

**NIBA Submission to the
Independent Pricing and Regulatory
Tribunal Inquiry into the Home
Building Compensation Fund**



1. About NIBA

The National Insurance Brokers Association (NIBA) is the peak representative body for general insurance intermediaries representing over 90% of insurance brokers across Australia. NIBA's membership ranges from large international insurance brokerages to small firms and individuals.

Insurance brokers perform a number of valuable services for their clients including;

- Helping clients to understand, manage and minimise their risk exposure;
- Identifying and arranging appropriate insurance or other risk financing mechanisms;
- Acting as the client's advocate when an insured event occurs.

In performing these duties, insurance brokers act as agents of their client and have statutory, common law and professional obligations to act in the best interests of their client at all times. Insurance brokers represent the interests of the purchasers of insurance, the policy- holders, and not those of insurance companies. Consequently, comments made by NIBA and its members are made on behalf of its members and the public that purchases insurance not on behalf of insurance companies.

2. General comments

NIBA welcomes the opportunity to provide a submission to the Independent Pricing and Regulatory Tribunal inquiry into the Home Building Compensation Fund (HBCF)

Insurance under the HBCF provides an important public service to consumers, acting as safety net to protect property owners against incomplete or defective building works. It is vital for consumers that the HBCF continue to operate as intended, however, NIBA is

concerned that the continued worsening of the schemes' financial position could result in negative outcomes for both builders and property owners.

Insurance is the transfer of risk from the insured to the insurance pool. Complexity arises in the valuation and pricing of the risk that is transferred into the pool. At a very high level, though, the process of insurance is simple and straightforward. Policyholders pay sufficient premium to cover the cost of claims, the cost of administering the process, and a return on the capital invested in the business by insurers and other key service providers. Therefore, the level of premiums is simply and largely a reflection of the total cost of claims in the area being insured.

If it is felt that the cost of premiums is excessive or unaffordable, the response is to either reduce the amount of cover being provided, or to take steps to reduce the number and cost of claims via effective risk management and mitigation.

The HIH Royal Commission clearly set out and explained what happens when the premiums being charged do not adequately cover the cost of risk being transferred into the insurance company. General insurers have prudential obligations to ensure that adequate premiums are being charged, and sufficient reserves are being maintained, so that claims can be paid. Unlike other insurers iCare is not bound by these obligations and has only recently increased premiums across a range of building classes to break-even rates.

iCare's financial statements paint a concerning picture for the future of the fund, indicating a continued decrease in the performance of the scheme. Due to historically low premium rates for most of the funds' operation, the HBCF reported a \$636 million deficit for the 2018-19 financial year, an increase of \$200 million from the previous year. HBCF

continues to receive significant tax-payer funding relating to reimbursement of losses arising from under-pricing of premiums. In July 2019 HBCF received \$12.2 million from the Crown in respect of realised losses in the 2017/18 financial year. According to their financial report, HBCF expects to receive funding from the NSW State Government post 1st July 2021 (when premiums for all property classes will reach break-even levels) until all losses incurred prior to the establishment of full cost recovery premium rates are recovered.

NIBA is concerned that despite their financial position, icare have announced their intention to reduce premiums for a range of building classes including single dwellings in the second half of this year. Given the deficit stated above and the context of this review the decision to cut premium levels in the middle of a review is difficult to reconcile.

It is important to note that the HBCF is intended to act as a last-resort for consumers, where traditional means of seeking compensation have been exhausted or are not available due to insolvency. The HBCF operates as part of a much larger system designed to protect property owners, including building regulating and certification and the home building licencing regime. Therefore, any further reforms to the HBCF need to be considered as part of broader reforms to the home building protection framework.

3. NIBA's response to questions

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

There are a number of reforms that NIBA believes, if undertaken would encourage the supply of new products in the home warranty space, including separate underwriting of insolvency and defects risks, the use of data analytics and predictive tools to assist the underwriting process, and real-time monitoring of builders' financial positions

The current HBCF product provides both product liability type cover (for defects in the standard and quality of the building) and financial insolvency cover (insuring against the financial failure or insolvency of the builder). NIBA proposes that the current product be grandfathered and replaced with separate insolvency and defect products, so that each risk can be underwritten and priced according to the nature of the cover provided.

Currently the underwriting process uses historical financial records when determining a builders' risk. This means that the financial position of the builder at the time of assessment may be vastly different to the position indicated by their financial records. It is important for the long term of the scheme that the underwriting process is able to identify these risks as accurately as possible. By switching from historical tax records to real time financial information, such as Business Activity Statements, underwriters will have a more accurate view of a builder's financial position at the time application. Data analytics should also be built into this assessment process to assist underwriters in identifying these risks. These analytical tools may also help underwriters identify warning signs of potential illegal phoenix activity¹ that has plagued the building industry for many years.

¹ Illegal phoenix activity is where a new company is created to continue the business of an existing company that has been deliberately liquidated to avoid liabilities (such as statutory warranties for building works) or outstanding debts, including taxes, creditors and employee entitlements.



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

The ability to limit insurance is a standard feature in many insurance markets, for example some providers of motor vehicle insurance will not provide cover to inexperienced drivers due to their risk profile. This allows insurers to mitigate their risk and keeps premiums low for other policyholders. This feature should be extended to private providers of HBCF, allowing them to limit insurance to high risk builders. Any private entrant to the HBCF market already faces extreme competition, especially when the incumbent operates at breakeven levels.

Prior to 2010, private insurers participated in the HBCF however, they all exited the scheme due to the low profitability and high risk of the fund. The financial position of the incumbent provider highlights the financial difficulties insurers face under the current framework. If private providers are to return to the scheme, they would be aiming for a profit margin that allowed for an appropriate rate of return on the capital invested in this line of business. Given that the current provider is yet to reach break-even levels across all major building classes, this means the private insurer would be at a significant disadvantage before they have even begun. The only way for private insurers to operate a profitable model would be for insurers to create a pool of high quality/low risk builders.

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

The decision to build a property is one of the largest investments most Australians will make. New South Wales Fair Trading currently provides homeowners with information to

assist them in choosing a reputable, licenced builder, including any finalised insurance claims against the builder, licence conditions and public warnings. However, further information could be provided to future homeowners to enable them to make informed decisions.

All builders who apply for insurance under the HBCF are assessed based on their risk and assigned a risk rating. This rating, if made public, could help homeowners avoid builders who are at a higher risk of insolvency, and those who engage in illegal phoenix activity.

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

See NIBA's response to question 1.

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

NIBA has received feedback from several of its members that the current eligibility process is unnecessarily complex, especially for small builders who engage in lower risk projects.

NIBA proposes a review of HBCF claims data, for the purposes of identifying high risk segments. For example, icare have already identified that incorporated entities have a significantly higher frequency of claims compared to sole-traders and partnerships. This is reflected in the premiums charged by the insurer. A low touch approach could be applied to segments that are very low risk, freeing up resources to enable greater scrutiny of high risks segments.

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

NIBA believes that better use of data analytics during the assessment process, and more relevant financial information would facilitate a less onerous eligibility process and enable

assessors to more accurately identify high-risk builders. NIBA believes that this could be done without subjecting the funded to greater risk.