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Home building compensation in NSW

Dear Jessica,

I would like to make a submission in response to the *Review of the Efficiency and Effectiveness of the NSW Home Building Compensation Fund: Draft Report*.

Benefits of first resort insurance offered by a one-stop-shop

A recent analysis by the Master Builders of NSW identified both Victoria and Queensland as having well performing regulatory systems (against a range of metrics). The analysis concluded that this is because:

- Regulation is delivered by independent building authorities
- There is one senior Minister responsible
- Both have regulatory frameworks in place for both engineers and architects and building designers
- Both have a Building Act that consolidates a range of building regulation into a single Act.¹

The key difference between the two jurisdictions appears to relate to home warranty insurance – in terms of its administration (government administered as part of a ‘one stop shop’ vs private) and coverage (first vs last resort).

¹ Master Builders Association of New South Wales 2019, *Build Better - A blueprint for delivering better building outcomes in New South Wales*.

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.

The Master Builders analysis found:

The most significant better building outcomes were derived by the QBCC who also administers Queensland's home building compensation scheme...the best building outcomes are achieved from having the regulator as the same entity providing home building compensation. As both the regulator and HWI provider the QBCC is incentivised to ensure that claims costs are minimised via its compliance, dispute resolution and audit inspection activities (MBANSW 2019).

The Productivity Commission in 2007 found that the Queensland system is 'generally seen as working well' and that 'one of the main strengths of Queensland's consumer protection system for the home building sector is that there are linkages between a builder's performance — in terms of the history of claims against him or her — and consideration of ongoing registration. Such a system will seemingly provide stronger incentives for builders to avoid having claims made against them, and to rectify legitimate complaints'.²

Such a system operated in Victoria until the 1990s (the Housing Guarantee Fund):

It was a single organisation that basically did the lot — it was a one-stop shop. It essentially looked after builder registration, the registration of all properties that were built, all works that were guaranteed, so that you knew what your liabilities were, the processing of complaints and claims, making payments and recoveries...that is how the whole system hung together...so you had your registration, you had your insurance, you had your claims, you had everything that people could go to. Today it appears that it is totally fragmented.³

According to the former CEO of the HBF:

When insurers take the full risk of warranty up front, it results in high premiums. However, with only one warranty body, the approach can be totally different. The body recognizes that claims are endemic to the building industry and that, each year, it will pay out significant sums in claims. Rather than treat this as insurance, it is treated as a 'working loss' and a fund is created to pay these inevitable claims. The only way this system functions properly is the concept of a financial guarantee of a builder's performance, not insurance. This body should have the right to reject candidate builders in the first instance...should a member builder's workmanship be unacceptable, the Warranty Body must have the power to...review the builder's licence or registration.⁴

A move to first resort would also complement the more proactive regulatory stance taken by the NSW Building Commissioner.

² Productivity Commission 2007, *Review of Australia's Consumer Policy Framework, Draft Report*, Canberra, p.102.

³ Stokes, M. 2010 - evidence to the Standing Committee on Finance and Public Administration - Inquiry into builders warranty insurance Melbourne.

⁴ Ibid.

The most likely Taylor Fry scenarios

In terms of the scenarios, it seems reasonable to assume that – should NSW adopt the Queensland model (a ‘one stop shop’ combined with first resort insurance) – over time NSW should achieve some or all of the premium outcomes experienced under the Queensland model (*ceteris paribus*). This suggests that the most likely of the options are:

- Scenario 1: NSW reduces claims costs to the level observed in Queensland. Expenses are in line with the Queensland scheme.
- Scenario 4: NSW reduces claims costs by 25%. Brokerage is removed.

This also seems to be what Taylor Fry imply are the most likely scenarios (by selecting these two to highlight in their conclusion of the section). It would be useful to have Taylor Fry undertake monte carlo analysis on all the variables that make up the scenarios to determine the most likely range (stochastic modelling). Understanding the potential distribution of outcomes would be more informative than the deterministic approach.

Potential savings from moving to first resort offered by a one-stop-shop

IPART in making its decision should consider the societal costs and benefits of the base case (existing situation) and the most likely of the first resort scenarios modelled by Taylor Fry. This would enable a more informed decision around the best way forward.

To assist the Inquiry, I have undertaken some preliminary, ‘back of the envelope’ estimates (using some assumptions and proxies where there are data gaps) of the most significant savings from moving from the base case to Scenario 1.

Please note that these are not exhaustive and should be treated with caution – for example they do not include:

- the cost to consumers of participating in dispute resolution (e.g. the time cost)
- the impact of potential market instability under the existing scheme
- the impact on HWI premiums under a post-COVID scenario of increased insolvencies.

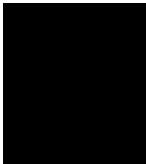
Even so, the analysis suggests annual savings of around \$93 million in terms of premium reductions, and savings to Fair Trading and NCAT from no longer handling disputes. The table below shows the initial estimates.

Area	Amount (\$) p.a.	Source and assumptions
Reduction in premiums	\$84,000,000	<ul style="list-style-type: none"> HBC certificates 2019 (70,000) - Taylor Fry, p.17 Per policy saving from moving to first resort (\$1,200) - Taylor Fry, p.6
Savings to Fair Trading from no longer handling disputes	\$5,814,000	<ul style="list-style-type: none"> NSW Fair Trading disputes (mid point) per year (2,250) - Taylor Fry, p.41 Cost for Fair Trading to resolve building dispute (\$2,584) - Proxy from Victoria - allocation of building permit levy revenue in 2019 to CAV to resolve disputes (\$16.8m), divided by forecast annual number of disputes to be handled by Domestic Builder Dispute Resolution Victoria (6,500) - Victorian Building Authority 2019, <i>Annual Report 2018-19</i>, p.107, Hall & Partners 2016, <i>Domestic Building Dispute Resolution Victoria Demand Estimates & Dispute Experiences</i>. p.14
Savings to NCAT from no longer handling disputes	\$3,203,400	<ul style="list-style-type: none"> NCAT home building finalisations 2018-19 (2,810) - NCAT <i>Annual Report 2018-19</i>, p.35 Cost to NCAT to hear building disputes - Proxy from Victoria VCAT (the fee charged to corporates reflects the full cost to VCAT of hearing disputes (corporate and non corporate) for claim or payment amount between \$100k - \$500k) (\$1,140) - source VCAT website: https://www.vcat.vic.gov.au/case-types/building-and-construction/apply-building-and-construction, and <i>Victorian Civil and Administrative Tribunal (Fees) Regulations 2016: Regulatory Impact Statement</i>.
Total	\$93,017,400	

Managing the transition

The Draft Report suggests that a move to first resort is not favoured because of transitional issues (and the resultant risk of premium increases). Given the ‘size of the prize’ (\$93 million) could I suggest that further consideration be given to how this risk might be mitigated, for example: learn from Queensland, use the regulatory ‘sandbox’, adopt a staged approach – bring some builds across to the new system in a staged approach/give consumers a choice.

Yours sincerely



Travis Ahearn
Director