



HOUSING INDUSTRY ASSOCIATION



Submission to the
Independent Pricing and Regulatory Tribunal

Review of the Effectiveness and Efficiency of the NSW Home Building Fund

1 June 2020

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contents



ABOUT THE HOUSING INDUSTRY ASSOCIATION	III
1. EXECUTIVE SUMMARY	4
1.1 HOME BUILDING AMENDMENT (COMPENSATION REFORM) ACT 2017	4
2. THE ECONOMY & THE RESIDENTIAL BUILDING INDUSTRY	6
3. BUILDING REFORMS TO DATE.....	8
3.1 PAST REFORMS	8
3.2 CURRENT AND FUTURE REFORMS.....	9
4. THE NEED FOR A COMPETITIVE MARKET	10
4.1 A REDESIGNED INSURANCE PRODUCT.....	11
4.2 FIDELITY FUNDS.....	12
4.3 DEFECT WARRANTY PERIOD.....	12
4.4 THE CURRENT INSURER OF THE SCHEME	13
4.5 VOLUNTARY HOME WARRANTY INSURANCE.....	14
5. OTHER PROPOSALS.....	14
6 RESPONSES TO QUESTIONS POSED IN THE PAPER	15

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ABOUT THE HOUSING INDUSTRY ASSOCIATION

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry, including new home builders, renovators, trade contractors, land developers, related building professionals, and suppliers and manufacturers of building products.

As the voice of the industry, HIA represents some 60,000 member businesses throughout Australia. The residential building industry includes land development, detached home construction, home renovations, low/medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA members comprise a diversity of residential builders, including the Housing 100 volume builders, small to medium builders and renovators, residential developers, trade contractors, major building product manufacturers and suppliers and consultants to the industry. HIA members construct over 85 per cent of the nation's new building stock.

HIA exists to service the businesses it represents, lobby for the best possible business environment for the building industry and to encourage a responsible and quality driven, affordable residential building development industry. HIA's mission is to:

"promote policies and provide services which enhance our members' business practices, products and profitability, consistent with the highest standards of professional and commercial conduct."

The residential building industry is one of Australia's most dynamic, innovative and efficient service industries and is a key driver of the Australian economy. The residential building industry has a wide reach into manufacturing, supply, and retail sectors.

The aggregate residential industry contribution to the Australian economy is over \$150 billion per annum, with over one million employees in building and construction, tens of thousands of small businesses, and over 200,000 sub-contractors reliant on the industry for their livelihood.

HIA develops and advocates policy on behalf of members to further advance new home building and renovating, enabling members to provide affordable and appropriate housing to the growing Australian population. New policy is generated through a grassroots process that starts with local and regional committees before progressing to the National Policy Congress by which time it has passed through almost 1,000 sets of hands.

Policy development is supported by an ongoing process of collecting and analysing data, forecasting, and providing industry data and insights for members, the general public and on a contract basis.

The association operates offices in 23 centres around the nation providing a wide range of advocacy, business support including services and products to members, technical and compliance advice, training services, contracts and stationery, industry awards for excellence, and member only discounts on goods and services.

1. EXECUTIVE SUMMARY

Following a direction issued by Minister Victor Dominello, Minister for Customer Service, in April 2020 the Independent Pricing and Regulatory Tribunal (IPART) released its Issues Paper (the Paper) into the Review of the effectiveness and efficiency of the NSW Home Building Compensation Fund (Fund).

HIA provides these submissions in response to the Paper.

Under the *NSW Home Building Act 1989* (HBA) a contractor must have in place home warranty insurance for any residential building work over \$20,000.

The Fund compensates homeowners if the builder they have contracted with is unable to complete the building work or fix defects because of insolvency, death, disappearance or licence suspension.

When undertaking this review the role of the Fund should not be confused with the broader consumer protection framework in place in NSW. The Fund operates as somewhat of a safety net and to promote the scheme to something beyond that creates a barrier to real reform. It is not the role of the Fund to resolve disputes between sellers and consumers, but to shield consumers from the full consequences of a failure by the supplier to meet their legal obligations.

This arrangement does not apply to any other industry of the economy.

The effective, efficient and sustainable operation of the Fund is vital to the residential building industry. As a quasi-regulator, the Fund significantly impacts the operations of individual builders, the level of residential building activity as well as housing affordability. Yet the Fund continues to be regulated in a way that will lead to premium increases and further entrench its operations within Government.

The most recent opportunity to redress the current state of the Fund fell well short and history shows that *tinkering around the edges* of warranty insurance reform has little tangible impact on the long term viability of the scheme.

This IPART review provides another opportunity to reform the Fund to ensure its future sustainability. HIA would urge IPART and the Government not to waste it. It is clear that the Fund is still in need of significant change.

As HIA has previously submitted and continues to advocate, the two most vital reforms that need to be implemented to secure the long term viability of the Fund are firstly a redesign of the warranty insurance product that is being offered, so that there is a shortened exposure period for major defects. Secondly, the Fund needs to return to the commercial insurance market. Without a return to the private market, the scheme will continue to make a loss and will continue to be a burden to the NSW taxpayer.

1.1 HOME BUILDING AMENDMENT (COMPENSATION REFORM) ACT 2017

The Minister, in the second reading of the *Home Building Amendment (Compensation Reform) Bill 2017* stated the legislative intent of the reforms that were being introduced:

The reforms in this bill introduce a modern, fit-for-purpose home building compensation scheme. The existing scheme is an old-fashioned, loss making, unsustainable government monopoly. The future system will be risk-based, self-funding, sustainable, innovative and competitive.

The 2017 reforms failed to achieve its key objectives of:

- Returning the scheme to breakeven;



- Preventing premium increases; and
- Attracting private insurers into the market for warranty insurance.

In HIA's view this is because the Fund remains unattractive to private insurers due fundamentally to the following five factors:

1. High minimum insurance cover

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

This approach acts as a significant disincentive to private insurers seeking to provide innovative and alternative solutions. It is clear that no reputable insurer has found a split product option attractive under this scenario. It is not commercially viable.

2. Long defects tail

The length of the defects tail provided by the Fund is too long, presenting an unacceptable and difficult to quantify risk to the private sector.

The warranty period needs to be shortened to three years. There needs to be a maximum three year mandatory tail period for defective work where the contracted builder is insolvent, dead or disappeared or has failed to respond to a court order for the rectification of defects. A product for an additional three years (and potentially a further 3 years after that) could be made available voluntarily and purchased directly by the consumer.

Also problematic is section 103BC of the HBA which provides that a claim in respect of the loss can be made to the insurer within 10 years after the work insured was completed.

Whilst originally intended to remove the uncertainty around when claims could be made, and to facilitate the timely release to builders of bank guarantees and deeds of indemnity held by insurers, the practical consequence of this provision is that a claim for warranty insurance can be made up to 10 years after the completion of the property.

This unintended extension of the defect period is a major barrier to the entry of private insurers into the market. A wait of 10 or more years to earn revenue from premiums is not contemplatable for private providers.

3. Uncertain claims trigger

The claims trigger should not be linked to a breach of statutory warranty. The definition of a breach of statutory warranty is nebulous and presents an unattractive risk to the private market.

Further, only structural or major defects (as defined by the HBA) should be required to have mandatory insurance. Post completion insurance to cover non-structural or minor defects should be a product available for a consumer to purchase similar to home and contents products, but should not be compulsory. As a 'safety net,' warranty insurance should be targeted at providing a minimum entitlement based on the greatest risk.

4. *Fidelity Funds permitted*

The 2017 Act permits the operation of Fidelity Funds.

Fidelity Funds operate outside of the established prudential framework for insurers. Insurance businesses are nationally regulated by the Australian Prudential Regulatory Authority (APRA) and Commonwealth legislation including the *Insurance Act 1973*, the *Insurance Reform Contracts Act 2001* and the *Insurance (Agents and Brokers) Act 1984*. As Fidelity Funds are not APRA approved, regulated, or compliant they are able to operate with lower operating costs than licensed insurers. Superficially, this suggests that they will be able to offer lower premiums. This situation presents yet another barrier to entry to private insurers.

5. *Government monopoly provider*

Fundamentally a public sector approach differs in a number of respects from that of the private sector, the need for profit generating activities to be a priority being one of them. This difference acts a substantial barrier to the entry of private insurers. Compounding this is the information advantage the Government monopoly provider currently has. To encourage the private sector to engage in the NSW warranty insurance market that information should be shared.

Because of the failure of previous reforms, that is, the lack of alternative indemnity product providers and private insurers entering into the Home Building Compensation (HBC) market, the only real tool available to deal with the inadequacies of the scheme has been the raising of premiums. This is an unacceptable long term solution.

Looking forward, IPART must also consider reforms currently on foot that will significantly impact the residential building industry. The introduction of a statutory duty of care that will apply to all building industry participants will mean that a builder could be held in breach of contract, in breach of the statutory warranties and in breach of another 'duty' which would seem to operate for an indefinite period of time and is largely ill defined. This will no doubt impact the risk profile of applicants seeking insurance from the fund.

These matters are elaborated on throughout this submission.

2. THE ECONOMY & THE RESIDENTIAL BUILDING INDUSTRY

The residential building industry is one of the major driving forces behind the national and NSW economies.

In 2019 HIA commissioned a report from the Centre for International Economics (CIE Report). The report found that:

- The housing sector, via land tax, municipal rates, other taxes on immovable property and stamp duties, directly contributes around \$51 billion in taxation revenue each year to state and local governments in Australia (about 10 per cent of the total revenue collected by all tiers of government).
- Dwelling ownership and housing construction provide 14 per cent of total GST revenue, despite providing only 11 per cent of economy wide Gross Value Added.

The residential building industry is also one of the most regulatory burdened industries in Australia. The cost consequences of this regulation cannot be understated. The Centre for International Economics estimated that in 2016-17 the total outlay made to acquire a new house and land package in a Greenfield estate was approximately \$841 000, but that only 50 per cent of this outlay reflects the actual

resource costs. The other 50 per cent is made up of regulatory costs, statutory taxes and excessive charges, which are respectively: 26 per cent, 21 per cent and 2 per cent of the outlay.

The Extraordinary COVID-19 Update paper published at the end of April this year by the HIA economics team forecasts some dramatic declines in new starts with home building falling to its lowest level since the GFC.

The table below, which is subject to revision, contains the statistics for NSW since 2007 – 2008 with forecasts through to 2021 – 2022. It makes for grim reading:

Dwelling Starts Forecast - New South Wales

Financial Year Starts

seasonally adjusted

Year	Dwellings '000	% change
2007/08	31.91	
2008/09	24.07	-25
2009/10	34.57	44
2010/11	32.37	-6
2011/12	30.81	-5
2012/13	42.46	38
2013/14	47.54	12
2014/15	58.02	22
2015/16	70.00	21
2016/17	74.49	6
2017/18	72.52	-3
2018/19	62.59	-14
2019/20 (f)	46.55	-26
2020/21 (f)	37.23	-20
2021/22 (f)	34.32	-8

Starts, by type

seasonally adjusted

Year	Houses '000	Multi-units '000	Total '000	Houses % total
2007/08	15.94	15.97	31.91	50%
2008/09	13.51	10.56	24.07	56%
2009/10	17.66	16.91	34.57	51%
2010/11	16.09	16.29	32.37	50%
2011/12	15.57	15.24	30.81	51%
2012/13	19.06	23.40	42.46	45%
2013/14	22.31	25.23	47.54	47%
2014/15	25.34	32.68	58.02	44%
2015/16	27.46	42.54	70.00	39%
2016/17	29.21	45.28	74.49	39%
2017/18	30.88	41.64	72.52	43%
2018/19	29.10	33.49	62.59	46%
2019/20 (f)	21.43	24.85	46.28	46%
2020/21 (f)	19.58	17.66	37.23	53%
2021/22 (f)	19.95	14.37	34.32	58%

A downward trend in building activity will have an adverse impact on the Fund.

Each month HIA surveys the largest 100 home builders in Australia on their volume of sales (contract to build). These builders account for one third of new houses built in Australia. New home sales have fallen by 22.8 per cent since the introduction on COVID-19 restrictions. In March, new home sales fell to their lowest level on record and they fell further in April.

Further, the number of cancellations of projects now exceeds 30 per cent, which is more than four times the typical rate of cancellations. For the purposes of comparison, during shocks such as the GFC or the 2018 credit squeeze, the cancellation rate peaked at 17 per cent.

On 14 May 2020, HIA's Chief Economist, Tim Reardon, stated that "in net terms, this equates to a contraction of more than 50 per cent in the volume of new building work in the future and this will begin to be felt across on-site activity in the second half of 2020."

The lead time for the home building pipeline is 6 to 9 months, so even if the economy restarts on 1 July the supply of work in residential building will continue to decline into 2021.

This would see home building in the December 2020 quarter at a level lower than during the 1990s recession, when the population was 32 per cent smaller than today.

The Government must exercise caution when considering reform options that would impose further regulation on the industry; of note, a number of the proposals within the Paper would do just that.

The residential building industry is a highly price-sensitive industry that is not capable of absorbing too much in the way of additional government imposed costs without causing a significant reduction in economic activity.

The industry is also highly competitive, with low barriers to entry. In normal times builders often reduce their profit margins in order to price their product competitively. This is likely to be exacerbated in the current climate. The industry is cyclical, but margins remain low even in boom times due to rising labour and material costs. Overhead costs as a percentage of turnover are also affected as production and cash flow slows down.

Building works are typically funded by way of overdrafts and trade credits with client payments legislatively required to be paid in arrears. There are inherent uncertainties in contract prices which arise from the fact that works are required to be priced before construction commences and are based on technical, financial and workforce assumptions, together with material costs/availability, access to site, timeframes, weather and statutory approvals/ delays.

These circumstances are best managed by private insurers operating in a competitive market. The private market is best placed to assess and cost the risks inherent in the residential building industry, can be more agile in responding to its cyclical nature and, as such can provide a solid and stable foundation for the product, despite the general economic ebbs and flows the industry can be susceptible to.

The entire residential building industry, including volume builders, small and medium sized custom and semi-customised home builders, and builders of large, structural renovation projects operate under a negative cash flow model.

The consequence of this is that residential builders carry the risk on all the projects they undertake. The way progress payments are scheduled does not accord with the way expenses are incurred. During the period, or stage, in which work is being carried out no further payments are received, but the builder will need to pay subcontractors and suppliers. These subcontractors and suppliers will naturally not wait for the builder's client to make payment late in the duration of the job.

The unprecedented impact on the economy of the COVID-19 pandemic is a factor that must be taken into account when consideration is given to reforms to home warranty insurance and the Fund more generally.

3. BUILDING REFORMS TO DATE

3.1 PAST REFORMS

As outlined in the Paper, the investigation and review of the operation of the Fund has been ongoing for some time, yet it is still not structured in a way that will ensure its long term viability.

2015 provided the most recent opportunity to reform the Fund. That Discussion Paper canvassed a range of options to redress the Fund's deficit, including reducing the coverage of the scheme by, for instance, reducing the coverage period for major defects, having the option for separate insurance cover for non-completion and defects, reverting to a voluntary scheme, or combining a voluntary and mandatory scheme.

HIA made a submission in February 2016 in response to that review and predicted that many of the reform options would have 'little, if any, positive effect on premium pricing, warranty claims or scheme losses.'

That review led to the passing of the 2017 Act. Broadly, HIA understood that the intent of the 2017 Act was to return the scheme to financial stability, reduce its reliance on NSW Government funding and encourage the entry of private insurance providers. This has not eventuated.

Largely due to the deficiencies of the 2015 review and 2017 Act, the industry was subjected to significant premium increases starting in April 2017 and followed by further increases at very short notice in 2018 and in 2019. Multi-unit dwellings saw an additional increase in January 2020 and are set for further increases in July 2020 and January 2021. The premiums on multi-unit constructions will increase by 75 per cent, or 4.79 per cent of the cost of contract.

These significant premium increases clearly demonstrate that the recent reforms have not been effective. The Government needs to take steps to ensure the Fund's financial sustainability through means other than just increasing premiums.

3.2 CURRENT AND FUTURE REFORMS

This review of the Fund cannot and should not be undertaken in a vacuum. NSW has seen and is still to see significant changes to the regulatory landscape which are likely to impact warranty insurance and vice versa.

As the NSW Government stated in its response to the Report of the Legislative Council Public Accountability Committee Inquiry into the Regulation of Building Standards, Building Quality and Building Disputes,

The Design and Building Practitioners Bill 2019 (the D&BP Bill) passed the Legislative Assembly on 13 November 2019. The D&BP Bill delivers on many of the reforms committed to by the 2019 Government response to the Building Confidence Report, authored by Peter Shergold and Bronwyn Weir, and will significantly improve the accountability of practitioners involved in design, building and construction.

The D&BP Bill requires the registration of design practitioners, such as engineers, designers and draftspersons, as well as other unregistered professionals who prepare and declare designs. Design and building practitioners will be required to declare designs are compliant with the Building Code of Australia.

The D&BP Bill also proposes to introduce a new industry wide duty of care that would apply to those carrying out construction work. The Bill will, in essence, extend a statutory duty of care to categories of persons to which the courts have consistently declined to extend that duty. The courts have refused to extend that duty for very sound reasons. Central to the cases in deciding whether a duty was owed were the salient features of the relationship and whether one of the parties was vulnerable in the sense of not being able to protect themselves from the consequences of the other parties actions.

While HIA has opposed the introduction of the duty, it does seek to hold all building practitioners accountable for their role in defective building work. HIA sees that this new duty could equally have an adverse impact on the Fund.

The Bill indicates that the duty would be owed to a variety of parties including building owners, home owners, owners corporations, subsequent title holders, small businesses, subsequent residential homeowners, vulnerable development clients (including some definitions of 'developer') by a variety of building practitioners including builders, building professionals/practitioners and subcontractors.

Not only would an individual be able to (if not required) to take actions for breach of duty against a range of individual building practitioners, it would seem that individual building practitioners could be sued individually and independently by multiple parties. It would be possible for a builder to have

become insolvent, for a claim to have been made on the Fund and for the homeowner to pursue another contractor for breach of a duty of care.

It is also unclear how maintaining express statutory warranties alongside the duty of care will affect a builder's risk and liability. Not only would they operate for different time periods, but both options are likely to be interpreted more broadly than the existing statutory warranties.

As mentioned above, it is possible that a builder could be held in breach of contract, in breach of the statutory warranties and in breach of another 'duty,' which would seem to operate for an indefinite period of time and is largely ill defined. How will an insurer issuing warranty insurance manage that risk?

Once enacted it will, together with the legislation that will provide the new Building Commissioner extensive powers of compliance and enforcement and in conjunction with the already existing powers mean that greater action can be taken than presently the case against defects. This would bolster consumer protections.

There are also the Six Reform Pillars that the NSW Government has established which are being overseen by the Building Commissioner. These reforms will improve standards in the industry and will also increase consumer protections.

The above initiatives will undoubtedly have an impact on the residential building industry and consequently on the Fund and they should be given significant weight when consideration of introducing reforms is given. The actual effect will not be known for a number of years.

It would be sensible and prudent to gauge the effects of these reforms on the residential building industry before any reforms are introduced to the scheme. Failing that, at the minimum, any reforms to the scheme would need to be coordinated with the coming reforms mentioned above. They should not be made in isolation.

4. THE NEED FOR A COMPETITIVE MARKET

The primary recourse for a consumer who finds defective building work is through the statutory warranties as set out under Section 18B of the HBA. These warranties act as the principal consumer protection mechanism, supported by contract regulation and a licensing framework.

An insurance claim is only required where the builder is unable to fulfil their obligations under the statutory warranties.

As a safety net, home building insurance provides a minimum entitlement that is distinguishable from consumer protection more broadly which can be described as a group of laws designed to ensure the rights of consumers as well as fair trade, competition and accurate information in the marketplace.

When carrying out this review IPART must factor these observations in when making its recommendations.

Set out below are what, in HIA's view, the necessary components of the Fund in order for it to meet the following objectives, set out at the outset but for convenience repeated here:

- Returning the scheme to breakeven;
- Preventing premium increases; and
- Attracting private insurers into the market for warranty insurance.

4.1 A REDESIGNED INSURANCE PRODUCT

HIA has consistently argued for the need for a split insurance product.

While the 2017 Act created a framework for insurers to offer a product that would cover just non-completion and a product that would just cover the warranty period, the fact that these two separate products must be for a minimum insurance cover of \$340,000 each has prevented this approach.

The legislation as it currently stands is essentially nothing more than a theoretical proposition. There will be no private entrants into the market unless there is a realistic possibility of being able to return a viable profit.

HIA has proposed that a builder could purchase a single policy at the minimum insurance cover price (\$340,000), but that private insurers should be able to offer warranty insurance separate from the construction period product. In other words, the product would be split into an insolvency product and a defects product, each providing a level of cover that combined is equal to the current level of \$340,000. The intention was to provide the product as a whole; not have two standalone products.

HIA is aware that there are two quite distinct types of insurers. There are those who specialise in non-completion products, but not the defect warranty insurance products. And there are also those who are specialists in defective building work, but not the non-completion risk area.

To genuinely invite split risk products by reducing the minimum insurance cover would encourage entry into the NSW warranty insurance market by private providers as it broadens the market beyond those providers (who are limited in number) who are prepared to take on both the risks of non-completion and defects encouraging competition. Defects insurance could be separately provided and separately priced by the private insurance industry.

If the product is split the risk could be separated.

The risk of non-completion is essentially a question of the financial viability of each builder, which is susceptible to accounting analysis and is far more quantifiable than defect risk. It is also an identifiable risk within an easily defined time period (the construction phase) rather than a long tail risk. Half of the capital investment is for example only 12-18 months as the only risk factor is non-completion. This would enable that part of the premium to be earned quickly and the risk would be diluted.

The operation of split product insurance would also resolve an ongoing anomaly within the regulatory framework.

Sections 96A and 3A of the HBA require that developers purchase defects cover only. As the developer remains the owner of the property until it is complete there is no external risk (i.e. a risk to a homeowner) of non-completion. However, given the structure of the products currently available, the only product a developer can purchase is one that covers both non-completion and defects. This means the policy wording must ensure that the actions of the developer are not contrary to the operation of the HBA. iCare states that the reason for this is because, 'Generally, the risk for work undertaken on behalf of a developer is only related to defective work and not non-completion. This is because a developer is excluded from being a beneficiary under a contract of insurance (policy).' Thus it should be recognised that a split product actually supports the current regulatory approach.

A genuinely split product also offers innovative solutions.

HIA is aware that there are some innovative products being considered which would offer nine years of defect warranty protection. This period could be broken down into three separate products each of three years duration. Only the first three years would be compulsory, with the following two products being

optional for the homeowner to purchase. Under such a model the consumer is empowered to make a choice about any ongoing defect risk as is the insurer in terms of the type of cover that could be provided and the costs associated with that cover. More choice breeds a more competitive market.

4.2 FIDELITY FUNDS

As noted in the Paper, the Government made changes to the HBA to allow alternative indemnity product providers (as well as private insurers) to apply to SIRA to enter the HBC market in NSW. The argument went that the changes would encourage competition in the market by allowing builders to access a broader range of HBC products. HIA voiced doubts at the time the changes would achieve the desired outcome.

HIA was also critical of the amendments allowing for Fidelity Funds to operate. Those concerns are repeated here.

In reality, because they are not subject to the same compliance and risk controls, Fidelity Funds offer poor consumer protection as compared to a licensed and reputable insurer with reinsurance.

Particularly during the period of their infancy, Fidelity Funds will be undercapitalised and exposed to larger (class type) claims. They have limited reinsurance protection. They are also unable to unilaterally increase contributions, which poses a risk of loss to the fund, as claims cannot be covered nor recouped. This creates moral hazard for the government, who are politically exposed to the risk of “propping up” the fund in the event there are insufficient pooled funds to cover a collection of larger claims.

Further, because they have lower operational costs, Fidelity Funds have a significant commercial advantage over regulated insurance businesses that are compelled to satisfy the full prudential requirements and scrutiny of APRA.

This creates an anti-competitive market environment. To ensure a competitive and viable market, Fidelity Funds must be regulated on an equal footing with insurers regulated by APRA.

Due to their operation as a trust arrangement, there is a lack of transparency in relation to the management and operation of Fidelity Funds. This could have significant implications for consumer protection.

Before approving a product or issuing a licence, SIRA intends to carefully consider the financial position and constitution of the provider and proposed product. SIRA also would be able to impose conditions on the licences of providers as well as require them to meet prudential standards and underwriting requirements, and to provide financial assurances if necessary.

As noted in the Paper, for “a new single dwelling, the premium has increased by almost 50 per cent from around 0.8 per cent of the property value to 1.1 per cent (including GST and stamp duty).” With the exception of multi-dwellings up to three storeys, premiums have been set at break-even rates since August 2019. As noted above multi-unit dwellings saw an additional increase in January 2020 and are set for further increases in July 2020 and January 2021.

4.3 DEFECT WARRANTY PERIOD

The current operation of the six year defect warranty period not only represents a significant drain on the Fund but also poses as an immovable obstacle to private sector interest.

10 year limit on claims

The major defects cover period needs to be removed, or at the very least considerably shortened. This is a major barrier to the entry of private providers. The maximum 10-year cap on when claims can be

made against home warranty insurance policies issued was introduced in 2011 and originally only applied to contracts entered into before 1 July 2010. Its intent was to remove the uncertainty around when claims could be made, and to facilitate the timely release to builders of bank guarantees and deeds of indemnity held by insurers.

The Paper states (at 2.2.2) that insurance providers could have to wait up to 10 years to earn revenue. In fact it is even longer than this. In NSW, if it can be demonstrated that the claim occurred within six years, it is possible to bring a claim for up to 10 years. As SIRA and iCare would be aware, a claim can continue to develop for a number of years after the 10 years provided it was brought within the 10 years.

Claims can and do continue to develop for a number of years after the 10 year period has passed. Claim development from an actuarial sense can take up to 14 years at the extreme end. Given this, no private insurer is going to participate in a scheme that means you earn your premium over that period of time and where there is no certainty of a return of the capital investment.

Defects Tail Period

Reducing the insurance cover period under private market conditions will have a range of positive effects on the consumer, the builder and the industry more broadly. For example, for the consumer the builder's obligations and responsibilities under the current 6 years statutory warranties applicable to major defects remains untouched. A consumer's fundamental right to have residential building work, completed and free from defects remains the centrepiece of the NSW consumer protection framework.

For a builder, reforms to the Fund that would practically allow private insurers into the market would take significant pressure off premiums helping to maintain affordability. Further, a shorter 'tail' provides an incentive for a homeowner to report defects as soon as they arise increasing the likelihood of the builder being present to rectify which will reduce pressure on the fund.

Finally a confident, buoyant and active building industry is beneficial for builders, taxpayers, and the state Government.

Reducing the insurance cover period will create an environment within which this can be achieved. In conjunction with this the severing of the link between a warranty insurance claim (because of the insolvency, death, disappearance or licence suspension of a builder) and a breach of statutory warranty provides clarity and certainty in relation to what can be claimed; this will reduce the frequency of claims ultimately reducing frustration and litigation around the type of defects that can be the subject of a claim. This creates certainty and bolsters confidence in the industry.

Under these circumstances risk can be effectively quantified having a positive impact on premiums and ultimately housing affordability. Further, the product becomes truly reflective of its purpose creating clarity in the industry as to the application of warranty insurance.

It would also mean that industry, insurers and consumers can be confident in knowing the types of claims covered by warranty insurance which will in turn enhance a consumers understanding of the intent and purpose of the product.

Consumers retain their current rights under the warranties, and would be able to pursue these rights in the same way as they can in relation to other consumer products under the Australian Consumer Law.

4.4 THE CURRENT INSURER OF THE SCHEME

Another major barrier to the entry of private insurance providers is that the private sector is essentially being asked to compete against the Government. It has been estimated that iCare would have a 30 point advantage compared to what a private provider would have to make to get a return on investment.

Asking private providers to compete against the Government who is not required to make a profit does not make sense from a commercial point of view.

iCare has an enormous data, information and infrastructure advantage over any private provider. Private entrants should be able to have access to that data. There would need to be open transparent sharing of data. Not having access to the information that iCare has is a major hindrance to the entry of private providers.

4.5 VOLUNTARY HOME WARRANTY INSURANCE

HIA finds the discussion in the Paper around UK home building insurance concerning. The NSW (and more broadly Australian) system is fundamentally underpinned by a different regulatory framework and, as such making comparisons is unhelpful. It is of note that whilst HIA has consistently advocated significant industry involvement, as exists in the UK, the UK system is not, as noted in the Paper, really voluntary, as lenders mandate insurance.

A solely voluntary last resort model is not appropriate, however if combined with a mandatory scheme may open avenues for innovative approaches. While the voluntary insurance model adopted in Tasmania failed and there are no insurers providing home building insurance in that jurisdiction, a model that incorporates both mandatory and voluntary cover has yet to be tested and is worthy of further consideration.

There are primarily two reasons for the need for some form of minimum mandatory warranty insurance coverage.

Firstly, warranty insurance is for the benefit not only of the homeowner under the building contract but their successors in title. Protection of subsequent purchasers is an important consumer protection measure linked to building approvals and inspections, yet subsequent purchasers would have no say in (and perhaps no knowledge of) whether an initial owner purchased insurance.

Secondly, certainty as to warranty insurance coverage is vital; any moves to a solely voluntary scheme would most certainly undermine this, jeopardising consumer confidence in the industry and introduce uncertainty about the size of the market with the consequence that an additional layer of risk would be added for the insurer.

5. OTHER PROPOSALS

Research carried out the State Insurance Regulatory Authority (SIRA) in 2018 into the causes of claims on the Fund found that they were overwhelmingly made because the builder had gone insolvent.

One of the research insights that came out of SIRA's investigation aimed at creating a sustainable home warranty scheme in the future was to do with the cost of remediation work. It was noted that the cost of remediation work can push a builder into insolvency. It was suggested that splitting the cost of remediation between the insurance company and the builder should be explored, so that the builder could remain solvent. It was proposed that this option would be available for one project only, but that business mentoring should also take place.

Another initiative that was discussed in SIRA's paper was centred on insurance policy data. It was suggested that data should be collected and to cross reference builder / home warranty policy information with Fair Trading complaints to identify potential builders at risk of hardship. Support should be given to the builders at risk with a specialised team to offer assistance and guidance to avoid insolvency.

HIA is of the view that these proposals have significant merit and should be instigated.

6 RESPONSES TO QUESTIONS POSED IN THE PAPER

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

See section 4 above.

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

Yes. Private providers, if participating should be able to limit insurance, or not provide insurance to high risk builders. Private providers should be able to enter the market and compete on the basis of selective risk. Currently SIRA requires an insurer to offer cover without being able to discriminate on the basis of a quality assessment. If a provider is able to price on the basis of quality risk a private insurer would be able to more effectively compete as they would be able to charge less than what iCare is charging based on the risk selection. This would also have the effect of improving industry standards and over time improving consumer protection.

To be able to compete against the Government on a selective basis is the only way private providers would be able to compete.

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?

There should not be a need for SIRA to regulate this product. APRA has the overriding task of regulating the insurance industry and to then have a state body is simply a double up.

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

No additional information is required. The information currently made publicly available is appropriate.

A consumer can access a great deal of information relating to a contractor. Service NSW host a public register of licence records from current and historical databases about builder and tradespersons licences. The Register tells consumers about current, expired and cancelled licences under the name or licence number being searched.

The Home Building Compensation Check, provided by SIRA, allows users to check if there is valid HBC cover over a property where required. The tool allows searches by HBC certificate number or address to verify if a HBC certificate was issued for a particular property and also search for certificates issued by a particular builder, to identify or verify work the builder has done.

Consumers also have access to a premium pricing tool and a digital HBC 'mapbox.'

The digital HBC check mapbox hosted by SIRA allows consumers to view all of a builder's past work where insurance was required. This tool enables viewing by suburb and residential address. Used in conjunction with other digital web resources a consumer is able to digitally view a builder's current and past work.

Fair Trading holds information about any compliance and disciplinary action that has been taken against a licensee. It is a simple process for a consumer to discover whether Fair Trading has issued a public warning about a person by visiting its public warnings webpage.

Fair Trading's complaints register holds information about businesses that have had 10 or more complaints made against them in any month.

The ASIC websites allows users to search for Australian company details, documents lodged, and persons banned or disqualified from operating a company.

The NSW Caselaw and Austlii websites allow users to freely search for published decisions of NSW courts and Tribunals and other jurisdictions.

There is also a vast number of websites, both free and commercial, containing reviews about builders.

All this information ensures that a consumer has an insight into the works builders have been engaged in and their compliance with legislative requirements.

How could the claims process be made more efficient?

Claims should be outsourced to an independent claims management firm with authority to decide all claims. The outsourcing of claims management has worked reasonably well in the area of Workers Compensation and is working well in the current marketplace for warranty insurance across the country. In fact, this approach would be preferred in light of the specialised nature of claims management and its complexity.

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

HIA notes that under SIRA's guidelines, licensed providers may offer contractors discounts or load premiums based on the licensed provider's risk management practices. Premium pricing does provide some incentives for builders to adopt good risk management and sound business practices which can attract a discount on a premium, but as the Paper rightly notes the cost of premiums is typically passed on to homeowners.

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

The risks to solvency of those operating in the residential building industry are complex and multifaceted; there are a plethora of factors that may impact a business financial position.

Australian Bureau of Statistics data directly states that 60 per cent of new businesses disappear within 3 years. Construction industry businesses have a 71 per cent survival rate.

In HIA's experience, some companies in the sector fail because of poor business administration while others collapse due to the actions of third parties, most notably non-payment. It must also be acknowledged that the financial failure of some firms will be an unavoidable consequence of the competitive forces of Australia's market economy. As some businesses fail, others will thrive and new opportunities will emerge for newer entrants.

During a residential building project, the first risk that threatens solvency is financial management. Cost overruns can result from a number of reasons including poor estimating, under-budgeting, overly optimistic pricing or cut price tendering, poor coordination between design professionals and the trades, delayed project stage payments, and changing client demands.

The second risk relates to time. Time overruns, which are often outside of a builder's control, (and delayed payments) can have devastating financial consequences for businesses in the construction industry.

An additional risk relates to the design of the building. There is a risk that the completed building will not meet the owner's needs.

A further risk manifests after the construction phase, as ongoing responsibility for defects and warranties is a key risk to the future viability of a residential building business.

The risk of insolvency is dealt with through elements of the regulatory framework that apply to residential building work, including the unique licensing arrangements and reduce the ability for directors of residential building companies to get caught with solvency issues. Residential builders need to obtain a builder's licence or registration to contract with a consumer, sub-contract or advertise, to undertake residential building work.

The current operation of warranty insurance means that a builder's financial position is consistently monitored by the insurer. At present, and before granting eligibility, the insurer reviews a builder's business history and finances to assess their risk. As noted in the Paper there is an annual turnover limit on builders based on the assessment of the value of works that a builder can prudently undertake given their financial position.

Despite these complexities HIA does see that there is value in examining and investigating how more timely and accurate financial information can be collected and assessed

In contrast HIA does not see the value in exploring the utility of onsite inspections to assess a builder's capability or capacity. The imposition of on-site inspections and discussions in relation to the introduction of a quality assurance and inspection regime should be treated with great caution.

Notwithstanding the cost implication associated with such proposals, this type of approach raises complex questions regarding what is adequate or appropriate supervision to ensure that building work complies with plans and specifications and is of an appropriate standard. This will depend on a number of circumstances. Factors such as the complexity and nature of the work, as well as the experience and skills of those persons (usually licensed and skilled trade contractors) undertaking it. Further, the residential building industry is already subject to a raft of regulatory arrangements, including inspections to ensure building quality and compliance. As outlined at the outset, further measures are currently in the process of being implemented into the industry in NSW.

While perhaps attractive in theory, experience has shown that such measures in practice simply:

- add cost, both tangible and intangible;
- provide fertile ground for disputation and litigation; and
- introduce measures more akin to the 'first resort' model of insurance, which currently operates under loss ratios of 300 per cent.

As SIRA noted in respect of remediation works pushing builders to insolvency, a similar observation may be made in respect of rectification orders.

Builders, can and do, get involved in disputes with homeowners about payments for completed stages of works. It is not uncommon for homeowners to withhold payment for a stage of work for which there is no contractual right to do so. It is HIA's experience that an owner will assert the work is defective or not complete. A complaint is then made to Fair Trading.

Fair Trading inspectors usually have no regard in their determination of a rectification order to the terms of the contract. HIA contracts for example state there is no right of set off for anything on progress payments except at final payment. A Fair Trading inspector will then make a rectification order against the builder but payment will not be enforced.

HIA submits this is unjust and that payment should be a mandatory condition made before the builder has to rectify defects.

Is an efficiency study of iCare's economic costs necessary?

HIA sees that there is value in examining the operations of iCare. As the monopoly provider of insurance, with a view to genuine attempts to create a competitive market for warranty insurance, understanding the operations of iCare would provide potentially valuable information.

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

HIA recognises that 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. However, HIA has consistently proffered that greater transparency is required regarding how eligibility is determined and how limits are set. It is also of note that a transparent approach may assist more generally with financial management.

Technology could be leveraged to improve knowledge of a builder's financial situation. Data and analytics should be introduced as a means of assessing performance. HIA understands that some builders are assessed on financials that can be 12 to 18 months old.

There could also be a broader approach to risk management considered. For example, applying Pareto's principle that, roughly 80 per cent of the risk comes from 20 per cent of the industry iCare, or a private insurer, could focus on managing the greatest risk. All builders with a turnover, for example, of \$2 million should not be held to the same level of scrutiny as larger builders. As a collective this segment poses very low risk. This would allow for greater scrutiny of larger more high-risk segments of the industry.

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

Yes.

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

As noted in the Paper, significant costs are entailed in arranging warranty insurance and meeting the general and extensive inquiries that are made into how builders run their businesses. In certain circumstances builders are required to provide bank guarantees and injections of working capital to satisfy eligibility criteria in order to obtain the insurance. Meeting these requirements can in itself impact on the financial and operational viability of the builders, especially where this process is drawn out.

In addition to determining a builder's eligibility based on the entity's financial reporting there is extensive consideration given to a builder's non-financial position. Builders are required to provide non-financial information relating to their previous business history and capacity; any claims notifications, NCAT/court orders and the builder's licence incident record; unpaid contract variations and Work in Progress (WIP) reports.

- *Further regulatory requirements*

Prior to even applying for an eligibility assessment builders also have to satisfy requirements relating to licensing, contracts, Continuing Professional Development and planning and council conditions for each project.

A significant amount of regulatory burden is also imposed through other regulatory instruments that are largely based on discretionary powers, for example, mandatory Codes of Practice and licensing arrangements are determined and administered largely at the discretion of the relevant regulator.

In accord with a 2006 IPART recommendation that *'the Government undertake regulatory impact assessment for all regulatory proposals and prepare a RIS for regulatory proposals that meet the following 'materiality' thresholds including other regulatory instruments (such as mandatory Codes of*

Practice, mandatory guidelines, Orders, Operating Licences etc) that are likely to impose an appreciable burden on any sector of the public' the NSW Government should establish processes to review these 'other regulatory instruments'.

For example, without any consultation with industry, NSW Fair Trading has over the years changed the application process for a NSW Builder's licence and often when changes have been made industry was not advised in a directed or timely way.

- *When to take out insurance cover*

It should be noted that even the process or timing of when to take out insurance cover is unclear. The regulatory requirements that set out when insurance must be taken out do not fit well with how it works administratively in practice.

Under the HBA a builder cannot do any work, or take any money until home warranty insurance is in place. However, the insurer requires a signed contract before granting insurance cover. Not being able to receive any money without having insurance cover for a project affects the certainty of progressing on the basis of that contract.

This confusion arose from the 2017 amendments. The amendment, now s 7(2)(f1) of the HBA, relating to the cost of cover is one for which HIA could see no purpose.

- *The Regulator's Guidance*

On its website¹, SIRA provides some rather unclear guidance about building contracts and HBC cover. The following guidance is directed to builders:

Your contract must disclose the total amount of money that you had to pay for the cover (which may include brokerage, fees and taxes).

If the contract will be signed before you buy the cover, it must include a reasonable estimate of what the cover will cost.

HIA makes the following observations:

The legislation requires that a contract must contain the 'cost of cover' (s 7(2)(f1)). It is not clear whether the 'cost of cover' is confined to the premium only, or the premium plus brokerage, fees and taxes. Including this information on SIRA's website, other than providing SIRA's view, does not provide clarity on the matter. The use of the phrase 'cost of cover' would tend to lead to the interpretation that it should be confined to the premium only.

In respect of the guidance relating to a reasonable estimate, HIA observes that although this might be a desirable outcome, HIA is of the view that there is nothing in the legislation that permits the use of a reasonable estimate in the contract. The phrase 'cost of cover,' may be ambiguous in respect of what is to be included in arriving at the cost, but probably cannot be read as being wide enough to embrace the notion of an estimate. A court or tribunal may take the same view. Consequently, SIRA's guidance poses a risk to members who seek to use an estimate to satisfy the legislative requirements.

During the reform consultation period, HIA argued against the insertion of the cost of cover provision into the HBA as the requirement to attach the certificate of insurance was already sufficient protection for the home owner. HIA's primary position would be for the cost of cover provisions to be removed, but

¹ <https://www.sira.nsw.gov.au/insurance-coverage/home-building-compensation-insurance/getting-home-building-compensation-insurance>

failing that it may be possible to amend the regulations in such a way as to embrace the use of reasonable estimates when dealing with the cost of cover.

The risk of doing something that does not comply with the legislative requirements, notwithstanding what the regulator advises means that there is an inherent risk and potential cost to the business.

- *Speculative 'spec' construction*

Section 96 of the HBA is headed *Insurance in relation to residential building work not carried out under contract*. The provision deals with the insurance requirements related to 'spec' builders, namely those building entities who own the land on which they carry out residential building work.

Speculative builders are required (1) to have arranged insurance cover before commencing residential building work on their own property, and (2) attach the certificate of insurance to a contract for the sale of land if the sale is within six years of completion.

There is an argument that a spec builder should not have to take out insurance until they enter into a contract for the sale of land as the whole point of the product is to protect the consumer, which here would be a subsequent title holder.

iCare recognises this argument at 20.5 of its Eligibility Manual, where it is noted that the risk for work undertaken by a spec builder 'is related to defective work and not non-completion of work.' This nuance is not reflected in the legislation.

iCare's stated reason for requiring spec builders to take out insurance cover before starting the residential building work is that 'there may be cases where a spec builder enters into arrangements to sell a property prior to completion of the building work.' This argument is rather hollow, as it would not prevent a requirement to take out completion insurance once a decision has been made to enter into such an arrangement and have the certificate attached to the contract for the sale of land.