

NSW Home Building Compensation Scheme

May 2020

1. Introduction

Dear Dr Paterson,

Thank you for the opportunity to provide this submission to the special review of home building compensation in New South Wales. We are pleased to support the review and look forward to the findings. Through managing the Home Building Compensation Fund (HBCF) (previously Home Warranty Insurance Fund) over the past five years, icare has developed an understanding of the home building compensation's long history and its role of providing a safety net for homeowners in situations when other consumer protection safeguards fail. We recognise that in supporting the construction market, policy and regulatory environments must strike a fine balance. Consumer and homeowner protection must occur in a manner that also supports the thriving of residential construction activity in New South Wales.

The purchase of a home is an emotive issue and the largest single purchase many New South Wales residents will make in their lifetime. The main goal of the consumer protection safeguards within the overall residential building sector regulatory framework should be unambiguous: protection of New South Wales homeowners. The size and significance of such investments make it essential that an array of regulatory protections, as well as insurance protections exist to support homeowners.

Builder's warranties stand as an essential guarantee of quality and are at the heart of the promise made in the transaction. The home building compensation scheme, as currently designed, stands in to support that promise, but only where the accountable builder is not able. As such, while a strong home building compensation scheme contributes to this goal, it is only able to play a small part as its role exists near to or at the end of the regulatory response chain.

Challenges of the home building compensation frequently stem from upstream issues, rather than from the operation of the scheme itself. Home building compensation schemes are beholden to various other ecosystem parts which must play the major role in ensuring the veracity of building processes. The number of issues requiring management in home building compensation schemes is largely a function of the effectiveness of guidelines, processes and regulations and their design, implementation and monitoring. Building code and building design, code compliance, engineering and architecture, trade and builder licensing and training and standards, industry regulation, building approval processes, project certification and complaint processes/dispute mediation activities all precede the home building compensation scheme's final remediation role. This demarcation between the mandatory insurance provider and regulation is also essential to good overall system design.

To support the protection of homeowners, the aim of the regulatory environment should be:

- to remove opportunities for builders, developers and tradespeople to complete work that is of unsatisfactory quality
- to ensure appropriate quality assurance and checking processes exist and are undertaken and effective
- to limit the ability of builders or developers to expose others to losses through insufficient business management capabilities

If these aims were met satisfactorily, there would be limited need for a home building compensation insurance product to exist at all. Insurance is a poor and costly substitute for adherence to quality standards and failure of the oversight, design and monitoring of building standards and lack of commercial acumen/capability within the building industry. Similarly, access to a mandatory insurance is an ineffective and imprecise substitute for rigorous license conditions.

In looking at home building compensation, it is imperative to consider the insurance product in its context, which is to (as far as possible) make whole those homeowners that cannot rely on their builder to rectify issues, in exchange for a sufficient premium to fund those losses. If this is recognised, overarching policy options regarding home warranty compensation also become clear.

Noting customer protection is paramount, we are open to further scheme or competition reforms and have discussed such opportunities within this submission. We emphasise however that the original privatisation of the former first resort scheme in 1997 occurred due to an expectation that private market insurers would better incentivise builders to improve work standards than government. This was manifestly incorrect and privatisation both lowered standards and reduced scheme sustainability.

We believe that any conversation on competition needs to recognise that without enforced homogeneity in underwriting standards, the competitive operation of a private market is misaligned with any regulatory steps towards improvement in industry performance, as it is impractical for an insurer to promote performance improvements unless all other market players do the same. This is especially true given the commercial relationships between insurers and brokers. Further to this, any discussions about competition reforms should be continually framed against the overarching purpose of scheme regulation, that is, the possibility of poor and inconsistent work performed by some builders and developers. Any reform decisions that would result in weakening of building or construction quality or assurance processes or that permitted less focus on builder and developer business management ability, would likely lead to unfavourable results.

As such, we strongly advise against regulatory sandboxing that enables risky or experimental regulatory or underwriting changes that could upset an already volatile market and create unacceptable risks to scheme sustainability. We instead support adopting changes that address in advance the requirements for interoperability, managing adverse selection, and sustainability.

It is our view that while competition is welcome, in the absence of likely emergence of competitors, there are significant costs and consumer effort required to navigate the current system whereby competition is allowed for but does not exist. We recommend that in the absence of competition in the market within five years of the 2017 reforms, the standing arrangements that allow for competition in the regulatory, pricing and distribution environments be wound back to allow efficiencies to be delivered to consumers.

2. NSW scheme performance

Since 2016, icare has:

- increased broker market competition by removing guaranteed broker commissions
- moved to a risk-based approach where builders who pose a lower risk are rewarded with lower premiums and more closely and premium categories more accurately reflected project risk
- reduced operating expenses through improved underwriting and claims management processes and partnerships
- engaged the ultimate beneficiary, the homeowner, in the insurance process for the first time with awareness campaigns, an online register of policies to enable identification of active HBCF policies and automated communication to confirm when icare understands a policy is incepted and completed
- improved financial governance and risk management

Under icare, the sustainability and fairness of the HBCF has significantly improved. Comparing the performance of the early government scheme (prior to icare) with scheme performance today is one way to show this. The legacy portfolio, which represents builds with policies that were written prior to the reforms of 2017, is only funded at 31 per cent, leaving 69 per cent unfunded and therefore subsidised by NSW Government. Policies written post-2017, have a funding rate of 75 per cent¹ and as such require markedly less government funding. By December 2018, icare had begun charging sustainable basis rates as per independent actuarial Scheme (not only HBCF) valuations for all construction types apart from Multi-Dwelling constructions. Further, a path to full funding under icare is also clear.

¹Based on figures to 30 June 2019, the most recent financial year end reporting date.

For new policies, a commitment has been given to industry to stage price increases on multi-dwelling builds through until 2021. The most recently filed premium rates (January 2020) therefore consists of a plan to:

- pass on discounts to lower risk building categories based on business efficiencies, changed Fund investment principles and maturing risk assumptions; and
- bring multi-dwelling rates to a sustainable basis across half year tranches across FY 2019/20 and FY 2020/21.

This way, pricing sustainability can be approached while also maintaining manageable cost increases for the construction industry over a period, rather than negatively impacting the industry with a large once-off price jump.

Recent operating cashflow for HBCF is another way to demonstrate improved scheme performance. While the net asset deficiency of the HBCF remains significant, over the period from the end of June 2017 to June 2019, operating cashflow for HBCF was approximately \$89 million positive, even when adjusting for government grants received². This is up from cashflow of \$23 million between the end of June 2015 and June 2017. It is noted that due to the long tail of the HBCF product, materially changing actuarial expectations can take up to seven years, which means that a lag between improvements in cashflow and any improvement in HBCF liabilities is reasonable. Improvements in cashflow are an evidencable step towards greater sustainability for the scheme.

Following on from figures quoted above, the funding deficit in the HBCF scheme comes in large part from the pre-2017 share of the portfolio. This is the result of historic portfolio under-pricing, which was an accepted NSW Government policy position at the time, taken to protect the market from sharp initial price rises. At the time, the prospect of raising prices back to sufficient levels for fund sustainability presented an unacceptable risk of adverse financial effects to builders and further reductions in building activity in an already depressed market. As a result, the decision was made to gradually increase prices, rather than price for sustainability immediately. In 2020, enough time has passed that pricing is now nearly completely caught up. This historic underfunding however, skews views of the performance of the fund, as the legacy portfolio is required to be presented together with new portfolio as one number, making it less visible that over time, year on year scheme performance has improved markedly.

However, it is also necessary to identify the legacy portfolio funding is not the portfolio area that creates funding challenges. While cashflow improvements for HBCF overall between June 2017 and June 2019 were notable, over the same period, the net asset deficit of the scheme increased by \$156 million. This paradox of improving cashflow against a declining asset position is useful for demonstrating key challenges in scheme sustainability. This is representative of the long-tail nature of the product, including the requirement to service previously underfunded legacy policies creates one. The inherent double volatility brought in periods of exposure as increases in claims occur at the same time premium pools reduce is another (and is likely to occur in the current environment as a result of the impact of COVID-19). Finally, as noted previously, multi-storey residential construction creates unique portfolio challenges due to inherently higher risk and volatility levels relative to single-storey construction. Multi-dwelling constructions generate only 12 per cent of HBCF revenue yet lead to more than 50 per cent of scheme losses.

Under current SIRA premium guidelines and icare business strategy, this risk imbalance will be corrected by 2021, where multi-dwelling builds will incur premiums equivalent to share of claims, but it is noted that this will make multi-dwelling premiums more costly for NSW builders and developers of medium density housing supply.

For new multi-dwelling construction, HBCF only provides coverage for one, two and three storey apartments. Residential construction of buildings greater than three storeys is subject to the Strata Building Bond and Inspections Scheme (SBBIS). Multi-dwelling construction is discussed further at Section 12.

²Including government grant cashflows received for the June 2018 and June 2019 years, the scheme operated in a positive cashflow position of approximately \$300 million in total.

Figures 1 to 5 below provide some basic historical information on claim numbers and types, claim payments, contract numbers and values, builder insolvencies and rejected claims:

Figure 1: Claims volumes and notifications, by calendar year

Calendar Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Notifications	26	133	121	134	265	194	317	439	543	75
Claims	301	404	313	242	412	544	386	435	509	119
Total	327	537	434	376	677	738	703	874	1,052	194

Note: As at March 3, 2020. A notification is the first indication of a possible claim. A Claim is when a “trigger” event described earlier has occurred

Figure 2: Total claims by type of claim made, total claim payments, by calendar year

Calendar Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Failure to Commence	50	27	11	5	26	18	14	14	7	3
Failure to Complete	234	272	122	59	159	235	154	164	201	41
Major Defect	45	163	236	277	406	292	294	387	476	80
Minor Defect	No data	89	115	90	175	264	215	88	242	48
Total Claims	329	551	484	431	766	809	677	653	926	172
Total Claim Payments (\$m)	2.38	24.85	27.23	14.74	21.15	29.02	54.96	47.72	56.3	6.7

Note 1: As at March 3, 2020.

Note 2: HBCF commenced in 2010, there have been changes to data collection over time and some claims are more than one type.

Note 3: Major and Other or commonly known as Minor defects as defined in the Home Building Act 1989

Note 4: Detailed data is available on the SIRA website in the Home building compensation scheme report 30 June 2018

Figure 3: Contract value and number of policies per financial year

Year issued	Total value all contracts (\$m)	No. policies
2010	4,409.4	27,562
2011	8,865.0	54,474
2012	8,721.6	42,409
2013	10,175.3	46,662
2014	11,880.2	52,768
2015	13,655.1	58,800
2016	15,374.1	62,454
2017	17,968.8	68,421
2018	17,226.0	67,812
2019	14,866.1	62,016

Figure 4: Number of insolvent builders by year of insolvency

Year issued	Total builders	Builders with claims
2010	44	n/a
2011	80	30
2012	186	58
2013	250	62
2014	282	72
2015	310	62
2016	373	89
2017	257	69
2018	399	74
2019	519	148

Figure 5: Number of rejected claims by year notified

Year	Builder found	Builder Licence not Suspended (CTTT)	Builder not dead	Builder not insolvent	Developer Exclusion	Incorrect Insurer	Not deemed a defect	Out of time	Grand Total
2011	3	-	-	5	-	-	13	-	21
2012	14	-	-	11	-	1	23	2	51
2013	5	-	-	16	-	-	21	5	47
2014	4	-	-	43	-	-	13	6	66
2015	6	1	-	41	-	1	24	18	91
2016	5	2	1	82	-	3	31	27	151
2017	2	2	-	11	1	1	20	17	54
2018	-	1	-	1	7	2	6	34	51
2019	2	-	-	8	11	3	6	39	69

The HBCF Claims process is outlined in the publicly available 'Claims information for Home Owners' document. Claims are managed within the icare HBCF claims system, which operates on Guidewire's insurance industry standard platform known as ClaimCenter.

3. Product history

The current iteration of the home building compensation scheme in New South Wales is the culmination of a long history going back to initial equivalent scheme inception in 1972. The design and operation of the current scheme regulated by SIRA, and the Fund as operated by icare, has been strongly influenced by the findings from multiple Federal and State reviews and inquiries³, as well as the impacts of several market events. Changes in the risks relating to the scheme over time have amplified incongruencies between private insurer and consumer needs, making reputable private insurers hesitant to re-enter the home building construction insurance product market, despite recent NSW Government reforms aiming to encourage private market competition.

The life of the scheme is best divided into four stages, summarised chronologically as a government-run first resort scheme at inception, then a private-sector-run first resort scheme, then a private-sector-run last resort scheme and finally the government-run last resort scheme that operates today. This history and some key milestones are summarised at **Figure 6**, below. A more detailed summary of the history of the scheme is presented in **Appendix A**.

Figure 6: The history of the Home Building Compensation Scheme in New South Wales

1 Government Run- 'First Resort' Scheme	2 Privately Run- 'First Resort' Scheme	3 Privately Run- 'Last Resort' Scheme	4 Government Run- 'Last Resort' Scheme
<ul style="list-style-type: none"> 1972: Scheme established 1992-1993: The royal commission into the Building Industry and Building Services Corporation report was released which recommended moving towards private underwriting 	<ul style="list-style-type: none"> 1997: Private Home Warranty Insurance Scheme commenced 2001: HIH collapses (40% of market) BIG Corp established for affected policy owners 	<ul style="list-style-type: none"> 2002: Scheme moves from 'first resort' to 'last resort' 2003: Removal of high rise buildings from the scheme 2009: In November NSW Government announces it will enter the market, managed by the NSW Self Insurance Corporation, as private insurers flag plans to exit the market 	<ul style="list-style-type: none"> 2010: Government enters the market with new premium structure and becomes the sole underwriter of home warranty insurance in New South Wales 2015: Renamed to HBCF and icare established 2017: SIRA appointed regulator 2018: Private competitors permitted to seek license

4. HBCF pricing and premium principles

It is appropriate to restate the current pricing and premium principles that currently exist around the HBCF. These principles exist to ensure the HBCF appropriately protects homeowners while supporting the building industry and promoting fairness, scheme stability and good management practices. SIRA's objectives in assessing insurer premium submissions for the Home Building Compensation Fund (HBCF) are:

- To ensure the HBCF premiums setting approach is aligned with the five principles adopted by SIRA, and
- To promote efficiency and viability of home warranty insurance.

As a statutory insurer with no profit incentive and sole provider of home building construction cover, icare seeks to be an exemplar of implementation of the premium principles.

³Some notable examples of inquiries and reviews include, but are not limited to, the 1992 Dodd Inquiry (NSW), the 1995 Crawford Inquiry (NSW), the 2002 National Review of Home Warranty Insurance and Consumer Protection (Federal), the 2003 Grellman Inquiry (NSW) and the 2008 inquiry 'Australia's mandatory Last Resort Home Warranty Insurance scheme' (Federal).

Principle 1: Premiums are fair and appropriately reflective of risk

Premium will be assigned to each project based on individual Adequacy of Premium examinations using:

- ultimate expected claims frequency targeted by:
 - construction type
 - statistically significant builder characteristics
- forecast average claims value
- investment earnings on unearned premium
- inflation and hyper inflation
- uncertainty margin
- transparency and ease of comprehension of pricing by industry
- minimum base premium.

This principle drives much of the complexity and friction about selling of home building compensation insurance. Historical and interjurisdictional models have relied on community rating or pooling of premiums to a single rate, regardless of construction type or builder characteristic. This has several benefits, including reducing the burden on builders to be assessed intensively for eligibility status, reducing cost of administration and avoiding adverse selection against desirable but higher risk construction categories. However, that approach foregoes proportionate risk allocation, enabling cross-subsidisation of substandard financial of construction practices by good practitioners, and essentially positioned the scheme to be a levy, spreading the burden of failed builders across the entire industry and their consumers to achieve a community outcome.

Between 2010 and 2016, there was a government position not to increase premiums during a slowdown of residential building activity in New South Wales. There was an optimism that a material increase in overall building activity would see private insurers wanting to return to underwrite the product at something close to historic prices, and a desire for home warranty cover not to become a lasting consumer protection levy. The current icare system intends to strike a balance between fair allocation of risk and risk pooling and is based on work done by icare and the then-Department of Finance, Services and Innovation's Data Analytics Centre (DAC) in 2016. icare overhauled the eligibility and project premium assessments to shift towards a risk-reflective basis to comply with draft principles. The primary change is a shift away from a "maximum annual turnover" and "community rating" model and towards one that reflected the severity and frequency of claims based on builder characteristics.

The two key indicators concluded from the new model are:

- builders at risk of insolvency in the medium term (36 months) (the DAC reported the model to have an **84%** accuracy)
- projects at risk to receive a claim; the DAC reported the model to have an **83%** accuracy.

That new model weighed the features by the statistical evidence, and found as a last resort scheme, the greatest indicators of severity and possibility of loss arising from an individual builder in the short and medium term were the indicators of insolvency:

- for short-term predictors, the most reliable indicators were changing contract amounts, number of jobs open in parallel, the participation in building multi-dwelling units and the number of jobs they have successfully completed historically
- of 219 predictors, the most reliable identified medium-term triggers were size of builder, commercial structure, size of liabilities and available assets, adverse behavioural history (complaints, licensing issues, etc.) and profit before tax.

It is important to note that not all builders displaying these characteristics will become insolvent and in fact the majority will not become insolvent, which makes it highly challenging to establish balanced criteria that enable Fund protection while maintaining a vibrant and competitive residential construction industry.

Data collection has been limited to the reviewed builder population of the HBCF portfolio (i.e. small, medium and major builders), based on annual re-assessments of eligibility, with other builders being assessed based on mercantile and other risk based alert monitoring. This is due to the capital-intensive nature of underwriting the financial and other information for the product, as outlined in Section 5.

To implement these changes, icare overhauled the model (which now form the basis of the current SIRA guidelines) based on:

- the approved Construction Profile (construction types and individual maximum project threshold) and its associated risk (for example, multi-dwelling buildings are attributed very high risk, alterations to single dwellings are attributed low risk)
- a shift away from “maximum annual turnover” to approving Eligibility Profile based on number of jobs open in parallel (Open Job Number) and the value of those open jobs (Open Job Value)
- a risk-weighted rating structure for builders (a capped bonus/malus to the base premium rate)

Principle 2: Premiums should not be excessive or inadequate

icare adopts the premium position that each price change made is to achieve breakeven premium rates. This includes a 15 per cent uncertainty margin which removes the underwriting strain that would otherwise place the financial sustainability of the HBCF at risk. It also stands in place of the profit a commercial insurer would require if it was operating in the market, to ensure icare HBCF is in a competitively neutral position against potential entrants.

icare’s expense ratio for managing HBCF is 19 per cent, compared to an insurance industry average across products of 24 per cent to 26 per cent. This is achieved through removal of distributor commissions and implementation of a performance-based remuneration model on the outsourced scheme agents, following the HBCF reforms initiated by NSW Government in 2015 and actioned by icare in 2016

Principle 3: Premiums should not be unreasonably volatile or excessive

Because of historical premium deficiencies compared to sustainable basis pricing and as noted in Section 2, certain construction types are still moving towards charging sustainable basis premium rates. To support industry and minimise volatility, rate changes needed to be staggered across multiple periods to avoid excessive volatility, impact to building industry or subject homeowners to a significant one-off period to period price increase to erase the imbalance through one major adjustment. Historical shortfalls from the legacy portfolio are not, and should not, be funded through future premiums.

For risk rating, capping and flooring continues to serve as a mechanism to limit premium volatility for individual builders.

Principle 4: Premiums should provide incentives for risk management and good business practices

Builder-risk based premiums provide discounts and loadings are based on risk factors with a technical basis. Clear communication of the factors that drive an individual builder’s discount or loading should occur, to influence builder risk-based behaviour, as considered in Figure 7:

Figure 7: Technical factors that drive builder risk rating discount or loading

No	Risk Factor	Description
1	Audited Accounts	Externally audited financial accounts - certified AASB111/ AASB 15 compliant The existence of additional controls and financial testing of reports increases the comfort in the financial statements reviewed and shows business maturity.
2	ANTA	Stand-alone Adjusted Net Tangible Assets (ANTA) in building entity as a percentage of assumed turnover Claims data shows the higher the levels of retained ANTA as a percentage of assumed turnover, the lower the frequency of insolvency
3	Net Profit Margin	Net Profit before tax as a percentage of Revenue Claims experience indicates that entities that have generated strong net margins for each of the past three years have a low likelihood of claims
4	Time in Business	Length of time in business as the current eligible entity Icare HBCF's claims experience is that claims are significantly less likely where entities have held their building licence for a longer period of time
5	Corporate Structure	Structure of the building business (i.e. sole trader, partnership company, trust) Icare HBCF's claims experience is that claims are significantly less likely where entities operate as sole traders or partnership
6	Adverse History	Previous association with adverse business credit/disputes history, entities which have generated HBCF insurance claims or material unpaid creditors or other characteristics identified as part of an eligibility assessment that present a substantial risk to icare HBCF
7	Reviews Not Current	Builder not submitting a scheduled eligibility review on time or that does not include all prescribed information
8	Building Review Program Participation	Builder's educational program participation. Inexperienced builders or builders changing their field using mentor to develop competence Participation in the BCRP can be a condition of Eligibility or applied to a project.

Some indicators were avoided as they were considered to promote less desirable public policy outcomes or be injurious (for example, icare accepts personal deeds of indemnity from directors without a risk loading, despite this being a significant indicator, and icare loads the premium for the highest risk commercial models rather than declining eligibility entirely, effectively prohibiting use of those legal commercial constructs). Discounts for audited accounts, strong asset base, profitability, time in business (a key hedge against 'phoenix' activity), currency of reviews and history of positive performance correlate with the severity of future claims, and as a last resort scheme, driving prudent financial behaviour has the most positive impact on the scheme.

HBCF's eligibility criteria is intended to ensure that "quick assets" on a building company balance sheet, that are included in the assets of related entities, are retained within the building entity to support the company in a difficult trading environment or where unanticipated events occur. Adjusted Net Tangible Assets and is intended to represent the net 'fire sale' position of assets less third-party liabilities. ANTA is viewed as a "buffer", available to the builder business for successful withstanding of normal business disruptions or "shocks". Claims data shows the higher the levels of retained ANTA, the lower the frequency of insolvency. Builders can choose whether to permit the level of ANTA retained in an entity to meet or exceed the minimum benchmark to attract a discounting impact (e.g. reduce dividend payments, retain property assets or limit related loans for non-core activity). Builders who choose to keep ANTA below the minimum threshold will pay a premium loading. Claims experience indicates that entities that have generated strong net profit margins for each of the past three trading years have a low likelihood of claims and as such will have a discounting impact.

As the sole insurer in the market, HBCF carries 100 per cent of the tail liabilities in the market since 2010. The share of tail liabilities carried by HBCF will not materially reduce for many years even though the market is open to competitor entry and competitors who write new business will be responsible for corresponding liabilities. Alternative eligibility models to the current state which allow a maximum annual turnover with no other limitations imposed, or a maximum turnover limit with no approved construction types, or an individual maximum project threshold or a maximum number of open jobs would cause risks to HBCF, depending on:

- the extent to which they encourage the financial resilience of builders to withstand adverse events, (for example, focus on trading profit over limited period only) and
- the extent to which they manage market behaviours of builders which in icare's experience influence the risk of builder failure, e.g. monitoring rate of growth, project completion times etc.

Setting ceilings on Open Job Value/Open Job Number and incentivising the amount of capital they have relative to this target, provides the greatest opportunity for growth in a builder's activity to be managed and incentivises pursuit of uneconomic growth to generate cash-flows as an arbitrage against other unprofitable projects, which we see as the biggest driver of severity in last resort fund claims.

Also operated is the Builder Contract Review Program (BCRP). The BCRP aims to assist new entrants to the building industry, as well as existing small to medium builders, to obtain eligibility (or cover for a specific project) where the builder is unable to provide suitable evidence of experience in the proposed building activity. The BCRP is intended to be a transitional phase and builders can apply in future to have the condition removed.

This is a program whereby a review and mentoring are provided for:

- proposed contract terms including scheduled progress payments
- project budget costs and gross margin expectation
- project construction schedule
- Builder's capability of managing the project in accordance with the construction schedule, contract and budget, and
- Inspection, supervision and quality control over building work.

There is a 10 per cent HBCF risk rating premium discount available where a builder participates in the BCRP. The discount applies to all projects undertaken by the builder and not only those projects required to be in the BCRP. More than 10 per cent of policies issues achieve this discount, and around 5 per cent of the projects insured are inspected and monitored in this way. While this option is available to small and medium builders where they seek support (arranged via their authorised distributor), builders are required to participate in this process to achieve eligibility to be insured where (if all other relevant financial and non-financial considerations are satisfactory):

- the builder has never successfully completed a new single dwelling or alteration project for a homeowner
- the builder is proposing to contract a significantly larger or more complex project than the builder's experience to date
- the builder has never worked for a developer or successfully completed a multi-unit project (as the multi-unit contractor or key manager within a building business) and seeks to; or
- it is recommended by an underwriter based on other review factors.

Mandatory participation based on the first three criteria is overwhelmingly the primary driver of inclusion in the program. The general underwriting principle is that a builder is reviewed and mentored for three jobs, after which participation is no longer required unless a subsequent change to practices triggers a new requirement (for example, further growth in job size).

Where a builder is subject to the BCRP as a condition of eligibility:

- The builder needs to pay the BCRP provider (sourced from a panel of participants assembled by HBCF) for the services; and
- The builder receives a discount on its premiums.

While icare has indicated to SIRA that it is open to expanding the scope of the BCRP beyond 10 per cent builder participation and has expanded its BCRP service provision panel as of 2020, as a responsible insurer, icare intends to defer doing so until further evaluation of performance. This is on the basis that unlike the other risk-based discounts, which measure severity as a consequence of financial practices most relevant to a last resort insurer, neither the program nor its predecessors in the commercial market (for example, Lumley) have demonstrated any statistically significant basis that the claim severity outcomes for mentored or reviewed builders is different than for those without mentoring or review or even justifies the existing discount. There has been criticism from BCRP participants and brokers that fees to the BCRP provider could cause extra financial burden for new market entrants, but this needs to be balanced against the insurer paying the costs and spreading the recovery across all participants mitigating against the earlier principle for risk rating. Noting home building construction insurance is a long-tail and volatile class, generally icare seeks very long-term pilots before significant expansions of cost-intensive interventions.

Principle 5: Premiums to be consistent with licenced insurer's capital requirements

The premium basis contains an uncertainty margin of 15 per cent. The level of uncertainty margin compares with the reasonable rate of return that would be expected if HBCF was to hold the prescribed capital requirements ("PCR") under APRA standards. It means that were a private insurer to enter the market tomorrow, market entry would be on a competitively neutral basis for that insurer, given that a reasonable product margin would exist in the market, upon which they operate a profitable operation.

5. What would encourage private market insurers to enter the market?

While icare is supportive of a possible benefit of a vibrant, diverse and competitive market, we note that there are a number of challenges in creating and sustaining such a market and recommend the current policy position regarding competition be reviewed. The barriers for a reputable insurer (or insurers) entering the market to provide competition in the home building compensation product space are considerable, despite the encouragement provided by the 2018 NSW Government reforms. There are several reasons for this identified in the IPART issues paper, but as the sole operator of a commercially equivalent scheme in NSW, icare will set out its experience with the product and the unique market challenges that relate to it.

icare's current revenue as sole provider of home warranty is \$134 million per year. This is particularly small, as demonstrated by comparison with the \$1.4 billion estimated to be spent on home and contents insurance in NSW or over \$2.0 billion in revenue from NSW Compulsory Third Party premiums (which, as with home building construction, is a compulsory insurance market).

Even where icare is generally charging break even premiums plus a market equivalent margin for competitive neutrality, icare's notional profit margin after expenses (present only to meet the competitive neutrality principle) is \$14.75 million per year. For each policy, premium income is earned over the insured period of seven years after issuing the policy, in accordance with accounting standards which require revenue to be recognised against the pattern of risk associated with the insured risk over the insured period. This long period of revenue recognition per policy has to be managed against approximately \$25 million in annual operating expenses, as well as claims expenses which could arise over up to the next 20 years in relation to policies already incepted, due to the long-tailed nature of home building construction liabilities. Where total revenue pools are this small and processing is so intensive, further divisions of the premium pool between participants would see proportional profit margins fall as premium revenues would be split amongst market participants, who would need to incur similar expenses regardless of their market share, including those that are fixed (or non-volume based), in order to provide the product.

Normally, in this sort of situation, an insurer might be able to leverage economies of scale within their organisation by deploying a portion of their already existing infrastructure to reduce any new fixed costs incurred entering a new market. However, the technical and ongoing nature of the information gathering activities required to underwrite the insurance mean the product is comparatively unique, as well as capital intensive to begin underwriting relative to other lines. As the major claim trigger for HBCF is builder insolvency, underwriters are primarily CA and CPA qualified, which limits the efficiencies between home warranty and other insurance products. The underwriting process and assessing the builder's financial viability might take weeks rather than minutes, particularly where the business has exposure to other industries and/or operates as part of wider corporate groups. Information is required to be gathered by builders, accountants and distributors for compiling submissions for underwriting and applicants are also subject to further and ongoing information requests during underwriting, which all take time to gather and process. These expenses would become significantly greater if the required underwriting obligations were expanded to include quality assurance, inspections, or financial monitoring as discussed in Section 11.

DAC findings in 2016 indicated that the greater the number of projects running in parallel, the greater the insurance risk. HBCF underwriting practices address this risk by continually assessing total job value and total numbers of jobs on hand (known as open job limits) for individual builders. HBCF has in place customised eligibility rules targeted at various segments of builders by construction type and builder's annual review categories are determined by builder size (new, system reviewed-small builder, small, medium and major builder). Whilst only 15 per cent of builders in HBCF's portfolio are required to submit a scheduled Annual Programmed Eligibility Review, such builders purchased more than 80 per cent of Certificates in FY 2019. HBCF's eligibility model is designed to capture majority of Builders, based on icare's risk appetite and impact to the scheme in a cost efficient and effective way. HBCF has a low frequency of major builder insolvencies, but when such an insolvency occurs, the impact on claims is high (due to the high numbers of open projects they run concurrently).

Case Study 1: HBCF Major Builder Interventions Case Study

A major builder (Big Builder), had eligibility restricted temporarily by HBCF in 2018, following an Annual Programmed Eligibility Review which identified the following issues:

- a large number of overdue open projects and loss notifications lodged by homeowners*
- business had underperformed and indicated unsatisfactory financial benchmarks, including insufficient working capital and adjusted net tangible asset positions*
- work in progress valuations on the balance sheet were challenged with the expectation that they would be compliant with relevant accounting standards and adjusted for the percentage completed rather than percentage invoiced in progress payments*
- Big Builder's poor financial position did not support the level of growth in open job limits sought.*

Big Builder was subsequently placed into the intervention program, where eligibility was temporarily restricted (i.e. Big Builder was only allowed to open a new project once an old project was completed (job off/on condition) to ensure homeowner's interests are protected and to avoid Big Builder's insolvency. HBCF worked with Big Builder's external financial advisor to ensure Big Builder managed the challenging period to improve its business viability.

In 2019, Big Builder's financial viability was restored and its request to increase its open job limits was approved by HBCF. In a letter to HBCF, Big Builder stated the following:

- HBCF teams' invaluable guidance has allowed Big Builder to improve the business management skills and our strategic planning mindset and it understood that the whole restriction decision was to support the business's ability to grow to a stronger position*
- There had been a substantial amount of time and effort from icare HBCF's end to assist Big Builder's eligibility and to communicate with Big Builder's senior management team and Big Builder appreciated the support and expertise that icare HBCF have given to improve the business's financial structure, business management and internal controls.*

Without the intense underwriting process, it is likely that Big Builder would have collapsed or suffered a significant failure, with a potentially catastrophic exposure.

Challenges regarding profit margin are exacerbated by the inherent loss volatility within the product. The 'straight through' SIRA pricing principle, aimed at reducing premium volatility sets premiums to the rate of the average year. As poor years in the construction industry tend to be 'bunched' together around triggers like the Global Financial Crisis, insurance providers might be expected to make significant losses for extended periods before the average premium can adjust to a higher level, for a run of 'profitable' years.

This means that the market is not only expensive to enter, but also a risky one in which to operate on a continuing basis, as activities can involve long periods of sustained insurance losses, with limited opportunity year on year to carve out profit from the small revenue pool. As a pertinent example, the possible impact of COVID-19 on HBCF funding ratios is still being assessed, but a relatively minimal impact might be a 30 per cent reduction in premiums combined with a 6 to 25 per cent increase in claims liabilities arising from an increase in builder insolvencies. This highlights the twinned exposure for both premium and claims to construction industry performance, which produces the underlying volatility of warranty insurance. It also reflects the historic experience with commercial insurers reducing risk by exiting the product (despite having a decade of tailing losses) in periods of economic turbulence.

The complexity of these challenges has led to the NSW Government being the sole provider to the scheme since the exit of private providers from the market in 2010, with icare operating as scheme manager since 2015. To our knowledge, no existing APRA-regulated insurer has applied for a licence to enter the home building construction market since reforms were enacted to allow competition. This supports the assertion that entering the market in its current form is an unattractive endeavour for reputable private insurers.

To attract private market entrants, the market would need to offer a greater chance at sustainable profitability for private insurers. Methods to achieve higher profitability, however, are likely to have negative effects. Adjusting revenue and liability factors more favourably towards private insurers would mean the product would need to become one of, or a combination of, more expensive, provide a shorter period of cover or provide less comprehensive cover. Such reform is clearly not in the interest of the homeowner, for whom the product exists, and would create mismatch between a builder's warranty and the protection available where a builder is not able to meet their obligations.

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

That eligibility assessment underwriting criteria are broadly similar and acceptance of all builders within each insured category for each participant, are requirements under current SIRA guidelines. There are options that exist to change this fixed standard, noting that changes would also have potential consequences.

In a best case scenario, allowing selection in eligibility criteria would induce a balanced market, with high risk builders being charged higher premiums and lower-risk builders being charged lower premiums. However, this becomes challenging in a market with a mandatory product of public good. The volatility of the product has historically demonstrated that competition through variation of eligibility models instead encourages unsustainable behaviours.

There are historical issues such as that which occurred with the failure of HIH in the early 2000s, where higher risk builders suddenly faced significant price increases or an inability to gain new insurance policies without that insurer in the market. Where insurers compete for the more desirable business of less risky builders, a price 'race to the bottom' could well be created in this situation. Continued competition that drives down the price in the market eventually makes it unsustainable in which to operate, due to the mismatched timeframes of liability recognition, revenue recognition and market volatility. This creates a potential risk of significant pricing volatility as risk is repriced.

More pertinently though, as market participants are also free to exit when the market becomes too risky or not profitable, it is not unlikely that market participants could also just decide to no longer provide the insurance to the market and exit entirely. This is the effect that triggered the commercial exodus from home warranty insurance in 2010. In 2010, the risk relative to the profit margin on policies became so poorly aligned that insurers exited the market, leaving the NSW Government to step in and manage the product and in particular, from a place where reaching sustainable rates of premium without dramatic premium price increases ended up taking more than ten years (with NSW Government covering the difference in unfunded costs).

On top of unsustainable price competition, there was also unsustainable eligibility allowances, where insurers loosened their eligibility requirements to enable builders to undertake more projects, simultaneously winning customers and generating more premium, but at the cost of the scheme encouraging sustainable building practices. Even in a best case scenario, where the Government underwrites the concentrated risk of the highest risk builders at an adequate premium and other business is written sustainably, the statutory insurer will be exposed to the most significant volatility and due to the inherently higher insolvency risk associated with small builders, likely remain the insurer for the majority of smaller business, ensuring the Government remains the largest participant in the home warranty market (as is the case with Worker's Compensation).

7. Are there any impediments to providers (insurers or otherwise) offering better value products to homeowners?

Products that offer better value to homeowners can be split into those that require changes to the underlying assessment of builder risk, and thus impact eligibility assessments, and those that do not.

Any consideration of increasing the flexibility of home warranty products available in NSW must consider and resolve the issues of interoperability. In the context of home warranty products, this is primarily a matter of how underwriting assessments are to be delivered and regulated with alternative products.

Both the existing 'sole provider' model and the 'equivalence of product' models ensure each residential builder in NSW is assumed to offer the same possible risks and are assessed against the same review of the financial risks builders pose to the consumer and the community, which is thorough and standardised.

The SIRA insurer underwriting guidelines establish that the existing and historic eligibility process is of essential community benefit as it plays a broad role overseeing builders in the residential sector. For example, regulators rely on eligibility assessments, with Fair Trading licensing conditions limiting work to projects not requiring home building construction insurance for those that have not passed an eligibility assessment. This both minimises risks and impacts of builder insolvency and provides notice and first response to those issues (for example, by suspending eligibility for insurance due to financial distress, preventing a builder from taking on new at-risk clients).

Any opening to alternate product models that impact underwriting criteria must consider who determines the kind of home building compensation insurance purchased for a project, how eligibility for different insurance types will be assessed, regulated and communicated and whether the variations create information gaps that increase the risk of insolvencies. This issue will be made even more challenging where there is regulatory sandboxing, for an alternate product potentially with limited capital support and limited initial customers.

While many of the issues are common to alternate products, the following section uses "introducing a First Resort product" and "splitting non-completion and defect covers" as examples of the issues at hand.

A First Resort insurer will have reduced interest in the insolvency triggers relative to a last resort insurer, and an increased interest in the construction risks of an individual build and its delivery. As such, there may be a significant variance in "First Resort" and "Last Resort" eligibility assessments.

First resort schemes also pose significant reputational risks for providers, and particularly government suppliers. Under a first resort scheme, if a builder is operating at the time of a claim, the insurer becomes joined to any dispute between the homeowner and builder, as is the common subrogation practice in liability products with available recoveries. The number of matters brought before Tribunal or Courts under New South Wales' previous first resort scheme was markedly higher than disputes between homeowners and icare HBCF under the last resort scheme.

If a builder is required to be assessed under both eligibility assessment models, interoperability (that is, the ability of builders to change insurers and for SIRA to compare underwriting results of different insurers, etc) could be (and would need to be preserved). This however, would mean both increased insurer underwriting costs (for a product that is already expensive to underwrite) as well as an increased administrative burden to builders under assessment.

If the builder is to be assessed only under one eligibility assessment model of their current insurer:

- the homeowner will not be able to elect for first or last resort cover, as their builder will only be entitled to one. This reduces the consumer choice added to the business environment
- community protection provided through standardised eligibility assessments will be watered down or reduced, leaving the community at greater risk of builder insolvency
- the insurer's role in supporting regulatory activity by sharing information may be compromised
- new, increased and entirely different assessments could add to the already significant cost of regulatory oversight, despite the overall premium pool being similar (or reduced due to competition).

Where a homeowner is ultimately required to receive the benefit of non-completion and defect cover, but an insurer is entitled to offer one without the other, interoperability requirements are heightened, to ensure the homeowner receives their legal minimum protection across multiple products and insurers have the underlying information necessary to price the component of risk they take. This again would require duplicate eligibility assessments and the ability for the regulator to compare and contrast policy documents to ensure the combined effect of cover meets the minimum breadth.

Alternatively, a greater separation between insurer and regulator could be considered, with eligibility assessments being undertaken by a statutory authority or regulator such as SIRA or Fair Trading, ensuring interoperability. Insurers would then be competing purely on price and product, and any additional underwriting required for alternate or superior products could be an optional transaction built into a provider's model. It is noted that prior to the 2002 reforms, this centralising of eligibility was offered but rejected by insurers in the First Resort market, as they did not want to rely on Government risk assessments and the ability for insurers to claim compensation, should risk assessments (or dispute resolutions) by Government result in a loss, was not clear.

Other product improvements

There are a range of product improvements that would benefit homeowners without directly impacting eligibility. Based on national and New South Wales claims experiences, such improvements could be priced for under the premium guidelines with reasonable risk tolerances. Examples of alternative products that could benefit homeowners include:

- policies that insure multi-dwelling new constructions over three stories. Insurers are not prevented by the legislation from providing high-rise cover, but it is a permitted exclusion which icare has exercised due to the challenges identified in Section 12
- optional increased policy benefits beyond the indemnity of \$340,000, as is currently offered in Queensland, or for a higher percentage of non-completion works

The largest impediment to the availability of these products is distribution, because while the homeowners are the sole beneficiary of improvements, the builder is the agent that both determines the product's price and has the obligation to ensure the insurances are in place. This exists by design, as otherwise, the homeowner would be required to gather all paperwork relating to the builder and receive builder approval, rather than placing this onus on the builder in the first place best expedite authorisation processes.

An additional current concern to product improvement above the legislative minimums is specific to icare. As the sole provider and inheritor of the historic pre-reform liabilities from subsidised pricing, there are both a government policy preference to not expand cover terms in a way that may discourage competition and a concern around increasing or varying cover in a way that could worsen the funding ratio if the initial premium assessments for new products proved insufficient. Where there is a policy preference to provide more flexibility and breadth of cover, icare is in a position to develop and provide these products to the HBCF customers fairly promptly.

8. What are the negative impacts of structuring to allowing for Commercial Competition?

Designing and offering either commercial insurances under the current model or alternative products that address the interoperability and consumer protection issues, is challenging due to the complexity of environment that such structures create. Critically, icare wishes to highlight that there is a mismatch between one government provider supporting the entire market, but maintaining a regulatory environment designed to maintain the possibility, however plausible, of competitive entry.

Product Inertia

The fluid environment created by the 'open door' limits the ability to investigate alternative products, due to the risk that a new product could be made redundant as the result of sudden market competition level changes. Further, while the scheme has been underfunded, there has been a reluctance to use insufficient funds to capitalise new or innovative products that provide better value to customers but add new risks. Improvements to the range or value of products available for homeowners will likely mean wider coverage, but setting a benchmark of wider insurance coverage will make the product less attractive to private insurers. The current structure therefore limits the ways products can be structured, as designing the scheme so it can serve several masters automatically requires a level of rigidity to ensure proper consumer protection continues to be maintained.

The current policy preference for a significant decrease of the statutory insurer's 'market share' as commercial entrants are welcomed, significantly limits icare's ability to arrange reinsurances. Robust reinsurance arrangements standing behind the Government-operated scheme could deliver to New South Wales many of the benefits intended from commercial competition, including reducing HBCF volatility on the Government balance sheet, as well as smoother long-term pricing. APRA-regulated or equivalent insurers may be more capable of returning to the market, but this time in a reinsurance capacity, if their attachment to the risk is at a significantly higher attachment point, covering only extraordinary risks, such as those with a once in 99 years probability of occurrence, for example.

Consumer Costs

Holding the door open to private competition and regulating the scheme like it exists in a competitive private market adds scheme costs. Regulatory structures create costs when keeping the market open to competition, as a solely publicly provided product would mean a vastly different regulatory landscape. However, when it receives no competitive entries, costs to maintain an open regulatory structure are incurred by government or passed on to policy holders, leading to a less sustainable scheme and higher premiums. Such additional costs erode any cost benefits that policy holders would otherwise be getting from the product operating on a not-for-profit basis through the current government provider and place significant guardrails on any policy investigations into alternative products that might have otherwise occurred in an environment with better clarity of future.

For example, icare currently pays the entire cost for SIRA's HBCF operations and investigations, which includes the regulation of icare, a public sector entity that would otherwise hold no profit margin. The cost of maintaining agency capacity for evaluating of new entrants is also incurred and political and community engagement with industry, as well as actuarial costs are also resultantly duplicated. Further, icare funds the support provided by SIRA to the Building Commissioner and SIRA's levy for home warranty has increased from \$2.1 million in FY 2017 to \$6 million in FY18, while icare has incurred an additional \$400,000 per year to comply with regulatory reporting requirements (establishing data feeds, etc). Equivalent review within Treasury prior to 2016 is estimated to have cost \$1 million per year total, in comparison.

The distribution environment, whereby brokers' engagement is mandatory creates further complexity for this product. HBCF's compulsory disintermediated operating model for product distribution means a builder must go through an authorised distributor to obtain home building construction eligibility and insurance. While the reforms were intended to create a 15 per cent reduction in costs by removing distributor commissions from the premiums, equivalent fees-for-service were introduced directly between builder and distributor, leading to less Government oversight of broker costs and performance but no overall cost reductions.

Brokers are mandatory under the current operating environment to maintain a healthy service provision industry for if competitors enter the market. It is estimated customers still pay over \$20 million in broker fees each year, meaning larger brokers make higher annual profits from fees than private insurers of the product would expect to make from insuring it. icare understands that some of the strongest supporters of privatisation are brokers, as well as industry associations that hold strong ties to brokers (rather than insurers), which is understandable in the context of mandatory statutory insurance with a captive market.

Many brokers provide inarguable value to their customers and many builders will still require support with the complex processes involved in warranty insurance. However, it is icare's view that the effect on such valued relationships would be minimal in a system that did not mandate broker use. Use of a distributor could be a discretionary election by the builder, based on their size and sophistication. Such services could also potentially be provided through accountants as they are in Queensland, given the builder's accountant is accountable for preparation of financial statements, depending on the builder's overall relationship with their broker.

icare already has the technology for direct builder engagement, eligibility assessment, underwriting risk control & reporting, insurance policy processing and issuing, premium collection which would enable a transition to an optional distribution model that would deliver increased consumer value. The margin charged on premiums for competitive neutrality is only required so as not to disadvantage commercial entrants. While some portion of the margin may be retained for smoothing of losses over time, an estimated 9 per cent of the 15 per cent margin is charged on public policy grounds of not disadvantaging competition.

The net impact on home owner is an effective increase to the total cost of insurance (including regulation, distribution and notional profit) of up to 30 per cent, or a total systemic impost on consumers of \$40 million per year, while delivering no benefits to date.

Ways to structure the scheme that could improve the value of the product to homeowners certainly exist where solutions do not consider maintaining a scheme open to private entry. For example, first resort (or wider support than last resort) coverage would likely be welcomed by homeowners, as it would provide them with support at an earlier stage in the process. Such coverage could also have the effect of improving dispute resolution processes between homeowners and builders across the system, by permitting icare HBCF to be involved with potential issues at an earlier time and therefore helping manage issues before they culminate in builder licence conditions or suspensions. While this would not be compatible with an open scheme as historically market competitive first resort schemes have meant unacceptable costs to both insurers and builders, such an approach could lead to lower overall costs across the building regulation ecosystem, through earlier intervention and streamlining dispute management processes so that they accommodate builder licence conditions or suspensions processes also. Further discussion about potential models is summarised below at Section 12.

9. What would improve the experience for homeowners making a claim on the Fund?

The HBCF scheme aims to provide a safety net for homeowners with incomplete or defective work where the builder (due to one of four “trigger” events of: insolvency, death, disappearance or where a licence is suspended due to non-compliance with a money order of a tribunal or a Court) cannot complete or rectify work.

For claim priorities, HBCF also aims to:

- ensure the HBCF is ultimately self-funding
- ensure builders take on the level of work commensurate with their financial capacity by using open job numbers and open job limits that align to the builder’s financial position
- provide HBCF insurance in accordance with the requirements of the Home Building Act
- proactively protect homeowners by responding to risk indicators such as loss notifications or NCAT orders relating to builders, or where market intelligence indicates a builder is experiencing financial difficulties and taking appropriate action, such as calling for a Special Eligibility Review of the builder (which could lead to possible suspension).
- ensure funds used to settle claims are returned to the NSW building industry.

HBCF Claims acceptance and payments are restricted by various caps and time limits to ensure claims are settled within policy limits. Policy limits are defined and established in the legislative framework as follows:

1. On receipt of a claim which has been ‘triggered’, HBCF Claims (through icare HBCF’s claim service provider, Gallagher Basset (GB)) liaises with the homeowner to gather what is known as the ‘prescribed claims information’ (PCI) (as listed in the publicly available document: Claims Information for Home Owners). Once all information has been received, the claim must either be accepted or denied by HBCF within 90 days, or else it is deemed as accepted.

Collation of the PCI ensures full and accurate documentation is available for the evidence-based management of claims.

2. Following receipt of all prescribed claims information, HBCF Claims (via GB) will assess the claim (this often requires the appointment of an independent third-party building consultant to visit the site of the claim and document findings within a report) to determine which claim items should be accepted (or denied) in accordance with the HBCF policy of insurance along with an initial estimate of the likely claim cost (known as the ‘scope of works’). The scope of works is then agreed with the homeowner and an overall decision of the claim is made by icare HBCF Claims (via GB), to either accept, deny or partially accept the claim⁴.

HBCF claims are governed by legislation, a regulatory framework and the relevant HBCF policy of insurance. This requires detailed and technical analysis of each unique claim to accurately list and quantify the items of each claim. The use of third-party building consultants in this phase ensures that supply of this service can easily be adjusted to match demand. Where required, claims decisions are escalated and legal advice sought where necessary.

⁴The homeowner may request a review of this decision in accordance with the publicly available: HBCF Complaint and Dispute Handling Procedures.

3. The next stage in the process is to obtain tenders from builders (known as the 'rectifying builder') to complete the scope of works. This is done by:
 - The homeowner directly requesting builders to submit a tender, and/or
 - icare HBCF Claims (via GB) posting the project on the icare HBCF 'Claims Quoting System' (CQS), and/or
 - In-house technical experts.

CQS currently operates by advertising a project (an email is sent to all those that have registered to receive project alerts) and only accepting tenders from those builders that have the appropriate HBCF eligibility that matches that of the original claim certificate to undertake the project⁵.

GB uses in-house technical experts and an online propriety system called 'GBuild' to obtain and review tenders received from builders and select which tender is most appropriate and competitively priced.

The rectifying builder tender phase is competitive, proactive and supported by online technology tools. This phase leads to a market-determined and tested determination of claims expenses. HBCF Claims closely monitors trends in claim expenses to ensure they remain within accepted tolerances

4. The homeowner then contracts with the builder they select, and GB makes progress payments to the builder in accordance with the schedule outlined in the new contract.
5. The rectifying builder is required to take out a new HBCF policy of insurance if the cost of the works exceeds \$20,000.00.
6. In some cases, the homeowner may request a cash settlement to arrange to complete the works either as an owner builder or with another rectifying builder whose tender was greater than that used to settle the claim. In either scenario, the claim is closed following the final payment, and recovery action against the original builder is pursued by HBCF where applicable.

Progress payments allows rectifying work to be remunerated as work is completed to the claimant's satisfaction. Claims are regularly reviewed to ensure the claim is progressing as expected.

icare HBCF claims will pursue recovery action against original builders where the chance of recovery is likely, and the costs of pursuing recovery do not exceed the recovery amount. As at 20 February 2020, \$178,000 had been collected for the calendar year to date. These funds are returned to HBCF reserves to off-set the costs of future claims. The overall process for a typical claim is depicted below:

Figure 8: HBCF Claim Lifecycle



Each stage of the process is supported by service levels to ensure claims management is timely, thereby minimising unnecessary delays in the process.

⁵Eligibility profile of a builder consists of the type of construction, the number of projects and the open job limits that builders can undertake at any given time

There are several benefits that exist with the current icare HBCF claims process. Firstly, homeowners can select and contract the rectifying builder of their choice. This ensures the homeowner remains in control of the project, which is often their home and principal financial asset.

Secondly, icare HBCF leverages and supports the NSW building industry to match capacity with the requirements of each claim, rather undertaking rectification work through a limited panel of builders. This supports the needs of homeowners in a transparent and competitive manner whilst ensuring rectification work is efficiently priced and delivered.

Thirdly, icare HBCF links various systems for screening builders who tender for claims work, to ensure suitable eligibility limits, permitting the use of builders with a sufficiently high eligibility rating to permit minimal risk of another issue developing with the rectifying builder and to gather a short list of builders that have worked previously in the area of the claim. After homeowner sign off, progress payments are made where possible to rectifying builders on satisfactory work.

It is recognised, however, that some opportunities exist to improve the experience for homeowners making claims on the fund. These factors largely relate to builder involvement and education. More involvement of the building industry in participating in the rectification and completion of claims and clearer education and communication to the industry that allows builders to understand they are not responsible for the prior builder's work would be likely to lead to a larger pool of builders being prepared to undertake claims rectification projects. Additionally, icare is improving systems to better link builder eligibility profiles with project work types, which will support identifying suitable builders for rectification work.

10. Are there unnecessary administrative burdens and barriers for builders?

HBCF's financial and operational impacts on builders are significant, and the product's impact is larger for the construction industry than it could be for the insurance industry. It is the insurer's duty, under existing guidelines, to weigh the likelihood of a builder's collapse and the impact of that collapse on the wider community (as measured through scheme outcomes) in determining how many construction projects they can have open, and at what value, at any one time, in exchange for on average 1.183 per cent of the value of those open jobs in premium.

As last resort home building compensation insurance is a consumer protection product, the builder will never receive any benefit from the policy, and the interests of the insurer and builder in the process are not only distinct, but mismatched. This leads to very different perceptions on the necessity of the administrative burdens of an eligibility assessment between the parties. The current design of the scheme strikes a balance between aiming to reduce the administrative burden on builders, while maintaining eligibility requirements that sufficiently protect homeowners and HBCF from builder failure. icare notes that striking a balance that encourages a vibrant building and construction industry, while appropriately protecting homeowners, is a challenging process, but significant work has gone in to the process to get the balance right.

Builder insolvency is the most common cause of a HBCF claim being triggered. Due to the long tail nature of HBCF product, HBCF already has a significant outstanding claims liability including the liabilities associated with past insolvency events and future insolvency events but for historical underwriting periods. Unlike a bank undertaking a similar audit, HBCF has no position as a secured creditor nor can it seek to become so, which limits the assessment's focus to be based on assessing immediate solvency/liquidity.

The process has been simplified and clarified over the past two years. A significant portion of the building community (the System Reviewed Small Builders) have a reduced frequency of eligibility assessments based on their maximum possible risk to the Fund. icare is currently exploring other options to reduce complexity without materially reducing the effectiveness of the eligibility process,

In the absence of commercial competition and a policy decision to place higher reliance on other instruments such as regulations to ensure good business practice, options do exist to return to a community rating model. This would remove the need for eligibility assessment entirely, reverting home warranty to a pre-1997 position and significantly reducing the administrative onus on builders. It should be noted, however, that any moves that approached community rating would have the effect of reducing costs for builders deemed lower risk, while raising them for those deemed higher risk.

11. How could the scheme further reduce defects and insolvency?

HBCF currently incentivises building participants to undertake good risk management and good business practices through premium bonus and malus structures and imposed open job limits. Through the BCRP, there is also oversight of progress payments, critical stage inspections, and other measures for select segments of builders. There are opportunities for the expansion of the BCRP or amendment of its criteria, and for closer interactions between icare and the regulators to enable icare to price for premium impacts based on outcomes of regulatory compliance activities.

However, it is important that this process does not consider the home building compensation scheme in isolation from the rest of the NSW Government regulatory and home building environment. icare's involvement through the home building construction scheme only occurs at the end of the process when all other avenues are exhausted. The stronger the regulatory and building environment throughout the process, the less likely it is that a claim manifests at the end of the process within HBCF.

It is noted from the outset that there is a paradox inherent in seeking to have the current provider take greater steps to avoid negative community outcomes by mandatorily taking steps to “support building work supervision and quality assurance” that are primarily meant to be addressed by existing regulatory arms of government and require an challenging and sometimes adversarial relationship with builders who purchase the product, while also trying to incentivise commercial entrants to offer a more flexible commercial product. The original findings of the Dodd and Crawford Inquiries highlighted that the combination of regulatory and insurance functions created conflicts of interest. The insurer's role was limited to the area with the highest scheme impact and where they arguably have a higher interest than the regulator, being the builder's financial ability to manage multiple ongoing projects, with other aspects incorporated into the licensing and regulatory regime managed by NSW Fair Trading.

Several regulatory and quasi-regulatory actions occur within the home building ecosystem along the way which are complex and assigned and linked to different NSW Government entities, prior to HBCF becoming involved. icare relies on other agencies for design of building codes and engineering and architectural requirements, regulation of construction processes, building certification requirements and management, trade and builder certification and mediation and arbitration of disputes between homeowners and builders. icare also has limited responsibility for multi-dwelling construction as previously noted, with multi-dwelling construction above three storeys falling within SBBIS. A summary of some of the responsibilities of different agencies is presented below at **Figure 9**.

Figure 9: Responsibilities of different NSW Government agencies/authorities

Building Commissioner	Fair Trading	Building Professionals Board
<ul style="list-style-type: none"> Investigation and disciplinary action for misconduct in the building industry Overseeing the end-to-end licensing and auditing across the building industry 	<ul style="list-style-type: none"> Licensing for trades and building Work inspections Dispute management for incomplete or defective building work High-rise scheme through the Strata Bond Building and Inspections Scheme 	<ul style="list-style-type: none"> Accreditation of building certifiers and code of conduct related to those accredited Receipt and investigation of complaints against certifiers Professional development for certifiers and certifier data collection
Planning, Industry and Environment	SIRA	icare
<ul style="list-style-type: none"> Linkage between the National Construction Code and the <i>Environmental Planning and Assessment Act 1979</i> and <i>Plumbing and Drainage Act 2011</i> Planning and development approvals (with Councils) 	<ul style="list-style-type: none"> Eligibility guideline development for builders (and audit of guidelines) Eligibility guideline development for scheme insurers (and audit of guidelines) 	<ul style="list-style-type: none"> Scheme underwriting for the HBCF scheme (buildings three storeys and under) Eligibility assessment (both initial and ongoing) for builders to ensure they meet SIRA criteria

The HBC scheme relies on the effectiveness of other parts of the government ecosystem when it comes to process and design. For example, while HBCF is responsible for remediating issues where a major defect occurs on an item, the design and building requirements relating to the item, as well as the process for checking and approving the item and ensuring the builder or installer has appropriate skill to perform the process, all sits out of icare’s sphere of influence. icare has limited control over issues of building quality, even though the builders who provide the lowest quality work might create the highest risk to the HBCF.

Case Study 2: HBCF investigatory action case study

In 2019, HBCF received adverse information and became aware that a director of the large building group was a director of another building entity that had recently become insolvent. As per its information sharing obligations under the Home Building Act 1989, icare HBCF forwarded this information to NSW Fair Trading Office for action.

On receipt of adverse information provided by HBCF, the Secretary of NSW Fair Trading advised the Builder that its building licence would be cancelled due to the director being both a director of the previous failed business when it went into liquidation and being a current director of the building group per s33B(xvi) Home Building Act 1989.

NSW Fair Trading subsequently rescinded the licence cancellation notice for the building group and advised it would not issue similar builder licence cancellation notices for the building group.

As a public entity with information-sharing rights under the Act, icare was able to review information concerning this director and the previous insolvency for potentially adverse information, and engaged with Fair Trading around their decision-making process.

In line with the determination in NSW Fair Trading Office, HBCF determined it will not treat the previous failed business as adverse information for HBCF eligibility purpose so as not to create a perverse ‘double jeopardy’ situation whereby a builder can be successfully appeal to Fair Trading for reinstatement, but then be denied insurance on the basis of conservative eligibility standards, triggering a necessity for Fair Trading to restrict the licence exclusively to non-residential work.

It should be noted that if the regulator has not seen fit to act against a builder such as Court prosecution action, licence cancellation / suspension or the imposition of conditions limiting the work the builder can contract it places HBCF, the insurer in a difficult position in determining what action to take against a builder's eligibility.

icare's role in the broader NSW Government regulatory environment is to manage the HBCF by underwriting and operating the home building compensation scheme, complying with the SIRA requirements that eligibility assessments protect the community from builder insolvencies. While icare is proud of its record in reducing the rates of builder insolvencies for eligible builders, leading to an estimated \$5 million per year reduction in claims costs relative to the previous eligibility assessment model, it is noted that such an objective becoming a mandated aspect of a broader regulatory environment might sit uncomfortably where there are commercial entity market entrants. Nonetheless, the current model minimises duplication of effort by having the insurer examine the builder's finances in greatest detail while other regulatory providers examine the quality and suitability of building activities.

A number of proposed "innovative methods" by which an insurer could mitigate the risk of builder insolvencies entail taking an inspection-based underwriting model and reflecting the outcomes of those inspections into eligibility and premiums. This is similar in some ways to the scope of the BCRP program discussed previously.

To incorporate aspects of monitoring progress payments, inspecting build sites for defects, investigating adequacy of contract price prior to insuring a build or other such interventionist methods into eligibility assessments, icare notes this requires an introduction of a "project-specific" underwriting as well as overall eligibility. Certifiers or equivalent professionals would need to be available to inspect each project in New South Wales, with suitable insurances in place. Financial assessments would need to be performed on each build, and icare would need to be given access to the terms of every signed contract, ideally with a copy of the contract kept on file.

This:

- Would significantly increase underwriting resourcing and expenses
- Would require additional compulsory compliance activity from builders, effectively adding a second onerous layer of compliance to whatever regulatory regime is in place
- Could lead to confusion as to build quality, with projects at risk of having different outcomes from insurer and regulatory inspections and reviews

These additional costs would be significant, taking an already-specialist and expensive classes of insurance to underwrite and making it significantly costlier (e.g. expenses as 19 per cent of premiums could increase to expenses as over 30 per cent of premiums). To ensure icare as a default insurer, let alone an entire competitive field of insurers, have access to the limited pool of qualified certifiers to inspect even a material sample of constructions in New South Wales would be challenging, especially in regional areas. As evidence, icare notes that it appointed all but one tenderer for the BCRP services, which only enables icare to inspect 5 per cent of constructions, and those primarily being from the simpler sample of projects.

icare also notes that there is no actuarially supportable evidence that this approach would materially reduce claims, and while it is not the main issue, it is also worth noting HBCF has independent valuations performed by external actuaries and is very long-tail, so any benefits this approach did take would not be felt in claims for four to seven years, with the added expenses needing to be recovered directly through premiums in the interim.

It is noted some historic private insurer models for underwriting home building construction insurance (for example, Lumley) included some of these elements as an "additional" service, which did not demonstrate improvements in their associated claims performances but instead only increased operational costs.

The key question to be fleshed out is what is the nexus between the gathered information and underwriting impact on eligibility. As a last resort scheme with a consumer protection focus, builders taking actions that are deemed outside insurer appetite can either:

- limit or cancel their eligibility (i.e. reduce the number of houses they can build or placing conditions on their licence preventing the builder from engaging in residential construction);
or
- increase their risk rating (i.e. increase the premiums charged to that builder for future jobs, but not the ones on hand)

Limiting or cancelling eligibility in a last resort scheme has the perverse effect of significantly increasing the chance of insolvency and thus increasing Scheme claim costs for non-completion. If the standards were conservative enough to materially affect building practices in New South Wales, it is fair to assume this step would also be viewed by industry associations as a significant restraint on trade.

Increasing future risk ratings would increase the cost being passed on to home owner consumers by those builders, which may have minor impacts on competition, but with premiums generally around only 1.2 per cent of a contract price and risk ratings adding a 30 per cent bonus or malus variance to that base cost, the impact of risk rating would only be a 0.7 per cent variation in price difference, which in the context of driving builder behaviour, is negligible and unlikely to generally impact behaviours.

Using the insurer to take on a broader role in regulating behaviours regarding compliance and building quality essentially creates a dual regulatory environment, with two authorities (icare and Fair Trading) enforcing separate standards, each directly impacting a builder's eligibility to trade. Further, unlike with the ordinary practice of regulators, the insurer's standards of compliance could reasonably be expected vary annually, based on their valuations.

This issue would be significantly exacerbated by the entry of commercial competition, as they would either need to be accountable for enforcing a framework for these new standards (and SIRA would need to regulate their commercial underwriting decisions) or they could set their own commercial standards, in which case significant interoperability issues would be raised.

Explorations of the inspection-based model using Queensland as model has highlighted that:

- inspections are more relevant within the broader insurance coverage Queensland provides (quasi-“first resort”), where the primary claim trigger is dispute regarding defect rather than builder insolvency
- the costs of inspections in Queensland are defrayed by comparatively high recoveries, made available because the builder is not insolvent at time of claim, which is not to be anticipated with a Last Resort product
- Queensland's funding ratio (i.e. the ratio of revenue to claim cost) cannot be directly compared, as their revenue includes licensing fees and other revenues as well as premium
- Queensland do not have the ‘dual regulatory’ issues as the equivalent HBC insurance is run as a purely government activity through their Building Commission office
- even including these considerations, it is noted that Queensland continues to have premium deficiencies.

12. Discussion on scheme model changes

Noting the above highlights the flow of construction responsibility, it is also useful to outline the HBC scheme's role in construction disputes, relative to other potential models. At the moment, the role of the HBC scheme is only to provide a 'last resort' cover to homeowners, meaning policies are only designed to provide cover for cases where builder becomes insolvent, or dies or disappears. This means where a builder is solvent, homeowners currently need to deal with builders, contractors, architects or engineers directly to seek rectification in the first instance, regardless of the pervasiveness of the defect. Where the homeowner is unsatisfied with the response, the homeowner then can engage proceedings with NSW Fair Trading and following that the NSW Civil and Administrative Tribunal (NCAT) if the process remains unresolved (or Fair Trading determines the matter is not suitable for its intervention).

This can be a long and frustrating process for homeowners, particularly where the homeowner is dealing with an unscrupulous provider and/or are unaware of their rights or the procedures in place to manage dispute resolution. This was even more so prior to 2009, under the private market-negotiated last resort structure, when a homeowner would have to try to enforce a Tribunal or Court order and instigate insolvency proceedings against the builder to satisfy the grounds for lodging a claim. The introduction of legislative changes deeming the suspension of the builder's licence for non-compliance with a monetary order of a Tribunal or Court order as an 'insolvency' for the purposes of home building construction insurance significantly helped to improve homeowner access to the cover provided by the home building construction scheme.

Nevertheless, there is a view that homeowner access would be further enhanced by earlier access in between the current position and a first resort product (for example, non-compliance with a rectification order issued by NSW Fair Trading). However, issues such as procedural fairness for the builder and from an insurer's perspective an associated suspension on the builder's licence would need to be considered.

The New South Wales scheme has been a last resort scheme since 2002. Per the Report on Home Build Amendment (Insurance Act) to the Standing Committee on Law and Justice in NSW in 2002, the change from a first resort scheme to a last resort scheme was considered positively by builders, as it means that dispute resolution and mediation in regard to defects became more a process between homeowners and builders, rather than insurers and builders. It was noted that the process was less positive for homeowners however, who now needed to be much more involved when a defect dispute arose with a builder.

Before 2002, the scheme was a first resort scheme. Typically, under a first resort scheme, a policy holder can make a claim on their builder's warranty insurance when the policy holder is able to prove the existence of defects. This makes dispute and claim processes more streamlined from the consumer point of view but tends to result in higher costs for builders. Such a system potentially increases the administration requirements on government as well, as processes are put in place to investigate defects and make rulings and the number of claims potentially rises due to the ease of using the process (and any investigation costs are borne by government, due to there being no private providers in the market). However, NSW Government incurs the costs of the process currently either through Fair Trading or NCAT, or through the icare HBCF process and coordinating defect dispute processes across the three areas provides an opportunity to reduce some costs overall.

Multi-dwellings

While formally, icare is not prevented by the legislation from providing high-rise cover, it is a permitted exclusion which icare and its predecessors in the private market exercised for a number of financial reasons, including being unable to reliably estimate losses or to obtain reinsurance.

It is acknowledged that multi-dwelling constructions pose significantly different risk profiles and claims costs to other residential construction work. For example, based on PwC valuation at Dec 19, the total claims liability was \$1,147 million. Of this, multi-dwelling construction liability including alterations and additions made up \$556 million (50 per cent), while single dwelling liability made up \$208 million (19 per cent)

Anecdotally, while HBCF does not insure more significant high rises, it is noted that the risks with larger buildings are much greater again (for example, Mascot, etc). Importantly, while HBCF does not cover new multi-dwelling construction over three storeys it is on risk for remediation, repairs, alterations etc. to existing multi-dwelling buildings irrespective of the number of storeys. The claims experience to date involving such projects indicates that both the solvency of the builders and work standards in this market segment are of concern. NSW is the only jurisdiction to provide home building construction insurance cover for work to existing multi-dwelling buildings over three storeys.

Residential construction of multi-dwelling buildings greater than three storeys is managed separately to HBCF, through Fair Trading and the SBBIS. The significant difference between SBBIS compared with HBCF costs to industry and consumer outcomes highlights that very different levels of consumer protection exist for different segments of the market, and that this has been the case since multi-story buildings were excluded from HBCF in 2003 to defer private market exit.

13. What features of schemes in other places should be adopted in New South Wales?

Currently no other State or Territory in Australia operates a wholly privately underwritten home building construction scheme and only the Queensland scheme operates in a way that is not last resort. The total exit of private providers from the scheme between 2009 and 2011 occurred in a relatively universal manner across Australia. The home building compensation schemes of each State also cover only up to three storeys builds, although as mentioned, NSW is the only jurisdiction that covers remediation, repairs and alterations to existing multi-dwelling buildings over three storeys.

Figure 10 provides a comparison of some key publicly available financial information from home building compensation schemes in New South Wales and other States, displaying that financial challenges regarding the scheme tend to be relatively consistent State to State. It should be noted that other States (apart from Queensland) offer less transparency on operations than New South Wales and as such, some figures are either unavailable or estimates drawn from available information. As well as this, it should be noted that the maximum level of mandatory cover in New South Wales is higher in other States. Per Figure 10, premium collected on New South Wales Home Building Compensation Fund policies in the year ended June 2019 was approximately \$139.0 million. This represents a relatively small revenue market. This is contrasted with the combined claims and unearned premium liabilities in the New South Wales scheme of approximately \$1.05 billion.

Figure 10: Comparison of different schemes from publicly available information

	NSW (HBCF)	Vic (VMIA)	Qld (QBCC)	WA (Dept. Mines Industry Regulation and Safety)	SA (SAicorp)
Premium collected	\$139.0 million	\$56.0 million	\$85.9 million		
Earned premium	\$129.0 million	\$65.7 million	\$77.6 million		
Claims paid	\$63.4 million	\$53.1 million	\$45.6 million		
Claims expense	\$300.8 million		\$24.9 million		
Claims liabilities	\$678.3 million	\$346.4 million	\$235.5 million		
Unearned premium	373.0 million	\$136.0 million	\$37.6 million		
Threshold for requiring cover	\$20,000	\$16,000	\$3,300	\$20,000	\$12,000
Max. cover amount	\$340,000	\$300,000	\$200,000/ (optional \$300,000 for additional payment)	\$200,000	\$150,000

The Victorian and New South Wales products are historically similar, with Victoria and New South Wales consulting closely on the product to 2010 as private insurers removed themselves from the product and left the market. The Victorian product currently appears less costly than the New South Wales product, however, this is likely due to different, less transparent reporting of the home building construction insurance fund in Victoria, as it is largely conflated with the results of the rest of the Victorian Government's main insurer, the VMIA and it is unclear whether liabilities are calculated in line with APRA standards as they are in New South Wales. As such, the financial results presented are skewed and not considered to be necessarily representative of a superior product. Even given the difficulty in fair comparisons, icare notes that premiums in Victoria have always been lower than New South Wales, even in the private market. Anecdotally, the previous private insurers have always noted that while neither jurisdiction offered commercial viability, higher New South Wales prices were driven by jurisdictional differences such as more frequent claims, less effective enforcement of building standards and higher construction costs.

The HBCF-equivalent scheme in Western Australia operated as a voluntary market successfully from 1985 to 1995. In order to offset the adverse selection of risk, builders could elect to either 100 per cent participation in the form of "one project in, all projects in" or nil participation. A market push, through public awareness advertising, for builders to insure and then use their insurance as a point of difference in their own marketing was essential to the success of the scheme. The economic downturn in 1994 resulted in a poor claims outcome for the Western Australian fund. As premiums contracted and claims increased, the private-insurer panel and reinsurers for the largest fund considered exiting the scheme. There was also evidence of builders withdrawing their offer of cover to lower their costs and pricing. In 1997, the scheme was made mandatory. The Western Australia experience shows that voluntary cover results in critical exposures that are exacerbated by periods of low economic activity.

The model of most interest for the purposes of comparison, is the Queensland model. The Queensland Building and Construction Commission (QBCC) model is a publicly operated model by a separate agency of the Queensland Government. The QBCC is responsible for regulation, licensing and certification, as well as providing underwriting for the home building construction fund. The Queensland model allows for intervention at an earlier stage than last resort and as such, it links through the processes of mediation and dispute management into the process. The Queensland system then also permits other revenue streams to be collected throughout the process. Again, it is challenging to know the true results that the QBCC model is producing due to the lack of comparability overall in its reporting. The QBCC Scheme, like the New South Wales scheme prior to 1999, did not administer or report on the 'scheme' (over seven etc years). It reported on the business on an annual basis and the budget for the business for the next 12 months would be based on forecast income and expenditure across all operations for that period only. Shortfalls in one area could be subsidised by another area.

As a base case, the model is interesting relative to the models used in other States and while it is too early to identify them clearly, there may be some learnings to take out of the Queensland model that can be applied to New South Wales.

Appendix A

History of the HBCF scheme and home warranty insurance/home building construction insurance in New South Wales

A1 Brief product history and scheme design

The scheme has evolved from initially operating as a Government run first resort scheme at inception, to a private sector run scheme, to the Government last resort scheme currently operated.

There have been multiple inquiries and reviews, both State and Federal, into how the home building construction scheme should be optimally operated since the scheme's inception, including:

- The 1992 Royal Commission into Productivity in the Building Industry
- The 1992 'Dodd Inquiry' into the Building Services Corporation
- The 1995 'Crawford Inquiry' into outstanding grievances with the Building Services Corporation
- The 1996 Review of Licensing in the Home Building Industry
- The 2002 National Review of Home Warranty Insurance and Consumer Protection
- The 2002 Joint Select Committee Inquiry on the Quality of Buildings
- The Standing Committee on Law and Justice, Review of the Impact of the Home Building Amendment (Insurance) Act 2002
- The 2003 'Grellman Inquiry' into NSW Home Warranty Insurance
- The 2005 Review of Licensing in the Home Building Industry
- The 2006/7 NSW Legislative Council's General Purpose Standing Committee Inquiry into the Operations of the Home Building Service
- The 2008 Federal inquiry, 'Australia's mandatory Last Resort Home Warranty Insurance scheme'

From these inquiries, several observations and findings have evolved the way in which home building compensation insurance is provided and these have led to the form and operation of home building construction insurance today.

A2 Initial scheme

The initial scheme was established in 1972 and operated by the Builders Licensing Board (later the Building Services Corporation (BSC) through the enactment of the *Home Building Act 1989*). The Builders Licensing Board had responsibility for builder licensing, scheme insurance and regulation. The scheme was operated as a Government run 'first resort' scheme, meaning claims could be made regardless of whether the builder was insolvent, had disappeared or had died.

A3 The Dodd Inquiry and the Crawford Inquiry

In 1992, the *Royal Commission into the Productivity in the Building Industry in New South Wales* recommended an inquiry into the Building Services Corporation, which gave rise to the Dodd Inquiry. The Dodd Inquiry found that amalgamating licensing, regulation, insurance and management into a 'one stop shop' was inappropriate and that regulation, insurance, consumer advice and dispute resolution should be separated because the original structure created conflicts of interest.

Similarly, due to identified ongoing issues with the Building Services Corporation, the *Crawford Inquiry* was established in 1995. The Crawford Inquiry was critical of bias and conflicts of interest in relationships between BSC officers and industry and trivialisation of defective work. It built on the Dodd Inquiry's findings supporting moving regulation and consumer protection to Fair Trading, as well as suggesting separation of licensing and certification to a separate body and improving the rigour around them.

A4 Scheme privatisation

A key recommendation from the Dodd Inquiry was that the product did not need to be a Government monopoly and could be provided by the private market. Following the Crawford Inquiry, in 1997 a privately-operated home building construction scheme commenced, with an aim to exclude builders with poor records from licensing and to be able to reward good builders with lower premiums. It was also expected that private insurers had greater capacity to manage insurance risks than government.

The compulsory scheme allowed private insurers, approved by the Minister for Fair Trading, to provide home warranty insurance. The scheme remained a first resort scheme for defective work claims, but for incomplete work claims it operated as a last resort scheme. Overall, the scheme provided similar cover to the previous, government operated scheme.

A5 HIH Collapse and subsequent reform

HIH was an approved private insurer with approximately 30-40% of the market share (according to the Grellman Inquiry). HIH offered both low premiums and relatively simple criteria for builders to obtain cover. In March 2001, HIH collapsed, having a significant effect on the market. Many builders who previously had used HIH to insure were rejected cover from other insurers for new projects, excluding them from the market. Dexta Corporation, the second largest home building construction insurer (post HIH) then flagged it would exit the market in 2002 due to inability to secure reinsurance arrangements.

To address this issue, the NSW Government made arrangements for reinsurance to permit Dexta to continue to operate in the market and set up the Builders' Insurance Guarantee Corporation (BIG Corp) to manage defects and non-completions that were previously covered under HIH policies. The NSW Government also increased the amount of cover to \$200,000 and increased the threshold value of building work where home building construction insurance cover was required from \$5,000 to \$12,000. Remaining home building construction insurance categories previously classed as first resort were recategorized, so all home building construction insurance was now last resort insurance.

The aim of reforms was to address the instability of the market and to ensure long-term viability of the insurance market.

Per the *Report on the Home Building Amendment (Insurance) Act 2002 / Standing Committee on Law and Justice*, the move to last resort insurance was seen as positive by builders, as it created a greater focus on dispute resolution and mediation in relation to defective work, instead of placing responsibility for rectification in the hands of insurers. It also noted that the same change was likely to be less positive for homeowners, who now had greater requirement to participate in the dispute process.

The NSW Government also required high-rise multi-developments to carry home building construction insurance, even though Queensland, Tasmania and ACT all did not require home building construction insurance for high-rise developments. It enabled this cover from three private insurers by supporting them through a reinsurance arrangement, as the insurers were unable to find other reinsurers to take on the risk. At the same time, Victoria reformed from requiring high-rise developments to carry home warranty insurance, to making cover optional and planning to develop a catastrophe fund to provide a level of cover.

A6 Grellman Inquiry

The Grellman Inquiry was presented in October 2003. The Inquiry was requested because of concerns by the building industry about insurance terms, particularly those which placed restrictions on work that could be performed or those which created requirements to add business capital or bank guarantees to gain cover.

The Inquiry found that home warranty insurance should continue to be offered by the private sector and endorsed the scheme becoming a last resort scheme. The reforms that the Inquiry suggested increased the number of private insurers entering the market, as guidelines relating to how the government consulted with insurers prior to implementing change improved, as did guidelines around claims processing and transparency and reporting of scheme information.

Submissions to the Grellman Inquiry consistently called for the removal of compulsory coverage for high-rise developments from the scheme. By this time, the NSW government (via SICorp) was already operating as the reinsurer to all remaining private insurers due to multi-dwelling construction issues, carrying all significant risks from volatility and essentially subsidising the private market.

The end of compulsory coverage for high-rise developments became a key recommendation of the Grellman Inquiry, noting that it should occur subject to mandatory certification for the construction of high-rise projects, by approved certifiers.

The Inquiry noted that high-rise projects are often developed through a consortium (developer, financier, builder, engineer/s), which spreads the risk across the parties (although increasing the impact when failure occurs). A degree of monitoring is created between the parties therefore, with the financier often monitoring the builder's financial security throughout the project, as an example (which is significantly less likely to occur in a small residential build project).

The Inquiry also noted that high-rise construction was fundamentally commercial, with vastly different risks to ordinary house construction. High-rise construction ordinarily poses minimal risk to the consumer during construction, as 'off-the-plan' purchases hold funds paid in trust, only releasing them at completion. This means the main risk in high rise construction is after the build and is from defects during the warranty period (noting that accumulation of risk from defects is high, given that a potential defect in one unit could extend across all units).

The NSW Government adopted the recommendation, in favour of amending the *Environmental Planning and Assessment Act* to improve the requirements around high-rise construction, including:

- mandatory inspections of all classes of buildings
- increased criminal penalties for certifiers applying improper conduct
- clarifying roles and responsibilities of certifier authorities

Reforms saw New South Wales align with other States regarding high-rise developments, shown as follows (per **Figure A1.1** below from *Inquiry into the Operations of the Home Building Service, 2006*):

Figure A1.1: Comparison of different home building construction insurance inclusions

NSW	VIC	QLD	SA	WA	TAS	ACT	NT
Maximum height of three stories [above car park]	Maximum height of three stories [above car park]	Maximum height of three stories [above car park]	Maximum height of three stories [above car park]	Maximum height of three stories [above car basement]	Maximum height of two dwellings [above car park]	Maximum height of three stories [above car park]	Maximum height of three stories

By 2004/2005, major insurers Lumley, CGU, Vero, QBE and Calliden were all operating in the market and servicing both New South Wales and Victoria (Victoria, which had been offering a first-resort market-based scheme since 1996, moved to a last resort scheme at a similar time to New South Wales as a result of policy consultation between the States to support the scale of the industry).

A7 Federal inquiry and the demise of the private scheme in New South Wales

In 2008, a Federal inquiry into *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, observed some challenges builders were facing in terms of insurers requiring guarantees in some cases, as well as some challenges consumers were facing in terms of not understanding the product or overestimating the type of cover provided. The findings of the Federal Inquiry however, were relatively minimal and recommendations were not significant.

In July 2009 however, private insurers began signalling that they would prefer to exit the scheme. Lumley and CGU became the first to exit the market, citing challenges with the decreasing size of the market in the aftermath of the global financial crisis. Other insurers indicated that the volatility of the market also created profitability issues which made the scheme less attractive, with QBE noting to the Victorian *Inquiry to Builders Warranty Insurance in 2010* that:

"Some of the organisations were making a loss for a prolonged period and probably could not see the opportunity to gain appropriate returns. There is a volatility in this product. It is a product that can appear to be profitable for a short term but then can have significantly large individual losses that really clean out the premium pool..."

QBE also noted there was reputational risk in the product which was related to criticism of the product that insurers felt was then unfairly conflated with them.

When Vero indicated to the NSW Government it was also looking to exit the market in the same period, the NSW Government announced it would put in place transitional arrangements to take the scheme back into Government ownership in July 2010. The scheme was set up for management by the NSW Self Insurance Corporation (SICorp) to continue providing insurance on a mandatory basis. At the same time, Victoria made similar arrangements to take home warranty insurance into the Victorian Government through the Victorian Managed Insurance Authority.

A8 SICorp operations and transition to NSW Government

SICorp commenced issuing certificates of insurance through the Home Warranty Insurance Fund (HWIF) as required under the *Home Building Act* from 1 July 2010, through appointed agents QBE and Calliden. Vero was not successful in tendering as an agent of SICorp (but continued to issue policies on behalf of SICorp for a 3-month transition period ending 30 September 2010).

HWIF was expected to be self-funding, aside from initial NSW Government operating grant funding of \$12 million. In June 2011, the income statement for SICorp recorded HWIF as receiving \$3.4 mil premium income and incurring \$2.6 mil claims costs.

As at June 2011, HWIF was carrying approximately \$47.8 mil in assets and \$39.0 mil in liabilities, with the bulk of liabilities unearned premium of approximately \$44.0 mil and an outstanding claims provision of approximately \$2.3 mil.

By June 2012, HWIF had an operating result showing a \$105.7 mil loss and a net asset deficiency of \$109.6 mil. While gross asset holdings had remained relatively consistent, unearned premiums had increased to \$81.5 mil and provisions (both future claims and general) had increased to \$52.1 mil.

Treasury annual report commentary noted that there was a consistent imbalance in the amount of premium charged and the costs incurred to support the Fund.

By June 2013, net asset deficiency had increased to \$171.4 mil, with unearned premiums increasing again to \$117.4 mil and provisions (both future claims and general) to \$97.8 mil, with gross assets again remaining relatively consistent. Loss in the year was approximately \$61.9 mil.

In 2015, as a result of legislative amendments initiated by NSW Fair Trading the HWIF fund changed its name to the Home Building Compensation Fund (HBCF) (not affecting the overall operation). By June 2015, the now HBCF was holding a net asset deficiency of \$293.8 mil, provisions and other liabilities of \$371.7 million, with an annual loss of \$88.9 mil.

The increasing net asset deficiency position and annual losses incurred in each year indicate that insufficient premiums were collected for the product in any of the first years the fund was operated by NSW Government.

A9 Redefining of defects

In 2015, legislative change updated the way defects were defined from 'structural' and 'non-structural' to 'major' and 'non-major'. This occurred to provide clearer differences between statutory warranty items which were considered to need a six-year (previously seven-year) period to manifest, compared with items that were considered to need two years and to reduce disputes around classification of defects therefore.

The updates had a wider effect than simply relating to home building compensation insurance (which had operated on the basis of a six-year / two-year period of cover for some time), as they applied to all defects covered under the *Home Building Act 1989*. Before 2015, the concept of 'structural defect' that was applied was less clear and defined through regulation, rather than legislation. In 2015, the update defined 'major defect' in legislation and provided a clearer, but narrower definition (for example, the stipulation that a structural defect results in or likely results in 'physical damage' to the building was removed when it was replaced with major defect). The new definition was also clearer in that it specifically included fire safety systems and waterproofing as major defects within black letter of the legislation.

Around the same period, the NSW Government also replaced the *Strata Schemes Management Act 1996* with the *Strata Schemes Management Act 2015* while undertaking a range of strata reforms. Part of these reforms included a requirement for developers to lodge a deficit bond of two per cent of the value of the contracted building work with Office of Fair Trading (OFT) against mixed use strata buildings and renovations not covered by the HBCF scheme. This bond was to cover any unresolved defects identified in the two-year period after the building work is performed. This is relevant because it was intended to provide a regime of warranty coverage for non-HBCF buildings, decreasing the case for such buildings to be covered within HBCF. There remain significant concerns, however, from most experts that 2 per cent is insufficient to cover the cost of repairs. This is underlined by the HBCF multi-story dwelling loss experience, which suggests that even when defrayed by investment income and pooling with other premiums, the break-even cost is between 5 and 10 percent of build value.

A10 SICorp to icare

In September 2015, the NSW Government created icare through the *State Insurance and Care Governance Act*, moving the State's disparate insurance schemes to one manager. As part of this, HBCF came to icare for management.

In the transition period to icare management, HBCF operated in a similar manner with challenges raised against icare requests to increase premiums. As at year end June 2016 HBCF held a net asset deficiency of \$375.8 mil against a \$82.0 mil loss and at year end June 2017 HBCF held a \$480.8 mil net asset deficiency against a \$105.0 mil loss.

In the year to 2018, the net asset deficiency decreased for the first time since HWIF/HBCF were in operation, falling to \$435.3 mil. This was in part due to reforms implemented by icare and in part due to grant funding from NSW Government to help support the balance sheet.

A11 2017 reforms

With a view to reduce the burden on NSW Government relating to the scheme, the NSW Government enacted reforms in 2017 to the Home Building Act 1989. The reforms looked to:

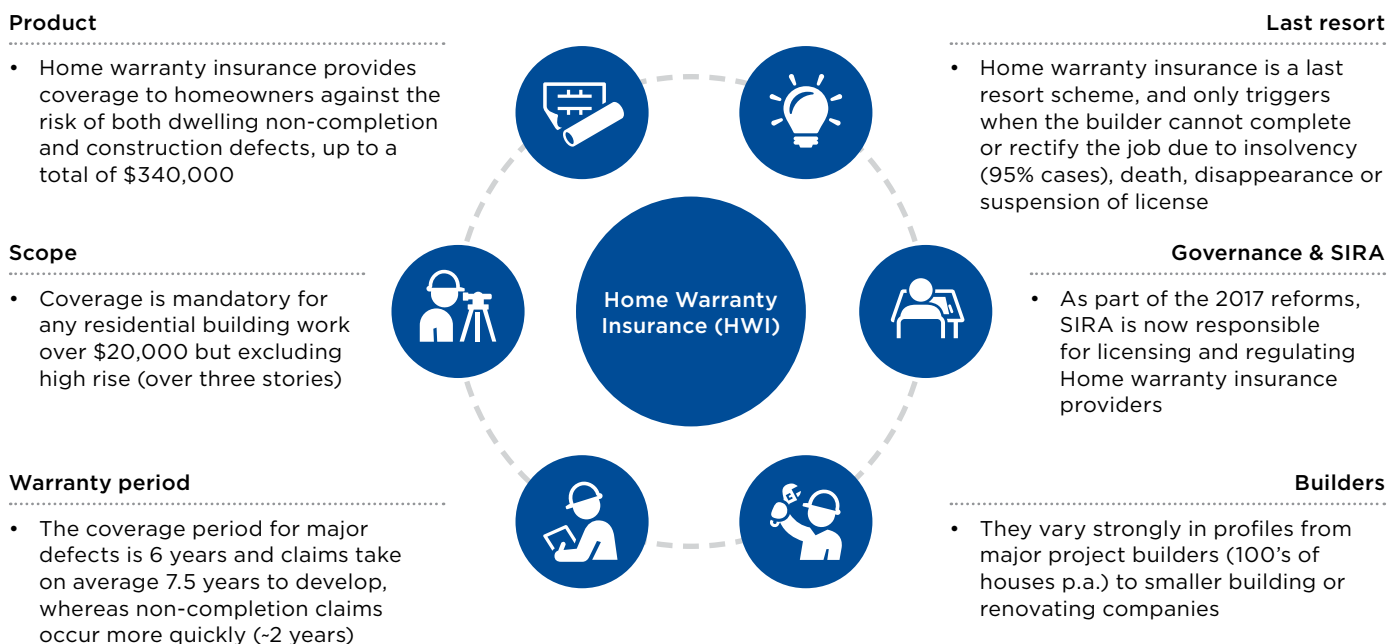
- open the scheme to private insurers, enabling them to apply to the State Insurance Regulatory Authority (SIRA) for a licence to provide home warranty insurance
- abolish broker commissions from the scheme
- amend premium pricing to allow closer operation to cost recovery
- allow for the provision of alternative indemnity products (for example through use of fidelity funds such as those offered in ACT and NT)

The effects of the reforms are ongoing due to their staged nature. As of the date of writing, no additional insurers have been licenced to provide the market with home building construction insurance products.

A12 Product design in the current state

The history of the product has led to its current design. Key aspects are summarised in **Figure A1.2**, below as to how the product currently exists in New South Wales

Figure A1.2: Current state of New South Wales home building compensation insurance



It is clear from examining the above history that the design of the product has changed significantly across the years of the product's existence. Key lessons have been identified from the product's history that have shaped the current structure of the product (as summarised in Figure A1.3, below). There are key areas of importance regarding separation of licensing, regulation and underwriting, covering for both defects and systemic issues, limiting over-regulation of the industry, recognising and addressing the industry's volatility and making sure coverage is clear, with enough premium collected for levels of coverage.

Figure A1.3: Lessons identified for product design from the scheme history

1 Government Run- 'First Resort' Scheme	2 Privately Run- 'First Resort' Scheme	3 Privately Run- 'Last Resort' Scheme	4 Government Run- 'Last Resort' Scheme
<ul style="list-style-type: none"> 1972: Scheme established 1992-1993: The royal commission into the Building Industry and Building Services Corporation report was released which recommended moving towards private underwriting 	<ul style="list-style-type: none"> 1997: Private Home Warranty Insurance Scheme commenced 2001: HIH collapses (40% of market) BIG Corp established for affected policy owners 	<ul style="list-style-type: none"> 2002: Scheme moves from 'first resort' to 'last resort' 2003: Removal of high rise buildings from the scheme 2009: In November NSW Government announces it will enter the market, managed by the NSW Self Insurance Corporation, as private insurers flag plans to exit the market 	<ul style="list-style-type: none"> 2010: Government enters the market with new premium structure and becomes the sole underwriter of home warranty insurance in New South Wales 2015: Renamed to HBCF and icare established 2017: SIRA appointed regulator 2018: Private competitors permitted to seek license
<p><u>Lesson 1:</u></p> <p>There is a need to separate licensing and regulation from insurance</p>	<p><u>Lesson 2:</u></p> <p>Need for the scheme to provide for both defects and systematic failure</p>	<p><u>Lesson 3:</u></p> <p>Need for the scheme for cover to be fit for purpose and to not over regulate the industry</p>	<p><u>Lesson 5:</u></p> <p>Cover needs to be clear and premiums either need to be sufficient, or supported with Government funding</p>
		<p><u>Lesson 4:</u></p> <p>Volatility of the scheme creates significant challenges to financial sustainability</p>	

As the product design stands, it is compulsory in nature. The builder holds responsibility seek home building compensation insurance from a licenced insurer for any building construction or amendment activities \$20,000 in value or over (as noted HBCF is the only insurer currently licenced to provide such insurance in New South Wales). Coverage levels are capped at \$340,000, regardless of the total value of the build and additional cover or blocks of cover cannot be purchased. Coverage is only available for residential construction activities in buildings up to and including three-stories. As coverage is last resort, the homeowner can only claim on the cover where the builder had disappeared, becomes unlicensed under certain circumstances, has died, or has gone bankrupt.

Defects are covered for a period of six years for a major defect and two years for any other loss, after the completion of work.

The product design therefore raises several initial points of interest:

- the product cannot be opted into or avoided by a homeowner (or a builder) (unless specifically exempted by SIRA)
- even though it is the homeowner receiving the coverage, it is the builder's responsibility to purchase the insurance on the customer's behalf
- coverage is capped at \$340,000 for all builds, which includes, for example, builds of significantly higher value (a \$5 million or \$15 million build would only hold \$340,000 cover)
- coverage is limited to residential property up to (and including) three stories, so builds over that height are excluded from home building construction insurance in New South Wales
- disputes and disagreements between a solvent builder and a homeowner do not fall under the realm of this cover and need to be dealt with through mediation or through litigation, NSW Civil Administration Tribunal (NCAT) or the court system.

Other points worth noting relating to product design are:

- SIRA must not reject premiums
- private sector entities can seek a licence from SIRA to provide insurance
- the product design allows for other innovative insurance products.

These considerations are important when assessing the nature of the product and optimality.



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