



Response to IPART Review
of the NSW Home Building
Compensation Fund

29 May 2020

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INTRODUCTION

Risk Specialist Group (RSG) and a group of companies with which it has been discussing improvements to the current industry issues raised by the *IPART Review of the NSW Home Building Compensation Fund* is pleased to submit this response to the questions raised by the paper.

This response to the IPART paper is structured in two parts:

- The first addresses IPART's particular questions
- [REDACTED]

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PART 1

Responses to Issues Paper

NON-CONFIDENTIAL

1. The Current Crisis in Home Building Compensation

The current crisis in Home Building Compensation is caused by the fact that, historically, administration costs and claims by homeowners have exceeded premium revenue. Private insurers have left the market due to its lack of financial viability and, even with quarterly premium rises, the Home Building Compensation Fund (HBCF) continues to lose money.

The cost of the remediation process once cases reach NCAT exacerbates the problem, as do the additional administrative costs of other agencies such as the Certifiers Board.

The Issues for Homeowners

For homeowners, home warranty insurance has long been criticised as being of little value, as not only does the cost of the insurance add to the contract value, but access to the funds in the event of a claim can often only be achieved following complex processes that necessitate the homeowner:

- Raising action through the consumer tribunal (and then only if the tribunal sides with the consumer and the builder fails to comply), or
- Seeking remedy from the builder through civil proceedings that trigger the insolvency of the builder.

Unlike any other general insurance product, this form of insurance pays out on a very small percentage of policies – a reflection of the complexity of triggering the policy.

The Difficulties for Builders

A builder's access to the product is equally difficult, with extensive information provision and financial review requirements – including requests for the injection of capital or the substantiation of an asset position that is considered reasonable and adequate in mitigating an insolvency risk.

Builders are subjected to annual insurance limits and job limits, often restricting them from taking on new work until existing jobs are verified as completed, which causes further frustration to homeowners who are unable to have their plans released from council and obtain a construction certificate prior to the builder resolving these insurance requirements.

The various legislation allocating responsibilities under home building regulation and insurance contracts contributes to some of these issues, causing confusion and increasing the costs of administering the scheme.

The Flaws in Current Guidelines

The guidelines issued by HBCF have a number of grey areas that builders / homeowners and Certifiers find difficult to interpret. Some definitions vary between councils and the HBCF guidelines, and there is no flexibility to resolve the variations.

Some major issues include the facts that:

- Pricing is not consistent with risk – for example, prior to August 2019 the insurance price of duplexes was almost three times the current price
- The definition and pricing of dual occupancy granny flats is inconsistent, causing confusion to Certifiers, builders and consumers
- Calculation of assumed turnover is unclear in the assessment process, confusing to builders and accountants
- The majority of financials are unaudited, leading to flawed risk assessments

- The delay in assessments causes undue stress to builders and delays in commencement of projects
- There is a lack of building industry knowledge and experience in the HBCF management arena
- The issue of certificates is not policed by HBCF, and fraudulently issued certificates create major additional legal and administration issues
- The industry bodies cannot properly focus on the issues of their members as they are non-profit capitalised, with the majority of income received in commission and fees.

The Demand for a New Approach

The fact that, over the past decade, the insurance landscape has changed to the degree that four major insurance groups in the Australian market have exited the schemes either as private insurance providers or risk-free service providers can itself be seen as market failure.

The polarising nature of the product means that insurers (including brokers) see the product as too difficult to manage and don't believe it provides sufficient ability to build their businesses. Knowing that previous insurers continue to incur losses from prior schemes is a further disincentive to attracting new market entrants.

A system that demonstrably disadvantages the primary stakeholders is not a system that works for anyone. The current system is unsustainable unless it:

- Is priced to a point of being unaffordable
- Continues to be cross-subsidised by the community.

Either case constitutes failure in a product intended to protect homeowners from the risks of engaging qualified builders.

To stem the losses, regain homeowner confidence and help protect builders from insolvency, a multi-factorial approach is required. It must:

- Address the of all of homeowners, builders and insurers
- Reduce defects, lowering calls on the fund – this requires a more rigorous and independent quality assurance process than is currently in place
- Build the amount of money available to the fund to stop the requirement for 'top ups' from public funds
- Provide additional oversight, and education where necessary, so that builders:
 - Correctly scope and quote work
 - Verify before obtaining insurance that they have sufficient working capital (not assets, which may not provide sufficient liquidity) to complete the project
- Attempt to attract private insurers back to the market, providing them with an acceptable risk level and profitability margin.

2. Responding to IPART's Questions

In this section, we respond to IPART's questions where we feel we can add value by doing so. For convenience, we have noted the page numbers where the questions were raised.

What would encourage private providers to enter the market?

(Page 02 of the Issues Paper)

In the last decade, four of Australia's largest general insurance groups (Suncorp, Wesfarmers Home Insurance, IAG and QBE Insurance Group) have participated in this market either as private underwriters and/or scheme service providers. Each of these companies has subsequently exited the market due to lack of financial viability of the scheme in its various iterations and other factors. Other factors include the notorious difficulty of managing this scheme, its complexity and stigma associated with the scheme polarising consumers, making it difficult for insurance companies to maintain brand integrity and to leverage and grow their businesses across other products.

It is highly unlikely, as these private insurers continue to pay historical losses, that they would re-enter the market unless there was a significant change. Such a change would, at its core, need to reduce the level of cover to the consumer well below the current scope of coverage in order to reduce the aggregate exposure to the insurer, demonstrating an acceptable risk / return profile and level of profitability.

A return to a 'no-risk' service-based approach such as the provision of underwriting / claims / administration services may encourage private providers to enter (or re-enter) the market, however this would not resolve the current issues with the scheme (which are predominantly financial) and would add even more cost to consumers.

Are there unnecessary administrative burdens and barriers for builders?

(Page 02 of the Issues Paper)

Obtaining Annual Cover

The administrative requirements for builders are significant, with mandatory requirements to achieve annual cover under current products including:

- Finalised financial statements
- Capital injections
- Evidence of director's loans
- Work-in-progress reports.

At the insurers' discretion, other information is also often required.

The purpose of this process is to have the builder demonstrate an acceptable level of net assets before being eligible for cover. This serves only to provide a 'snapshot' of the builders' assets at the time of application. If the assets are not sufficiently liquid for conversion to cash as required, and the builder lacks genuine working capital to fund building progress between progress payments from the homeowner, the builder is likely to become insolvent. The current process does not gather the right information to predict insolvency, and can therefore be viewed as a redundant administrative task.

Obtaining Project Cover

In addition to the annual cover, builders must obtain additional cover for each contract, which can require:

- More applications and supporting information to obtain additional cover
- Reporting to insurers.

These administrative requirements add time and cost which are ultimately passed on to the homeowner.

How could the scheme further reduce defects and insolvency? How could enhanced information collection be used to further mitigate builders' insolvency risk?

(Pages 02, 08 and 18 of the Issues Paper)

There are multiple synergies between the process discussed here to assist in reducing defects and insolvency and the later questions about enhanced information collection. We have therefore chosen to respond to these questions together.

Collection of Information

Rather than reviewing builders' net assets as discussed above, an overhauled scheme should combine educating smaller builders around costings, margins and cash flow combined with a process that reviews their access to cash to fund projects-in-progress. This would also have the side-effect of removing some of the pressure to complete jobs rapidly in order to raise capital, which may adversely affect quality (i.e. contribute to the introduction of defects).

The insolvency risk could be practically eliminated by ensuring the builder has quoted the work correctly, has clearly outlined the materials and standard of quality, has adequate margin and is drawing down payments only when the work has been completed to the correct standard of compliance.

Collecting and documenting this evidence should form part of the overall documentation for the project, and shared with relevant parties including insurers, independent building consultants, certifiers and the homeowner.

Builders and homeowners would mutually benefit from being guided through the contract and progress – ensuring the costings are adequate, the contract is well documented and monies are being drawn at the appropriate time ensuring there are adequate funds to complete the project.

Insurers would have better visibility over the projects they are underwriting, eliminating the need for unnecessary annual limit verification and financial assessments.

Quality Assurance

A stringent quality assurance process is needed from preparation of contract documentation through to completion of projects. Key aspects of a quality assurance process should include:

- Peer-reviewed contract documentation including Development Application-approved plans
- Mandated quality inspections by a qualified independent building consultant at nominated points of the build, integrated with the certification process – at a minimum these should be at lockup stage and prior to handover

This process should focus on compliance with the National Construction Code (formerly the Building Code of Australia) and promptly identification of potential defects, noting that the earlier defects are discovered, the cheaper they are to fix.

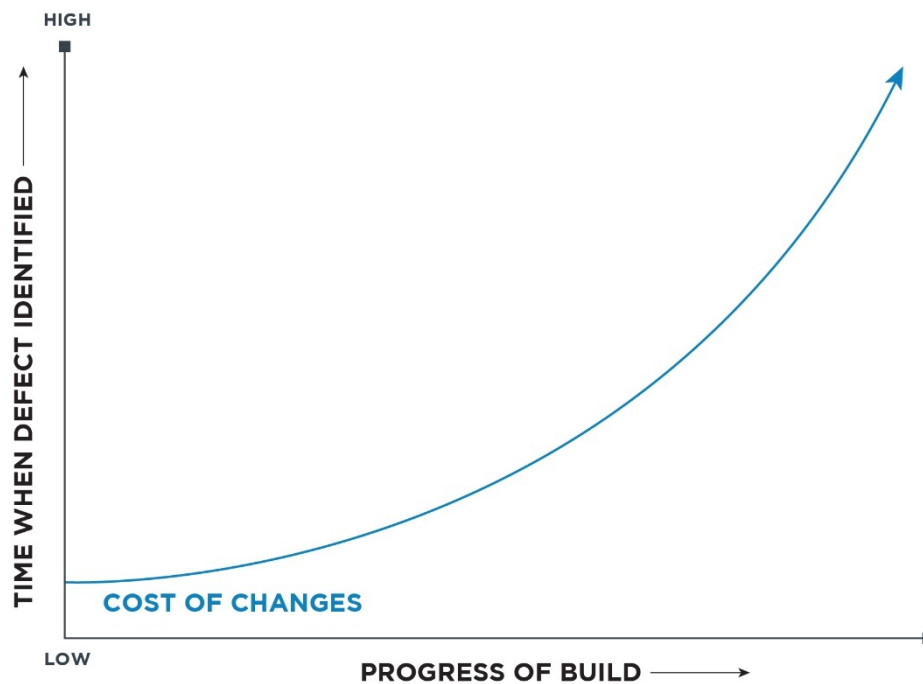


Figure 1: Cost to remedy defects increases the later they are discovered

Protection Against Insolvency

Retaining funds to cover defect resolution in the form of a Retention Fund or Performance Bond, and closer oversight of project budgeting, would both help to mitigate the likelihood of insolvency.

The introduction of a Retention Fund or Performance Bond would ensure:

- Compliance and best-practice pending completion
- That funds are available for defect rectification during the statutory warranty period if required, including if the builder has subsequently become insolvent or ceased to trade for any other reason.

Periodic independent review of progress payments and project financials would verify that payments are not being front-loaded and/or spent funding other projects. For smaller builders in particular, this could provide a further opportunity for builder coaching and education in project financial management.

Dispute Resolution

Prompt dispute resolution during the building process would not only support a better quality outcome for the building, but substantially reduce costs compared with the current process which ultimately escalates to the NSW Civil and Administrative Tribunal (NCAT).

This could be achieved with the early involvement of an independent mediator (discussed in more detail later).

Are there any impediments to providers offering better value alternative indemnity products to homeowners? What changes to the scheme would encourage the supply of new innovative products – both different types of insurance and alternative products?

(Pages 02 and 08 of the Issues Paper)

Significant impediments stand in the way of the introduction of alternative products. They include the:

- Need to satisfy legislation
- Fact that the current risk model is loss-making and providers are unable to reliably assess the risk profile of a builder or building project
- Likely need for multiple products to allow insurers to focus on their preferred area of exposure, and the area of risk they are most comfortable assessing – for example loss of deposit, incomplete works, trailing defects etc.

A multi-product model is unlikely to provide better value than existing products, as it will add further administrative burden and cost, while limiting the value of cover to the extent that the insurer sees viability in the product.

What would improve the experience for homeowners making a claim on the fund?

(Page 02 of the Issues Paper)

In its current form, the average consumer considers the cover to be of little benefit, as essentially the builder must be bankrupt before a homeowner can raise a claim. Those who have been through this process and been compensated may see benefit in the scheme, but the majority of homeowners do not.

A less adversarial, multi-stage approach to resolving issues between builder and homeowner in remedying defects would be both more cost effective and lead to better outcomes in quality.

Introducing a mediation process between builder, homeowner, an independent building consultant, Certifier and a trained mediator would be a lower-cost initial approach to homeowners with concerns during the building process or, later, seeking to make a claim. If this step fails to resolve the issue, it could be escalated to the next level of dispute management.

The appointment of a panel of builders able to rapidly novate part-completed contracts and attend to remediation works during the contract or statutory warranty period where the original builder becomes insolvent or otherwise ceases trading would ensure homeowners' issues were rapidly addressed – a big advantage over the current scheme. This should also be significantly cheaper than the current claims and remediation process.

What features of schemes in other places should be adopted in NSW?

(Page 02 of the Issues Paper)

The features of other schemes in Australia focus on three main variables:

1. Limits of cover per state
2. Private insurers or government insurers (with insurers as service providers)
3. First resort cover (Queensland) or last resort cover (all other states).

Given the limited nature of cover, the unwillingness of private insurers to participate and the fact that the Queensland scheme is running at significant losses, there are arguably few features of existing schemes that could be adopted in their entirety in NSW.

The ease of cover and first resort nature of the Queensland scheme has merit only if complemented by programs that manage the root causes of builder failure, in order to limit the complexity of access to the product and ease of making a claim without cross-subsidisation by public funds.

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

(Pages 06 and 14 of the Issues Paper)

As noted earlier, the current scheme is loss-making and does not offer an acceptable risk / reward profile to insurers.

Moving to a more holistic model that spans the process from contract development to the end of the statutory warranty period, which considers the right cost, structure of funding of building contracts including defect identification, and which includes both financial and workmanship checks and balances at appropriate stages, would open up a competitive market that could link with other products and services that would directly contribute to a builder's success in completing a building contract.

Products and services that would support such a model include:

- Front end support for builders establishing contracts and negotiating insurance and finance, including connectivity with financial institutions
- Quality certification
- Periodic audits of project financial status
- Independent mediation as a first step in dispute resolution.

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

(Pages 06 and 15 of the Issues Paper)

RSG strongly recommends against this for two reasons:

- It may not be feasible to insurers as the small premium pools associated with these segments would not adequately fund the resulting exposure
- Having insurers 'pick and choose' the organisations they will insure in prior scheme iterations contributed to significant difficulty in obtaining cover and increased the cost of cover to consumers.

To what extent do the requirements of the *Home Building Act 1989* duplicate the *Insurance Act 1973* and increase costs of entry for private insurers?

(Pages 06 and 18 of the Issues Paper)

The requirements under the *Home Building Act 1989* (HBA) for insurers prescribe the types of contracts that require insurance and the period and limits of liability.

There is no direct duplication of requirements with the *Insurance Act 1973* which, in general terms, sets out the requirements and obligations of an insurer including its compliance requirements with licensing, Australian Prudential Regulation Authority (APRA) prudential standards and monitoring, and the roles of appointed actuaries and auditors amongst a number of other requirements.

Given the lack of duplication, there are no additional costs of entry for private insurers above the existing costs of compliance, although these are already extensive.

How could the claims process be made more efficient?

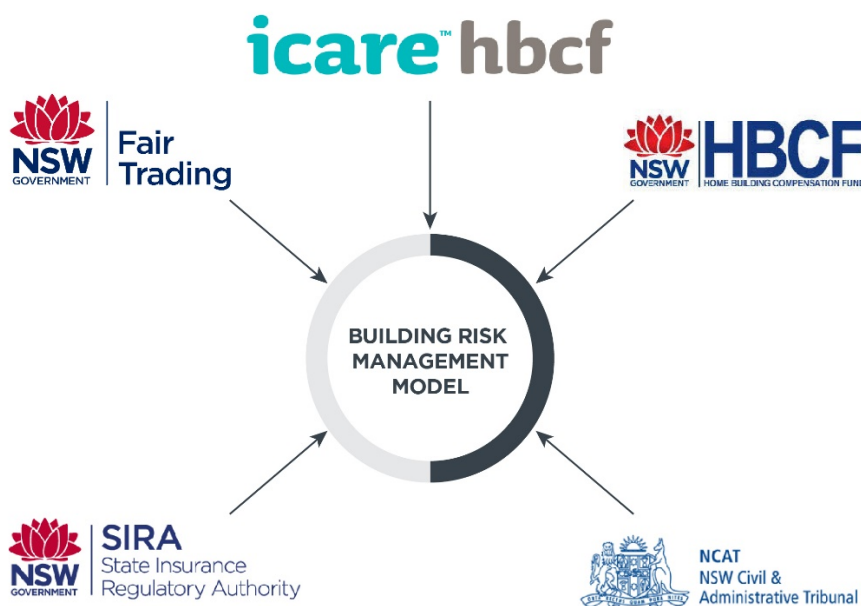
The claims process could be made more efficient by centralising the multiple functions currently performed by multiple agencies under one group. Currently building-related compliance and claims issues are dealt with by multiple agencies:

- icare HBCF, which administers builders' Certificates of Eligibility, Certificates of Insurance (for those builders that insure through icare HBCF) and Home Building Compensation Fund (HBCF) certificates (unless the builder elects to issue the HBCF certificate himself)
- NSW Department of Fair Trading, which:
 - Manages Certifiers
 - Provides a mediation mechanism for homeowners to lodge complaints about incomplete and defective building work and builders performance
- The State Insurance Regulatory Authority, through which homeowners can lodge Home Building Compensation (HBC) Scheme claims if eligible
- The New South Wales Civil and Administrative Tribunal (NCAT), where homeowners and builders seek determination in relation to defective and incomplete building work and progress and final payments for works completed.

The inefficiencies of multiple agencies administering different parts of the building compliance, compliance and rectification processes include:

- Duplicated administration costs
- Increased communication time and risk of lost documentation
- Confusion for builders and homeowners about which agency to contact, potentially wasting agency time
- Inconsistencies in advice provided to builders and homeowners, slowing down or further complicating the complaints and defect rectification processes.

Centralising all building-related activities under one agency would improve efficiencies and dramatically reduce costs, compared with the current situation.



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

(Page 08 of the Issues Paper)

The State Insurance Regulatory Authority (SIRA) already makes provision for incentivisation for builders to undertake effective risk management and demonstrate good business practices.

As the Issues Paper notes on page 21, “One of the principles in both SIRA’s eligibility and premium guidelines is to provide incentives for risk management and good business practices. Insurance providers may offer contractors discounts or load premiums based on the licensed provider’s risk management practices. Discounts and loadings must conform with principles one, two and three and should be designed, to the extent possible, to generate incentives to reduce the level of risk.”¹

Better collection of documentation, as discussed in Information on page 4 could give insurers confidence to implement these clauses, subject to specific criteria documented as part of the policy. Criteria could include:

- Adhering to provision for retained earnings
- Complying with agreed cash flow provisions
- Completing all work to the independent building consultant’s and certifier’s satisfaction or other factors agreed between the builder and the insurer.

Is an efficiency study of icare’s economic costs necessary?

(Page 08 of the Issues Paper)

This is an issue on which further industry discussion is required.

On one hand, the current scheme necessitates high levels of administration and outsourcing to fulfil the requirements of the product. The current claims levels and costs reflect the scheme attributes as opposed to the performance of the nominal insurer, which suggests an efficiency study is not required.

On the other, review in consultation with a cost review of related agencies including the Department of Fair Trading (NCAT) and the Certifiers Board may support and quantify the financial benefit of the suggestion above to combine multiple agencies under one umbrella. (See What would improve the experience for homeowners making a claim on the fund? on page 7.)

¹ SIRA, Home building compensation (premium) insurance guidelines, January 2018, p 6.

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

(Page 08 of the Issues Paper)

Yes, it requires a combination of simplification and better oversight. The current eligibility process should better manage the builder through the execution of their responsibilities under a building contract – the right margin, the correct use of trades, a thorough certification regime that serves to limit the likelihood of dispute, defects occurring in the first instance and limited losses in the event of insolvency.

Could this be done without subjecting the HBCF to greater risk?

(Page 08 of the Issues Paper)

With a series of other amendments to the scheme, the eligibility assessment process could be simplified. Amendments to allow this to happen should include:

- Closer oversight of the variables currently contributing to losses under the scheme
- Introduction of construction of quality inspections in conjunction with the certification process
- Implementation of a Retention Fund or Performance Bond scheme managed by a professional fund manager to ensure monies are available when needed.

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

The regulatory and administrative burdens and barriers to entry under the current scheme have been covered in responses to other questions in this paper. An effective overhaul of the scheme should address the administrative overheads and barriers to entry both for builders and private insurers.