $600) for a 10-year policy which is not sufficient to enable the insurer to do a substantial number of checks.
- Poorly performing builders can avoid accountability by 'code-hopping'. This means that when builders are excluded from one industry-led code because of poor performance, they can choose a different insurance provider aligned with a different Code.

The UK is further considering measures to improve their home building market such as:

- Minimum standards of cover and levels of protection
- An easier form of redress for consumers through a New Homes Ombudsman
- Higher profile marketing by insurance providers and builders during the conveyancing process to make clear what the insurance covers.

85 https://hoa.org.uk/advice/guides-for-homeowners/i-am-buying/new-home-warranties-cover/, accessed 24 March 2020.

86 http://www.nhbc.co.uk/Homeowners/WhatdoesBuildmarkcover/, accessed 24 March 2020. Exchange rate 1GBP = 2AUD as at 24 March 2020.

87 House of Commons Library, *New-build housing: construction defects – issues and solutions (England)*, August 2019, pp 16-18.

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