IPART
Independent Pricing and Regulatory Tribunal
New South Wales

REVIEW OF THE
EFFICIENCY AND EFFECTIVENESS OF THE NSW HOME BUILDING COMPENSATION FUND

Final Report

November 2020

Special Review

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The Independent Pricing and Regulatory Tribunal (IPART)

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1 Executive Summary

Each year, more than 20,000 new homes are built in NSW, and a similar number of renovations and alterations are in progress.[1] A small proportion of homeowners encounter problems—some builders do not finish projects, and some buildings are found to have defects. The building business is responsible for rectifying any major defects within a six-year warranty period after the building has been completed, and within two years for minor defects.

However, in some cases, homeowners cannot seek recourse from the building business because they no longer exist – often because they have become insolvent. In other cases the builder will have disappeared, died, or had their licence suspended for failing to comply with a money order.[2] In these circumstances, homeowners can make a claim under the home building compensation fund (HBCF) as a last resort.[3]

The key exception is where the building project is the construction of apartment buildings more than three storeys. The HBCF does not cover these high-rise apartments, but the NSW Government is currently putting in place quality assurance measures for these buildings that should encourage private insurers to enter this market in the future. In the meantime, an alternative mechanism, the Strata building bond and inspections scheme, applies to these buildings.[4]

For residential buildings that are covered by the HBCF, building businesses must pay mandatory insurance at the beginning of every project covered under the scheme to fund any claims that may arise. These costs are usually passed onto the homeowner in full. Currently there is only one home building compensation (HBC) provider, the NSW Government insurer, icare. icare manages its exposure to claims by assessing the financial position of building businesses undertaking work covered by the scheme, and places limits on their construction activity and charges premiums that reflect their risk.

The NSW Government has asked the Independent Pricing and Regulatory Tribunal of NSW (IPART) to review the efficiency and effectiveness of these arrangements. This report sets out the results of our analysis, and our findings and recommendations to the Government. The Government has discretion about whether it implements those recommendations.

1 Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 17.
2 Issued by the NSW Civil and Administrative Tribunal or NSW courts.
3 For projects worth more than $20,000. Defects must be identified within the relevant warranty periods of six years for major defects and two years for minor defects.
4 From 1 January 2018, developers of new residential strata buildings (4 storeys and higher) have been required to pay a building bond to NSW Fair Trading equal to two percent of the building contract price. This building bond may be used to pay for any identified rectification work within 18 months of completion or is otherwise returned to the developer. See NSW Fair Trading, *Strata building bond and inspections scheme*, accessed 16 September 2020.

1.1 More effective regulation in the construction market for residential dwellings would reduce defect risks for homeowners

A strong regulatory framework and enforcement of building standards is necessary to ensure the incidence and severity of defects in the residential construction industry is low. While most building businesses perform high quality work, holding all businesses accountable for the quality of their work would minimise the cost of claims under the HBC scheme, keep the price of premiums low for all homeowners and save homeowners substantial time and money pursuing defect rectification.

Currently, the costs of claims under the scheme are relatively high. The average cost of a claim in NSW is around $90,000 – more than 50% higher than claims made under similar schemes in other jurisdictions - despite fewer claims in NSW. This is driving significantly higher average premiums compared to those in other jurisdictions, reflecting the higher expected liabilities caused by costly defects. The average premium in NSW is around 1% of the value of the contract, compared to just 0.3% in Victoria.

Our terms of reference asks us to consider the scheme's efficiency and effectiveness in protecting consumers currently covered under the scheme. It also specifically asks us to consider how the HBCF's incentives could encourage good business practices and confidence in the market for construction of residential dwellings.

Only a small number of defect disputes (around 0.4% of all building works[5]) end up as HBCF claims. This is because the HBCF is a "last-resort" scheme, which means that a claim can only be made if the building business can no longer be pursued – usually because it has become insolvent. As a result, the current sole HBC provider, icare, has determined that it is more cost effective to focus on mitigating builder insolvency risk to manage the costs of the fund, rather than managing the risk that a defect will occur.

In line with our terms of reference, we have made a number of recommendations to improve the operation of the HBCF. However, given the HBCF's last resort nature, there are many other factors in the broader regulatory environment that influence scheme costs. We have not set out to review the whole residential construction regulatory regime and our recommendations should be considered alongside the ongoing work of the NSW Building Commissioner and other related reforms.

1.1.1 Building sector reforms will take time to reduce HBC claims

The NSW Government is undertaking a number of reforms to improve the quality of residential construction and bring confidence back to the industry. Many of these are focused on the multi-storey segment of the residential market at present, where the more expensive and systematic problems have occurred. However, once introduced, these would apply to the new multi-storey buildings three-storeys or less that are covered under the HBCF. The recently appointed NSW Building Commissioner is leading this work program (see Box 4.1).[6]

5 SIRA, Home building compensation scheme report – Data Tables, December 2018 and IPART calculations.

6 The Building Commissioner was appointed in August 2019. See NSW Building Commissioner appointment, accessed 16 September 2020.

We support the Government's approach to improving building quality through the compliance and enforcement regime under the Building Commissioner. We propose that these should apply more broadly to the low-rise residential building sector in future.

In addition, we are recommending changes to the rules around how building businesses can collect payments from homeowners to minimise their out of pocket costs when projects are not completed. We are recommending that the NSW Government align the rules in NSW with those in Queensland and Victoria, including that:

- deposits are capped at 5% of the contract value, down from 10%, and
- progress payments must reflect the value of the work completed.

These rules should provide stronger incentives to complete projects, and reduce the costs of resulting claims under the scheme.

We also recommend that service standards should be introduced for Fair Trading for the time taken to resolve disputes, for example, 80% of disputes resolved in 28 days and average length of time to resolve disputes is 28 days. The service standards for NCAT hearing and resolving a dispute should deliver better customer service, for example, 80% of matters are finalised within 6 months (down from 18 months currently). Both Fair Trading and NCAT should collect and publish information on the number and type of complaints and time taken to resolve them.

1.1.2 First-resort cover could be offered on a voluntary basis

Currently, unless a building business is already insolvent, homeowners must pursue defect complaints they cannot resolve with their builder through Fair Trading, NCAT and/or the court system. Homeowners incur legal and building expert costs, as well as accommodation and other expenses while their dispute is being resolved. These costs can be high where it takes a long time to resolve a dispute.

An alternative system ("first-resort" cover) allows for claims to be made in relation to any defects that arise—not just those where the building business is no longer trading. As a result, HBC providers have an increased interest in managing construction risks (rather than just insolvency risks). If building businesses do not rectify defects quickly, providers would engage a third party contractor to rectify defects, and recover the costs from the building business. The threat of legal action by a well-resourced insurer compared to a homeowner provides a strong incentive for builders to comply with building standards, and promptly rectify any defects. Providers could increase the builder's premium for future work, restrict their job limits, or decide not to insure them in the future, which would provide additional incentives for compliance.

While first-resort products can provide these additional incentives for builders to ensure good quality work, we are not recommending that they become **mandatory**. In our view, a last-resort scheme is more likely to lead to greater efficiency, and more product offerings to meet customers' needs. This is because it would better facilitate competition.

From an insurer's perspective, in order to offer a first-resort product, they would have to manage defect risks, in addition to the insolvency risks. In the current residential environment, an insurer would need to devote substantial resources to managing this risk. This could be all-consuming for its business. An insurer may not have the necessary corporate knowledge to deal with enforcement of building standards and certification. As a result, we consider that it is unlikely that insurers would enter the market if they were required to provide cover for all defective work. This would reduce the likelihood of competition in the market.

However, once these risks of defects are better mitigated through the broader regulatory regime, insurers may be more inclined to offer a first-resort product on a voluntary basis. In particular, the Building Commissioner's aim is to establish mechanisms (a building risk rating tool and a single depository of all building designs, consents and certifications) that allow insurers to determine the trustworthiness of buildings and building businesses (see Box 4.1). As a result of these measures, the Building Commissioner is aiming to create sufficient confidence in the market for voluntary first-resort decennial insurance products to be available by 2023 for the multi dwelling segment of the market (Class 2 Buildings).

In the meantime, the Building Commissioner's reforms should also strengthen incentives for building businesses to deliver quality work, leading to outcomes for homeowners that are similar to those under a first resort scheme.

1.2 Our recommendations seek to increase HBC providers

In 2018, changes were made to the HBC scheme to open the market to insurers and alternative indemnity providers.[7] However, icare remains the sole provider in the market. Without a choice of providers for building businesses, there is less pressure on icare to provide an efficient product and quality service. Our terms of reference asked us to investigate whether there are any impediments to private sector participation in the market.

We have found that new entrants have been discouraged from entering because the risks of defects is uncertain and the costs are high, with icare's HBCF continuing to make losses each year (as premiums were previously set below breakeven levels). In addition, the regulatory regime is also overly prescriptive and duplicative. There are regulatory barriers to entry preventing non-insurer alternative indemnity providers from entering the scheme.

We have recommended changes so that new entrants are subject to a less prescriptive regulatory approach that is proportionate to their influence on the market. This will allow them more flexibility to manage their own risks. Private providers have commercial incentives to offer products and services to attract market share, and make an economic return. They will continue to be subject to prudential oversight to ensure they maintain adequate capital to meet their liabilities. We also consider that the State Insurance Regulatory Authority (SIRA) should maintain a role in enforcing compliance with claims handling and other service standards. This is because the scheme's incentives mean that building companies are the upfront customers of insurers and providers of alternative indemnity products (AIPs), but homeowners are the ones that benefit from the product. Often this is a one-off transaction for homeowners.

7 SIRA, *Home Building Compensation Scheme reforms*, accessed 10 September 2020.

We have recommended changes to the *Home Building Act 1989* (HB Act) to give effect to the NSW Government's intentions of the 2018 reforms to allow non-insurer providers like fidelity funds to offer AIPs under the scheme. Currently, it is very unlikely that a non-insurer could meet the legislative requirements to become a licensed AIP provider, because they would almost always be carrying on an insurance business. Prospective AIP applicants should have certainty about the requirements of the HB Act before putting resources into developing their application and business model.

We also recommend that the NSW Government requires icare to make available separate cost-reflective construction period and warranty period products so that a new entrant could provide cover for one period only. This would reduce the burden on providers to hold capital to cover liabilities for up to 10 years, which has deterred market entry.

These changes may lead to entry by niche product providers in the medium-term, similar to the experience in the domestic building insurance market in Victoria and the ACT. However, it is still likely to take a number of years to achieve a workable level of competition in the HBC market. This is especially the case in the current economic environment. The COVID-19 pandemic is likely to lead to a number of insolvencies as construction activity falls, increasing the number of claims, which would further discourage entry in the short-term.

1.3 There should be greater regulatory oversight of icare

Our terms of reference asked us to review the efficiency of the scheme, for which icare is the sole provider. With no alternative providers, icare does not face competitive pressure to improve its service offering, because it does not risk losing customers. Stakeholders submitted that many of icare's services are onerous and lack transparency.

As a monopoly government service provider, we recommend that icare should be subject to independent price regulation where premiums are determined by an independent regulator. This would involve a detailed assessment of icare's cost efficiency. Additionally, we recommend that SIRA determines icare's builder eligibility assessment and claims handling process to reflect the outcomes that would reasonably be expected in a competitive market.

We also recommend that icare provides greater transparency about how it determines builder eligibility. Many stakeholders expressed concern that icare's eligibility process was too inflexible and unpredictable.

1.4 We conducted public consultation as part of our review

A large part of our review has been consulting with stakeholders, including building companies, insurers, potential AIP providers, government agencies and the general public as well as undertaking our own analysis. As part of our review, we:

- released an Issues Paper in April 2020 outlining our proposed approach to the review and invited comment
- released a Draft Report in September 2020, with our draft findings and recommendations and invited further comment

- held a virtual public hearing in September 2020 for stakeholders to present their feedback directly to the IPART Tribunal
- considered all submissions to our Issues Paper, Draft Report and feedback received at our Public Hearing, and met with different stakeholder groups to discuss their concerns and get their input
- undertook independent analysis and research to develop our Final Report, including engaging actuarial firm, Taylor Fry, to compare the NSW Home Building Compensation Fund with the Queensland Home Warranty Scheme, and prepare actuarial advice on any additional prudential capital requirements on HBC providers if they were to offer split HBC products as allowed under the HB Act – one product for the construction period, and another for the warranty period. Their advice is available on our website.[8]

It is up to the Government to determine if it implements our final recommendations.

1.5 Structure of this report

The remainder of this report discusses our analysis, findings and recommendations in detail. It is structured as follows:

- Chapter 2 discusses the context for this review and how we have approached it
- Chapter 3 provides information about the costs and efficiency of the HBCF
- Chapter 4 discusses the effectiveness of the scheme in protecting homeowners from loss
- Chapter 5 discusses the changes that would be required to facilitate the entry of alternative indemnity provides to the HBC market
- Chapter 6 explains how changes to the regulatory framework could reduce barriers to entry for private insurers and providers
- Chapter 7 discusses our recommendation to require icare to offer separate HBC products for the construction period and warranty period
- Chapter 8 provides recommendations to improve the efficiency of icare
- Chapter 9 discusses our recommendations to improve icare's builder eligibility process
- Chapter 10 discusses our response to other issues raised by stakeholders through our review.

8 Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020.

1.6 List of findings and recommendations

Findings

Recommendations

2 Approach to the review and key themes from stakeholders

In February this year, the NSW Government asked IPART to review the effectiveness and efficiency in the home building compensation fund in protecting consumers who are currently covered under the scheme.

This is not the first time the home building warranty/insurance schemes have been reviewed (See Box 2.1). Since the introduction of the scheme in 1972, there have been many inquiries, mainly due to the significant costs of the scheme. These have led to changes in its operation and coverage. In 1997 the NSW Government run scheme was privatised to reduce the risks to the state. The collapse of the major insurer HIH four years later, which had 30 to 40% of the HBC market, led to reductions in coverage. As the remaining private insurers gradually withdrew from the market the NSW Government insurer re-entered the market as the monopoly provider in 2010. More recently, Fair Trading reviewed the financial sustainability of the scheme in 2015 as costs continued to escalate.[9] In 2018 changes were made to transition premiums to cost reflective levels, and the scheme was reopened to competition.[10]

This chapter sets out the focus and scope of this review, and how we have approached our investigation. It also sets out stakeholders' key concerns about how the scheme is currently operating.

Box 2.1 Previous reviews on Home building compensation insurance and warranty schemes

1992 **Productivity in the Building Industry in New South Wales (Gyles Royal Commission)**

- Recommends private underwriting

1993 **Inquiry into the New South Wales Building Services Corporation (Dodd Inquiry)**

- Finds the scheme is susceptible to claims of conflict because it is both the insurer and arbiter on disputes – therefore the 'one stop shop' approach is inappropriate
- Recommends separating the key functions of industry regulation and consumer advice, dispute resolution and insurance
- Recommends privatising the scheme – holding of the insurance risk is not in the best interests of the citizens of NSW

1997 Scheme privatised

9 Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper*, December 2015.
10 SIRA, *Home Building Compensation Scheme reforms*, accessed 10 September 2020.

1998	Home building insurance extended to owner-builder work
2001	HIH collapses with 30 to 40% of the market. Other insurers raise their premiums, leading to builders being unable to afford insurance
2002	**National review of home warranty insurance and consumer protection prepared for the Ministerial Council on Consumer Affairs (the Allan Inquiry)** ▼ Finds that the "first-resort" schemes were in practice operating as "last-resort" schemes – insurers were expecting a homebuyer to exhaust all other avenues of appeal before claiming on their insurance policy ▼ Recommends placing less emphasis on insurance and giving more attention to strengthening the regulatory framework
	Scheme becomes a 'last-resort' scheme for both breach of statutory warranty and non-completion (previously, claims for breach of statutory warranty could be made if the building business was still trading, but insurance claim for non-completion could only be made if the building business was insolvent, dead or could not be found)
	Period of cover for insurance split into 6 years cover for structural defects and 2 years cover for non-structural defects (previously 7 years for all defects)
	Claims for non-completion of building work capped at 20% of the contract price for the work
	The Minister able to approve an alternative home building indemnity scheme
2003	**NSW Home Warranty Insurance Inquiry (the Grellman Inquiry)** ▼ Finds that private sector should continue to provide home warranty insurance ▼ Recommends excluding high-rise apartments from the scheme because they are commercial projects with materially different risks. ▼ Recommends introducing a system to regulate insurers with guidelines for premium determination and claims handling, and creating an industry deed setting out the basis for underwriting and participation by insurers
2004	Residential construction buildings more than three-storeys excluded from mandatory insurance requirements
	Board established to monitor the scheme and advise the Minister. Guidelines for insurers on 'market practice' and 'claims handling' adopted and compliance with these became a condition of approval for insurers.
2007	**NSW Legislative Council General Purpose Standing Committee No. 2, Inquiry into the Operations of the Home Building Service** ▼ Concerned by evidence about the poor consumer protections offered by the current scheme, in particular the 'last resort' nature of the scheme and the tendency to escalate disputes. Payouts were seen to be inadequate while the costs associated with exhausting other avenues before claiming can be exorbitant. ▼ Recommends that the NSW Government adopt the Scheme Board's proposal for an extra 'trigger' to enable consumers to make a claim when a building business has its licence suspended, but is not insolvent. ▼ Recommends early and fair dispute resolution.

2008 **Productivity Commission, Review of Australia's Consumer Policy Framework**

- Recommends improving the effectiveness of early stage consumer protection measures by better linking licensing to building business performance and better dispute resolution procedures.

2008 **Senate Standing Committees on Economics – Australia's Mandatory Last Resort Home Warranty Insurance Scheme**

- Finds that there are still problems with dispute resolution in domestic building – especially long-drawn-out tribunal cases.
- Recommends improving the builder licensing (linking performance to licencing) and dispute resolution arrangements directly, rather than to government ownership of the insurance. COAG should pursue a nationally harmonised 'best practice' scheme of consumer protections for domestic building.
- Rejects a voluntary scheme because this would leave consumers without a minimum level of protection if a building business collapsed.

2009 Homeowners able to make a claim if a building business's licence had been suspended for not complying with a court or tribunal compensation order

Lumley General, CGU Insurance announce their intention to withdraw from the scheme

2010 NSW Government assumes responsibility for the scheme as a monopoly provider, and the remaining insurers, Calliden, QBE, and Vero stopped offering insurance

The benefit of the insurance extended to successive title owners

2015 **NSW Fair Trading – Reform of the Home Building Compensation Fund**

- Presents options to improve the financial sustainability of the fund

Owner-builders cover no longer issued

The State Insurance Regulatory Authority (SIRA) becomes the scheme regulator

2017 **SIRA HBC eligibility and premium standards consultation**

- Consults on how premiums should be calculated and assessed, and how building contractors should be assessed for eligibility for insurance

2018 Reforms implemented to allow for private insurers to enter the scheme, and offer separate cover for the construction period and warranty period or combined cover

Source: SIRA, *Home Building Compensation Scheme report - June 2018*, pp 43-44, accessed 10 September 2020.

Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper,* December 2015, pp 42-49; The Senate, Standing Committee on Economics, *Australia's mandatory Last Resort Home Warranty Insurance scheme*, November 2018, Chapter 2, accessed 10 September 2020; NSW Parliamentary Library Research Service, *Home Warranty Insurance,* E-Brief 7/2010, March 2010, accessed 10 September 2020; NSW Government, *Independent Review of the Building Professionals Act 2005, Final Report,* October 2015; Rippon J, *Closing the Gap: Decennial Liability Insurance – The solution to the strata living crisis in New South Wales*, March 2020.

2.1 What have we been asked to do?

In reviewing the effectiveness and efficiency of the HBCF, the NSW Government has asked us to investigate:

- the scheme's incentives for building industry participants to undertake good risk management and encourage good business practices
- whether the scheme needs to further mitigate building businesses' insolvency risk, for example, through enhanced information collection in relation to builder progress payments, critical stage inspects, and issuance of compliance certificates or other measures
- any other impediments to private sector participation in providing insurance through the home building compensation scheme
- whether there are unnecessary regulatory burdens and barriers to entry for building participants.

The review comes two years since the scheme was opened to private entry, and new guidelines were implemented on how insurers must manage their risks. No private providers have yet entered the market – although two providers applied to the scheme regulator for a licence to operate. One of these applications was withdrawn.[11]

As a result, building businesses still do not have a choice of providers, and there is no competitive pressure to innovate, improve customer service, or reduce costs. Some building businesses are frustrated with their interactions with the Government insurer, icare, and consider that the scheme imposes a significant burden on their business. They have also faced increasing premiums (although these are usually passed onto homeowners in full) as they have been transitioned to cost-reflective levels.

2.2 How have we undertaken this review?

IPART is an evidence-based consultative regulator. All reviews IPART undertakes, including this review of the Home Building Compensation scheme, use a rigorous, transparent and inclusive review process. We actively engage with stakeholders and undertake research and analysis, seeking expert advice where necessary. This approach:

- maintains transparency
- informs and strengthens our decisions
- ensures genuinely impartial determinations and recommendations.

Specifically, for this review, we have undertaken detailed analysis and public consultation:

- In December 2019 we consulted on the draft Terms of Reference for the review and received eight submissions before finalising the Terms of Reference in February 2020.

11 Information provided by SIRA, 2 November 2020.

- We held numerous stakeholder meetings in the first quarter of 2020 including meeting with the NSW Government insurer, icare, the scheme regulator, the State Insurance Regulatory Authority (SIRA), the NSW Building Commissioner, and the NSW Department of Customer Service, who are responsible for building and construction regulation policy.
- In April 2020 we released an Issues Paper, which set out the key issues for this review. We received 24 submissions, which have been published on our website.
- We then met with several stakeholders who made submissions to our review, including potential HBC providers, building associations, individual building businesses and icare. We also met with the icare independent consumer advocate. The icare consumer advocate commenced a review of the scheme in June 2020, which has involved conducting in depth interviews and surveying building businesses and claimants on their experience with the scheme. The consumer advocate completed its review in October 2020, and the report will be published by the end of the year.[12]
- We received detailed claims and cost data for HBCF from icare, and information on their risk mitigation processes.
- We appointed actuarial consultants, Taylor Fry, to provide expert advice on the costs of the NSW scheme, compared with the scheme in Queensland. The Queensland scheme provides a greater level of protection to homeowners because claims can be made even while the building business is still trading. This report has been made publicly available on our website, subject to any confidentiality.
- We released a Draft Report in September, and received 14 submissions.
- Following the release of this Draft Report, we held a virtual public hearing. 44 stakeholders attended and provided feedback on our draft findings and recommendations.
- We engaged Taylor Fry to prepare actuarial advice on any additional prudential capital requirements on HBC providers if they were to offer split HBC products as allowed under the HB Act – one product for the construction period, and another for the warranty period. This advice is available on our website.

In considering stakeholder feedback and undertaking our analysis, we have had regard to the following factors, as required by our terms of reference:

a) the need for the scheme to provide an adequate level of protection to customers having regard to the other measures that are likely to contribute to the efficient and effective protection of customers

b) the need to encourage confidence in the market for construction of residential dwellings

c) the costs and benefits of any proposed changes to ensure an efficient and financially sustainable outcome

d) the coordinated approach by the NSW Government to fix the failures of the statutory warranty and home building compensation schemes

e) developments in other jurisdictions.

12 icare, *Customer Advocate*, accessed 26 November 2020.

2.3 What stakeholders have told us

Although homeowners are the beneficiary of the scheme, we have only heard from a few homeowners and consumer groups in response to our Issues Paper. However, we have considered consumer's issues raised in relation to the scheme recent reviews, including the recent NSW Upper House Inquiry into the Regulation of building standards, building quality and building disputes.[13] We also considered the early findings of the consumer advocate about homeowner experiences with the scheme.

The majority of stakeholders we have heard from during this review are:

- Residential building businesses and other contractors. The obligations under the scheme fall on these stakeholders, and many considered that they are overly burdensome.
- Potential HBC providers who consider that there are barriers to them entering the market.
- Brokerage businesses, which prepare eligibility applications for building businesses and distribute HBC on behalf of icare.

Key concerns of the different stakeholder groups are outlined below. Many of these issues have been raised in previous reviews, in particular, through Fair Trading's 2015 discussion paper on the scheme, and SIRA's 2017 consultation on the eligibility and premium standards.

Overall, there was general agreement between stakeholders that risk-management through the scheme is not enough to encourage better building practices. Lowering the risk-profile of the construction industry requires reducing defects through a more rigorous and independent quality assurance process than is currently in place (such as more independent critical stage inspections) and improving accountability through greater transparency (for example, through a builder ratings system, or the publication of complaints made to Fair Trading).[14]

2.3.1 Homeowners

We have heard from homeowners that it is currently very difficult for them to assess the likelihood of encountering problems when they are choosing their builder. When disputes with building businesses arise, it can be unaffordable and slow to resolve them.[15] A common theme in previous reviews is that the scheme should be operated on a "first-resort" basis, so that if disputes are not resolved in a timely way, homeowners could make a claim to the insurer while the building business is still trading.[16]

13 Public Accountability Committee, *Regulation of building standards, building quality and building disputes*, accessed 10 September 2020.

14 For example, see Law Society submission to IPART Issues Paper, June 2020, p 6; Tyrrell submission to IPART Issues Paper, May 2020, pp 1-2; Builders Collective of Australia submission to IPART Issues Paper, 31 May 2020, p 1; Risk Specialist Group submission to IPART Issues Paper, May 2020, pp 4-5,

15 For example see P. Gurrier Jones submission to IPART Issues Paper, June 2020.

16 For example, see Productivity Commission, *Review of Australia's Consumer Policy Framework*, 2008, pp 118-127; Senate Standing Committees on Economics, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, November 2008.

Consumer groups are also concerned that some homeowners are excluded from the scheme. In particular, they consider that the scheme should apply to the construction of multi-storey apartments above three-storeys, and claims should be accepted for defects that occur within seven years (instead of six years) from the completion of the building.[17]

2.3.2 Building businesses

Building businesses are responsible for taking out HBC insurance on behalf of homeowners. Before they can do this, icare first assesses their eligibility to take out insurance. We received submissions from a number of building associations and building businesses explaining the impacts of icare's eligibility process on their businesses. Building businesses must provide detailed financial information to their insurance broker, and icare uses this information, along with its previous work history, to manage its exposure to risks. It does this by placing limits on the building business's construction activity, and if necessary, requiring it to meet other conditions (for example, putting more funds into the business). The insurer can also prevent building businesses from obtaining insurance if they pose too great a risk to the fund.

Limits on the number of jobs a building business can undertake can slow the pace a business can grow, and it can be time consuming and costly for building businesses to arrange to meet the conditions. These conditions can be imposed even when the building business has a strong record of producing high-quality work. If conditions are not met within the time periods allowed, builders' eligibility for insurance can be suspended, causing them to lose building contracts.

Through the review, different building businesses have told us that they consider that:

- The scheme should not be mandatory, noting that very few homeowners benefit from the scheme and many may not purchase the insurance if they had the choice.[18]
- Exclusions to the scheme should apply to certain types of work (including non-structural work, pools and landscaping, low-rise apartments managed under a strata scheme, and single construction projects with a contract valued over $10 million), or certain building businesses (including well-capitalised building businesses, who could self-insure), and longstanding building businesses with a proven track record of rectifying defects).[19]
- The scheme should not be operated as a first-resort style of insurance model, because it would discourage private sector entry and be a conflict of interest through conflating the roles of insurer and regulator, to the detriment of building businesses.[20]
- The current scheme has run for many years at significant losses thereby making it a very unattractive proposition for a private sector, profit seeking business. [21]

17 See Public Accountability Committee, *Regulation of building standards, building quality and building disputes*, November 2019, pp 39, 53-54, 62, accessed 10 September 2020. The Law Society also considered that the three-storey height limit is arbitrary, and showed be reviewed. Law Society submission to IPART Issues Paper, June 2020, p 1.

18 Discussions with building businesses.

19 For example, see SPASA submission to IPART Issues Paper, June 2020, p 8; The Landscape Association submission to IPART Issues Paper, June 2020, pp 1-2.

20 HIA submission to IPART Draft Report, October 2020, pp 3, 7.

21 HIA submission to IPART Draft Report, October 2020, p 3.

- The scheme should be operated as a levy program (where premiums are not set on the basis of an individual builder's risk). A stakeholder considered that this would produce "enormous savings in administration costs in relation to managing the eligibility process and create a level playing field for all builders.[22]
- icare should take a more flexible approach to eligibility, including applying a "light-touch approach" to market segments that pose a low risk such as sole traders and partnerships, and applying different rules to different sub sectors (such as for swimming pool businesses, where jobs can be "open" for longer periods).[23]
- icare needs to improve its communication with building businesses, including explaining why certain information is required; and having discussions with building businesses about eligibility issues, including how financial information has been interpreted. When issues with their eligibility arise, they should be able to communicate to icare directly, rather than through a broker.[24]

Most building businesses we spoke to also said that they wanted a choice of HBC providers. With insurers competing to win the business of builders, there would be a greater incentive to provide good customer service to building businesses, and to tailor products that reflect the circumstances of their individual businesses.

2.3.3 HBC Providers

Stakeholders submitted that the following changes should be made to encourage entry into the market:

- Changes to legislation to give effect to the intent of the 2018 reforms to allow fidelity funds, which are not regulated by the Australian Prudential Regulation Authority (APRA), to enter the market.[25] (However we also heard that fidelity funds offer poor consumer protection compared to a licensed and reputable insurer with reinsurance, and that they would be undercapitalised, particularly in their infancy).[26]
- Replacing icare's existing combined product with separate insolvency and defect products (that provide $340 k of combined cover) so that each risk can be underwritten and priced according to the nature of the cover provided.[27]
- Shortening the mandatory length of the warranty period to three years, with additional coverage offered voluntarily. Allowing for claims up to 10 years after completion in an unacceptable waiting period for providers.[28]

22 The Landscape Association submission to IPART Issues Paper, June 2020, p 2.
23 When a pool is constructed as part of a new home, the pool building business must start on the site at the commencement of the home building project, but cannot complete the work until the house construction is completed. SPASA submission to IPART Issues Paper, June 2020, p 3
24 For example see All Trades Maintenance submission to IPART Issues Paper, April 2020, p 1; discussions with various building businesses.
25 SecureBuild submission to IPART Issues Paper, May 2020, p 12.
26 HIA submission to IPART Issues Paper, June 2020, p 12.
27 HIA submission to IPART Issues Paper, June 2020, pp 5, 11, National Insurance Brokers Association (NIBA) submission to IPART Issues Paper, May 2020, p 5.
28 HIA submission to IPART Issues Paper, June 2020, pp 5, 11.

- Removing the link between a claim over the defect period to a breach of statutory warranty to reduce high frequency of claims and uncertainty for underwriters[29]
- Removing SIRA oversight for insurers, as they are already regulated by APRA.[30]
- Removing heavy-handed risk-acceptance requirements, including allowing providers to offer cover to a limited number of low-risk building businesses.[31]
- Expanding the market by making insurance for owner-builders mandatory.[32]

On the other hand, icare submitted that it would be more cost effective to remove the ability for alternative suppliers to enter the market altogether. It submitted that it could offer cover more cheaply if it did not have to include a margin for competitive neutrality (noting that this is around 9 to 15%), and if it wasn't required to pay for the framework that supports competition (that is, its agency capacity for evaluating competitors via a levy to SIRA).[33]

2.3.4 Brokerage businesses and associations

We received a number of submissions that disagreed with our draft recommendation to make the use of brokers voluntary. Stakeholders submitted the mandatory use of brokers should be maintained because as a competitively delivered service, they are a more effective way of managing builder's eligibility assessment applications, and they provide additional oversight in ensuring that builders meet their obligations to purchase insurance.[34]

2.4 What are the challenges in addressing stakeholders' concerns?

In considering stakeholder issues there are important trade-offs to be made. For example:

- Increasing the coverage under the scheme would lead to better consumer protections, and providing this assurance to homeowners could help return confidence to the sector. The flipside of this is higher claim costs, and therefore higher premiums – further adding to housing affordability concerns in an economic downturn.
- Reducing the financial requirements on building businesses would ease the burden on these businesses, but could increase the rate of insolvencies, leading to more homeowners left with incomplete homes. This would result in more claims under the scheme, increasing the cost of cover for all homeowners doing new building work. It could also have broader consequences for the industry. For example, a large number of additional insolvencies could further reduce consumer confidence in the building industry, reducing activity in the sector, and resulting in even more businesses exiting the market.
- Making it easier for new providers to enter the market by reducing regulatory requirements could lead to better choice and value in HBC cover products. However, this needs to be balanced against the risks of lowering protection for homeowners. If a large

29 HIA submission to IPART Draft Report, October 2020, p 4.
30 HIA submission to IPART Draft Report, October 2020, p 15.
31 NIBA submission to IPART Issues Paper, May 2020, p 6.
32 For example, see Buildsafe submission to Draft Terms of Reference, January 2020.
33 icare submission to IPART Issues Paper, June 2020, p 18.
34 For example, see NIBA submission to IPART Draft Report, October 2020, pp 1, 5; and MBIB submission to IPART Draft Report, October 2020, p 5.

building business fails, and a provider becomes insolvent, either homeowners with cover with this provider would be left without protection, or taxpayers would have to fund the cost of any claims (we note that there is also provision for SIRA to provide a safety net for policy holders if a provider is declared insolvent through a Building Insurers' Guarantee Fund, which is funded by providers[35]).

These trade-offs mean that there is no "silver bullet" that will "fix" the scheme. Rather, the regulations and requirements on building businesses and insurers needs to be balanced so that their benefits exceed their costs. For example, the requirements on building businesses that are intended to reduce the number of insolvencies should result in benefits (lower claims costs, and maintaining consumer confidence in the construction industry) that are greater than the costs to building businesses of complying with the requirements, and the cost to the scheme.

In balancing these trade-offs, we have sought to make recommendations that deliver the following outcomes:

- a choice of products that improve outcomes for homeowners and building businesses
- affordable cover
- better administrative processes
- confidence in the market for construction of residential dwellings
- improved financial viability of the scheme.

35 SIRA, *Home building compensation reforms*, accessed 10 September 2020.

3 Costs of the home building compensation fund

In reviewing the efficiency of the home building compensation scheme, we have considered the key cost components of the scheme, and how they are recovered through premiums and taxpayer funding.

SIRA is responsible for assessing whether premiums are financially viable and reflective of risks before changes to premiums take place.[36] We have had regard to icare's most recent premium filing, which explains the basis of their proposed premiums, as well as its detailed underlying claims data.

To help understand whether the scheme is likely to be delivered efficiently, we compared the costs of the NSW HBCF to similar schemes, taking into account the differences between schemes. In doing so, we have considered the developments in other jurisdictions, as required by our terms of reference. To assist us with this task, we engaged Taylor Fry to compare the NSW scheme with the home warranty insurance scheme in Queensland. Its report is available on our website.

This chapter provides an overview of the costs of the scheme, and how they compare to other states.

3.1 Overview of our findings and recommendations

Average premiums in NSW are significantly higher than in other states. At an average of around 1% of the building contact price (exclusive of charges), premiums in NSW are around 20% higher than Queensland, and three times as high as Victoria. In addition, unlike in other states, taxpayers in NSW must make a significant contribution to the costs of the scheme—mostly because premiums have previously been set too low to recover the costs of claims.

Premiums are higher in NSW due to significantly higher average claims costs, rather than a higher rate of claims. There are fewer claims in NSW compared to Queensland and Victoria, but the average cost of a claim in NSW is two to three times higher. In part, this reflects a higher level of cover than other states, higher building costs, and a larger proportion of eligible apartments (which are significantly more risky than single dwellings). However, once adjustments are made to account for these differences, we estimate that claims costs in NSW are still around 50% higher than other states.

This could reflect a number of factors. Higher claim costs for defects are likely to reflect weakness in the broader regulatory environment that lead to defects being more severe in NSW compared to other states. In addition, the rules about how building businesses are allowed to collect payment for their work are more flexible in NSW compared to other states, which means that if a builder becomes insolvent prior to work being completed, a

36 SIRA, *Home building compensation reforms*, accessed 9 September 2020.

homeowner is likely to be out of pocket to a greater extent because they have paid more up front. This can lead to higher costs for non-completion claims.

It is also possible that the higher claims cost could reflect higher cost rectification works in NSW as a result of icare's claims management processes. However, further evidence is required to understand whether this is a factor. As discussed in more detail in Chapter 8, we are recommending that price regulation is required for icare because it is a monopoly provider. As part of this process, the price regulator should review whether the current arrangements for rectifying works are resulting in efficient outcomes. We are also recommending that SIRA report on costs as part of its annual performance monitoring review so that icare's costs can be more easily tracked over time, and compared with costs of the schemes in other states. This should include a metric of average cost of claim per dwelling, by construction type and claim type, and track operating costs by function over time.

The following chapters discuss our recommendations aimed at putting downward pressure on the costs of the scheme:

- Chapter 4 discusses changes to the broader regulatory environment that could reduce the severity of defects and the extent that homeowners are out of pocket when work is not completed, in order to lower claims costs.
- Chapters 5 to 7 discuss our recommendations to reduce barriers to entry. More cost-effective providers entering the market offering lower premiums would improve the efficiency of the scheme. New providers would also have an incentive to provide an attractive product offering and good customer service to building businesses to gain market share.
- Chapters 8 and 9 explains our recommendations to improve the efficiency of icare as the monopoly provider, and put downward pressure on the costs of its distribution model.

IPART findings

1 HBCF premiums in NSW are significantly higher than premiums for similar schemes in other states.

2 We estimate that the average claim value in NSW is around 50% higher than claims made under similar schemes in Victoria and Queensland (after adjustments have been made for differences in coverage and building costs).

3 NSW has fewer claims than claims made under similar schemes in other states.

Recommendation

1 SIRA report on costs as part of its annual performance monitoring review so that icare's costs can be more easily tracked over time, and compared with costs of the schemes in other states.

3.2 Premiums in NSW are higher than in other states

Home warranty insurance is mandatory in every state in Australia except Tasmania,[37] however the products vary between states. Some of the key differences include:

- The amount of cover offered (for example, claims of up to $340,000 can be made in NSW, compared to $300,000 in Victoria. In Queensland, each claim type (pre-completion and post-completion) is capped at $200,000).
- The project threshold for mandatory cover (for example, $20,000 in NSW, compared to $16,000 in Victoria, and $3,300 in Queensland).
- When a claim becomes eligible under the scheme. Notably, the scheme in Queensland is different to other states because claims can be made before a building business becomes insolvent (that is, it is a "first-resort", rather than a "last-resort" scheme), and therefore can give rise to more claims.[38]

Figure 3.1 shows that the average premium of 1.01% (as at June 2020)[39] for the NSW HBCF is significantly higher than similar schemes in other states. Differences in premiums will reflect some of the factors outlined above.

We consider the premium in Victoria is the best comparator for NSW. Victoria has a similar level of building activity to NSW, and the coverage, project threshold, claims criteria and administration of its domestic building insurance are similar to NSW. It has an average premium of 0.325%[40] which is around a third of the cost of the NSW scheme.

The residential construction industry in Queensland is the next closest in terms of level of activity. The average premium in Queensland is 0.83%,[41] which is higher than Victoria, but still lower than NSW. The coverage provides a lower maximum claim amount, but homeowners can make a claim on the fund when a dispute is unable to be resolved while the building business is still trading. Importantly, unlike in NSW, the premium includes the costs of dispute resolution (see section 3.4).

37 Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 17.

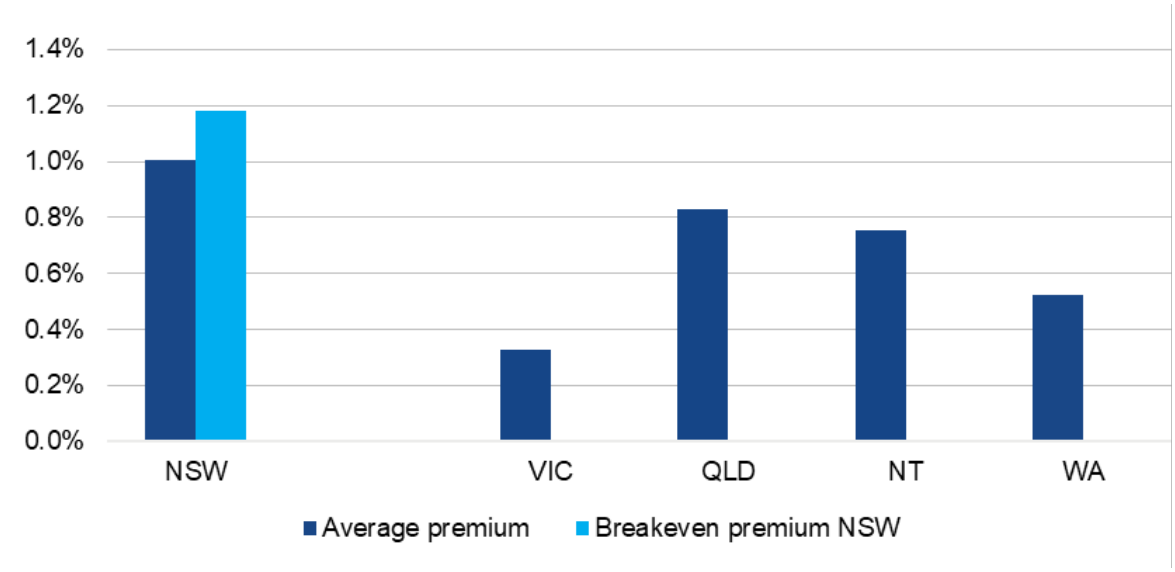
38 icare, *Home Building Compensation Fund*, accessed 10 September 2020; QBCC, *Home warranty insurance*, accessed 10 September 2020; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 11; VBA, *Insurance for building and plumbing work*, accessed 10 September 2020.

39 This is the overall premium. The premium for each construction type varies (See Figure 4.2). icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 13.

40 Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, 29 November 2019, p 14, accessed 10 September 2020.

41 Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 24.

Figure 3.1 Comparison of average premium rates by state (June 2020, exclusive of charges)



Source: icare, *Premium Filing January 2020, Home Building Compensation Fund,* p 13, 17; Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, p 14, 29 November 2019, accessed 10 September 2020; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23; Master Builders Fidelity Fund, *Fidelity fund contribution scale rate*, accessed 10 September 2020; Information received from WA Department of Mines, Industry Regulation and Safety, 7 August 2020.

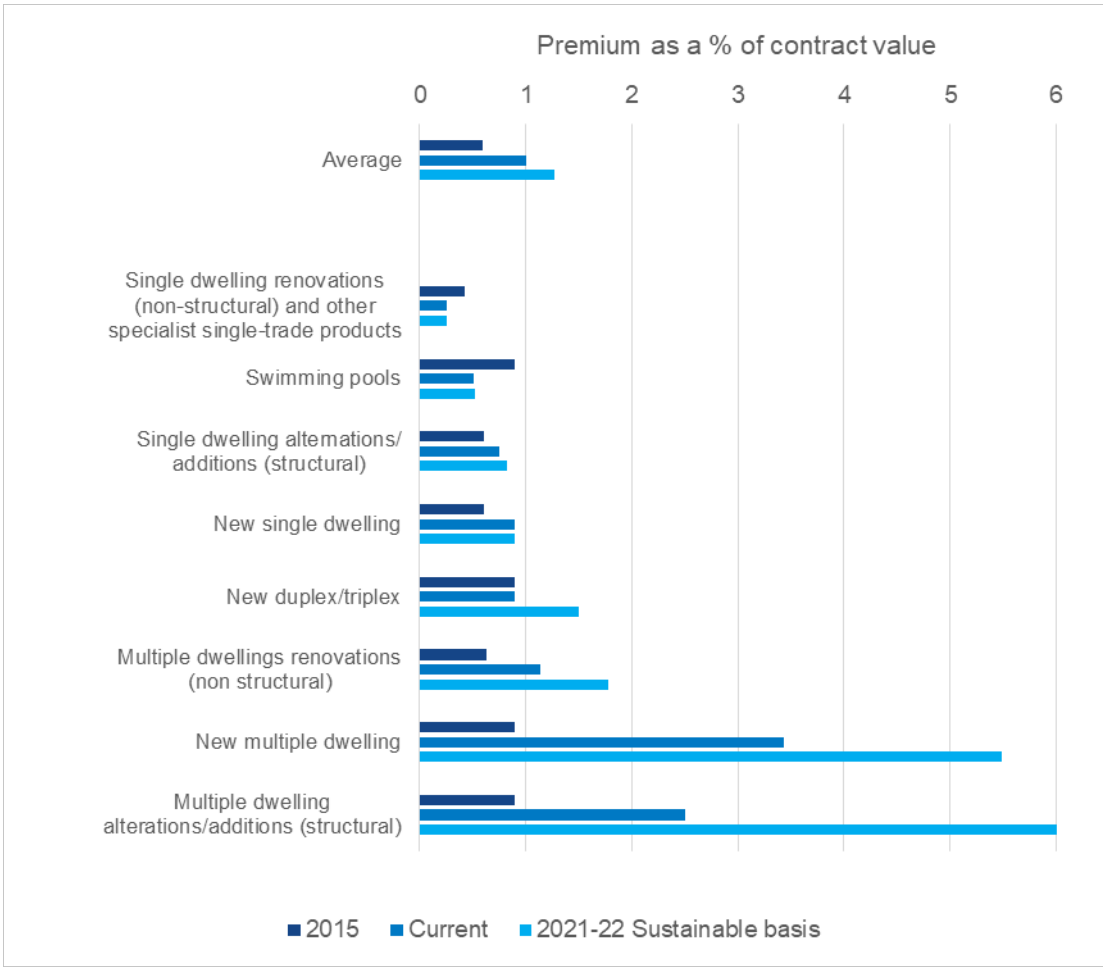
In addition to having higher premiums, the NSW HBCF also requires taxpayer funding to cover the costs of claims (Box 3.1). Unlike in Victoria and Queensland, where premiums are set at breakeven levels, the current premiums in NSW are only forecast to recover around 85% of costs (Figure 3.1). This is primarily because premiums on multi-dwellings are still below breakeven levels (single-dwelling structural alterations are also slightly below breakeven levels) (Figure 3.2).[42]

After several years of price increases, the premiums for other building types have now reached a sustainable level (they are expected to cover the costs of future claims). The transition path for multi-dwellings to reach breakeven levels has been longer because much more significant increases were required to reflect their higher risks. Figure 3.2 shows that premiums for new multi-dwellings and structural alterations to multi-dwellings have roughly tripled compared to 2015 levels, and will need to double to around 6% to become sustainable.[43] Including GST, stamp duty and brokerage, for a new dwelling with an average cost of $350,000, the premium would equal around $26,000 for each new apartment, up from around $16,000 currently. This compares to around $4,000 for cover for a single dwelling at current rates.

42 icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 11, 17.

43 *Ibid*; Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper*, December 2015, p 19.

Figure 3.2 icare's HBCF premium rates by construction type (exclusive of charges)



Data source: icare, *Premium Filing - Home Building Compensation Fund,* January 2020, p 13; Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper*, December 2015, p 19.

We received several submissions noting the high cost of premiums.[44] One individual stated that they had paid $23,000 in insurance for a small duplex development.[45] We note that premiums payable on each residence in a duplex are currently the same as for a single dwelling. However, from January next year, premiums for duplexes, triplexes, and granny flats will rise to 1.50%, compared to 0.89% for a single dwelling. The rates will no longer be aligned due to adverse emerging trends for new duplex/triplex construction types.[46]

44 For example, see T.Tyrell submission to IPART Draft Report, October 2020, p 1.
45 Anonymous submission to IPART Draft Report, October 2020, p 1.
46 Icare, *HBCF premium guidelines*, accessed 18 November 2020.

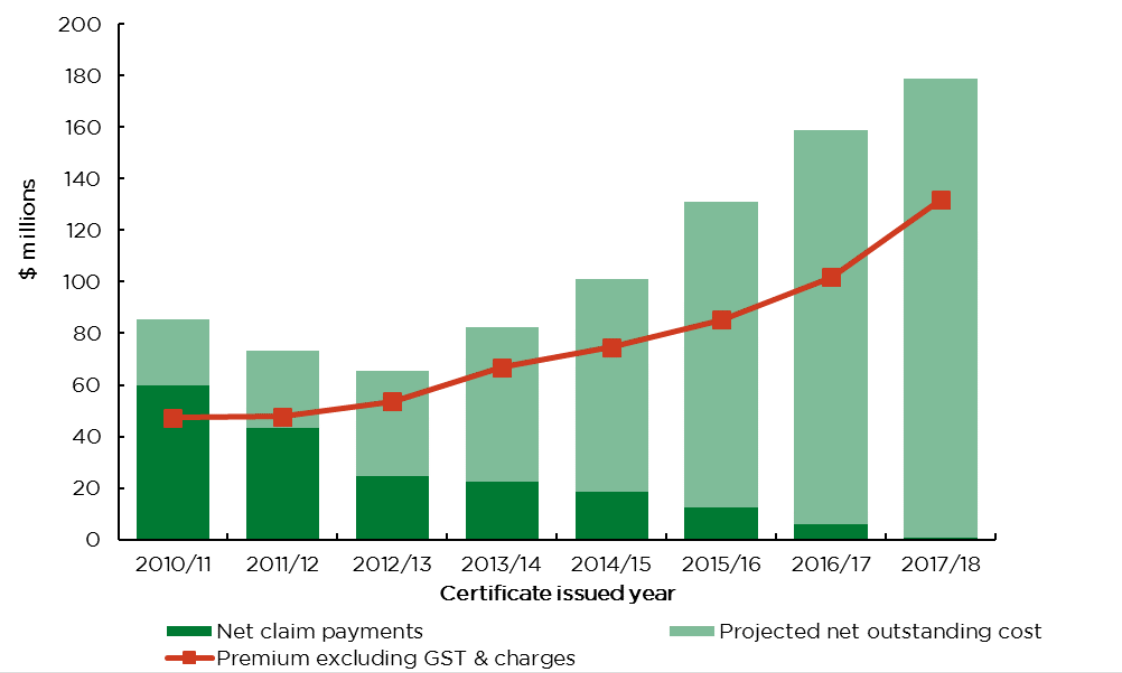
Box 3.1 Significant taxpayer funding will be required to meet the costs of the scheme for the foreseeable future

The HBCF is heavily reliant on NSW Government funding to cover the cost of claims on policies issued over the last decade. This is because premiums on these policies have been set lower than the amount required to cover the cost of the claims. In Figure 3.3, the forecast level of taxpayer subsidy for policies for previous years is the difference between the height of the total costs (green bars) and the premium (the red line).

Figure 3.3 also shows that liabilities remains outstanding for many years after a policy is issued, which makes it a 'long-tailed' product. It shows that in June 2018, claims could still arise from policies written in 2010-11, and the projected outstanding cost for claims in this year remained over $20 million. However, the total actual claims cost of these policies will not be known until at least 2020-21 (when the policies expire) and may be higher or lower than the estimated $85 million shown in this chart.

During 2017-18, icare received $138.4 million in funding relating to reimbursements of prior year losses and an additional $43 million in respect of policies written post 1 July 2018. As at June 2019, the fund had assets of around $400 million, compared to forecast claims liabilities of just over $1 billion. This means it still has a forecast deficit of around $650 million, which will need to be funded by taxpayers.

Figure 3.3 Premiums compared to costs by certificate year



Source: SIRA, *Home building compensation scheme report*, 30 June 2018, p 35, accessed 10 September 2020.
Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, pp 5, 23; icare, p 211.

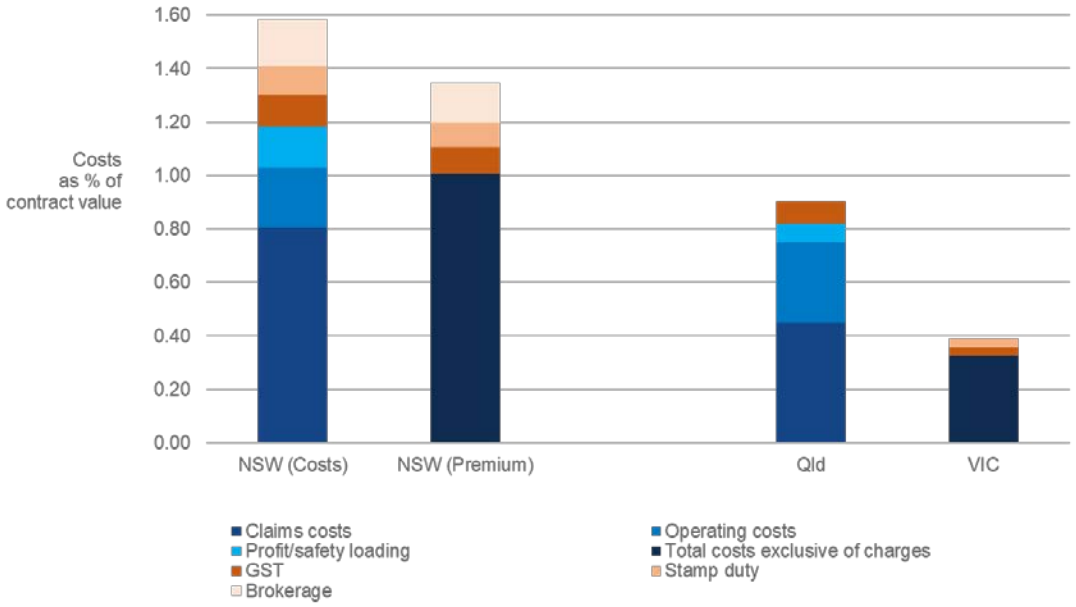
3.3 Average claims costs are higher in NSW

Claims costs are the primary costs of the NSW Home Building Compensation scheme, making up around 70% of total costs (excluding the charges shown in orange in Figure 3.4). The costs of operating the scheme make up a further 20% of costs. A profit/safety margin is then added to these costs, bringing the total cost in NSW to 1.2% as a percentage of the average building contract values (exclusive of charges).[47]

In addition, GST (10%), stamp duty (9%), and brokerage (around 15%) adds roughly another 34% to the costs of the scheme.[48] Including these costs, the average cost of the scheme in NSW is around 1.6% of the contract price, or around $5,500 for a $350,000 contract.

As noted in the previous section, premiums have not yet been set at breakeven levels. On average, premiums are currently around 15% less than costs.

Figure 3.4 Costs of home warranty schemes as a proportion of the average building contract value (2020)



Note: In Queensland, no stamp duty is payable on home warranty insurance premiums. There is also no brokerage fees applicable as builders eligibility is undertaken as part of builder licencing, and building businesses purchase certificates of insurance specific to each project directly from the Queensland Building and Construction Commission (QBCC) the statutory provider of home warranty insurance in Queensland. We do not have a breakdown of costs for the Victorian scheme.

Data source: icare, *Premium Filing January 2020, Home Building Compensation Fund,* pp 11, 17; Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23; Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, 29 November 2019, p 14, accessed 10 September 2020.

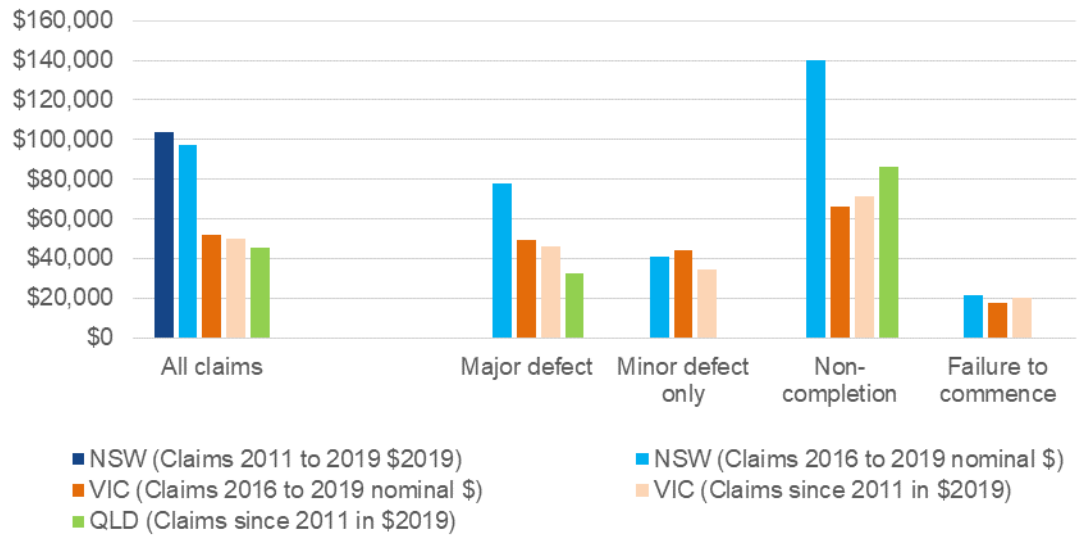
47 icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 11, 17.
48 Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23.

Figure 3.4 shows that claims costs in NSW are around 0.8% of contract values. This is significantly higher than other states—exceeding the total premium of 0.325% in Victoria, which includes both claims costs and operating costs.[49]

The cost of claims in NSW is being driven by a higher average claim value, rather than more claims. The average claim value is higher across each claim type (Figure 3.5). Claims for the most prevalent type of claims, major defects, average around $80,000 in NSW, compared to $30,000 and $50,000 in Queensland and Victoria respectively.

Claims that occur before the building is complete average almost $140,000. Almost half of these costs reflects the cost of completing work that a homeowner has already paid for. These non-completion claims are capped at 20% of the total contract value.[50] The remaining claims value represents the costs of rectifying defects that are identified in the incomplete work. Non-completion claims make up around 40% of all claims in NSW (Figure 3.6).[51]

Figure 3.5 Average claims costs per dwelling – NSW compared to Victoria and Queensland



Note: The data was not available on a comparable basis across all years, or dollars. The information is displayed based on the availability of data. The NSW 2011 to 2019 average is based on claims made with icare only. Adjustments have been made to the Queensland data to exclude claims relating to contracts less than $20,000. To calculate these averages, each claim is only counted once per dwelling. NSW claims with both a major and minor defect have been allocated to a major defect claim, and all claims with a non-completion component have been allocated to non-completion claims category (even if the cost of the rectifying defects is a larger portion of the claim).

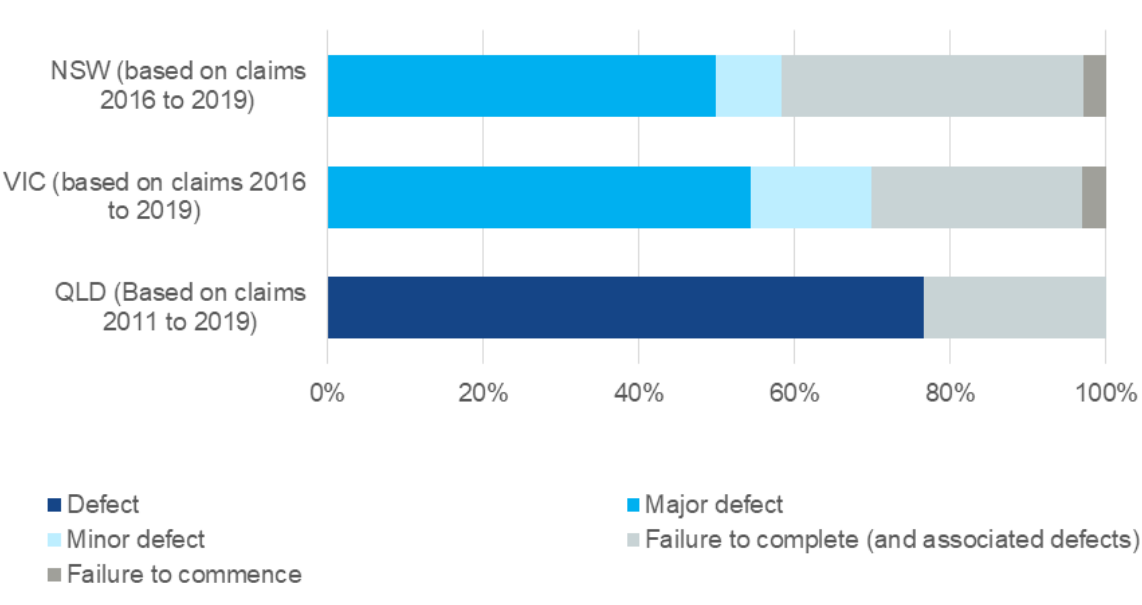
Data source: Based on information provided by icare, September 2020, *SIRA, Dec 2018 - Home building compensation report Dec 2018_Data Tables*, accessed 10 September 2020. Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020; *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, Correspondence with Taylor Fry, 24 July 2020; correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

49 Victoria's domestic building insurance scheme Performance report 2018-19, 29 November 2019, p 14, accessed 10 September 2020.

50 Section 62ZP (1)(i) of the *Home Building Regulation 2014*.

51 The claims costs in this section are lower than the amounts quoted in the Draft Report, because we have taken into account additional claims data. Our Draft Report did not include claims on multi-dwellings in NSW (construction types C02, C03, C08), as costs had been reported on a per policy, rather than a per dwelling (or certificate) basis. These costs now include the data on these claims.

Figure 3.6 Claims by type – NSW compared to Victoria and Queensland



Note: The data was not available on a comparable basis between categories, or across years. Each claim is only counted once per dwelling. NSW claims with both a major and minor defect have been allocated to a major defect claim, and all claims with a non-completion component have been allocated to non-completion claims category (even if the cost of the rectifying defects is a larger portion of the claim).

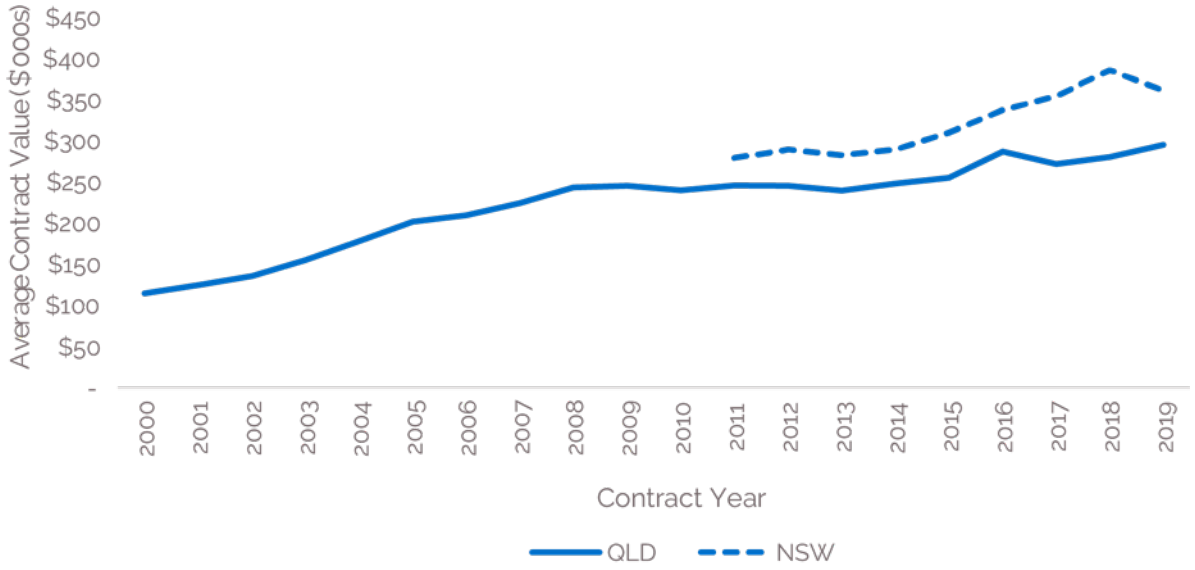
Data source: Based on information provided by icare, September 2020; information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020; *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, Correspondence with Taylor Fry, 24 July 2020; correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

There are a number of factors that explain some of the difference between the average claim costs in NSW and other states, including:

- Different levels of coverage. In particular, NSW has a higher maximum claims amount of $340,000 (up from $300,000 in February 2012[52], the maximum claims value in Queensland is $200,000[53] for each claim type (pre-completion/post-completion), and all policies issued before July 2014 in Victoria also have a maximum claims cost of $200,000.[54]
- Homeowners in NSW can recover any legal or other reasonable costs incurred in seeking to recover compensation from the contractor for the loss or damage or in taking action to rectify the loss or damage[55] (legal costs account for about 1% of all claims costs).
- Building costs in NSW are likely to be higher than in other states, leading to higher cost rectification works. Figure 3.7 shows that the average contract cost of a new dwelling in NSW is around 20% to 30% higher than in Queensland.

52 SIRA, *Home Building Compensation Scheme report - June 2018*, p 43, accessed 10 September 2020.
53 QBCC, *Home warranty insurance*, accessed 11 November 2020.
54 VMIA, *Domestic Building Insurance – What's covered?;* accessed 10 September 2020.
55 Section 40 (2)(e) of the Home Building Regulation 2014.

Figure 3.7 Average contract value for new constructions in Queensland and NSW



Data source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 20.

After we adjusted for these factors,[56] the average claims cost in NSW of around $75,000 is still around 40 to 65% higher than Victoria and Queensland, a difference of around $25,000. This could reflect more severe defects in NSW, reflecting weaknesses in the broader regulatory environment. For example, if it take a long time to resolve disputes, defects (such as waterproofing issues) can worsen over time.

In addition, the rules about how building businesses are allowed to collect payment for their work are more flexible in NSW compared to other states, which means that if a builder becomes insolvent prior to work being completed, a homeowner is likely to be out of pocket to a greater extent because they have paid more up front. This can lead to higher costs for non-completion claims. This is discussed in more detail in the next Chapter.

It is also possible that the higher claims cost could also reflect higher rectification works in NSW as a result of icare's claims management processes. This process involves icare seeking quotes from shortlisted building businesses that have registered their interest to undertake the repair work. Generally at least three quotes are preferred.[57] However, further evidence is required to understand whether this is a factor.

As discussed in more detail in Chapter 8, we are recommending that price regulation is required for icare because it is a monopoly provider. As part of this process, the price regulator should review whether the current arrangements for rectifying works are resulting in efficient outcomes.

56 We subtracted legal costs, reduced costs directly related to building rectification by 20%, and then capped all claims at $200,000.

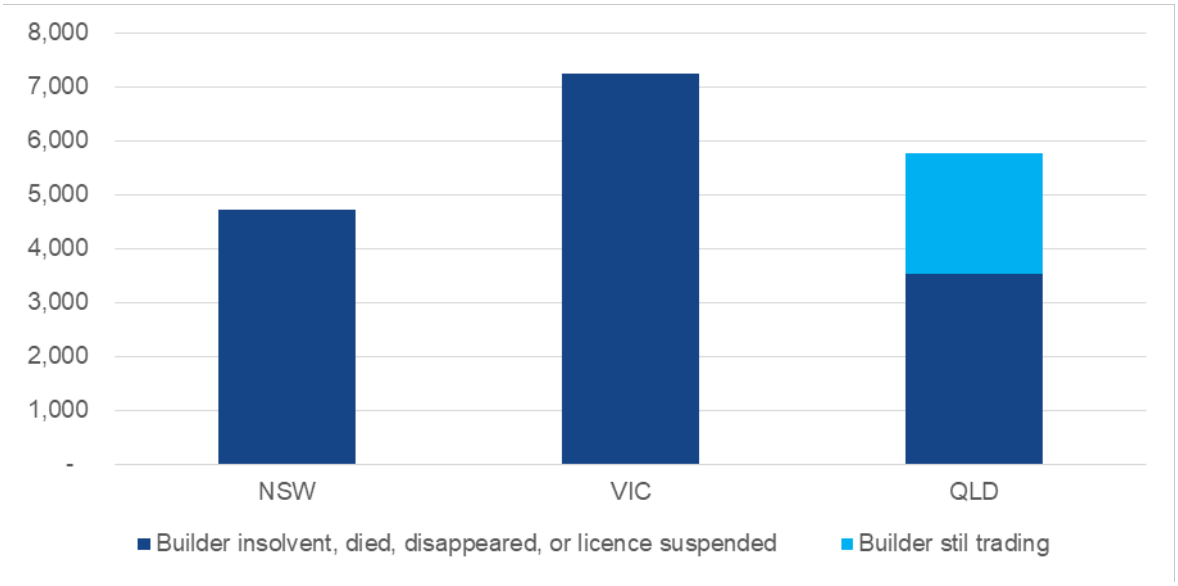
57 Information provided by icare, 21 May 2020.

3.3.1 NSW has fewer claims than other states

The total costs of claims that is required to be recovered from premiums reflects not only the average claims rate, but also the number of expected claims. All else being equal, a higher claims rate will require higher premiums.

We found that the number of claims in NSW is not a factor in explaining higher claims costs. Figure 3.8 shows that NSW has significantly fewer claims than other states. Between 2010-11 and 2018-19 there have been around 5000 claims in NSW, compared to around 7,000 in Victoria, and 6,000 in Queensland.

Figure 3.8 Claims numbers 2010-11 to 2018-19 – NSW compared to Victoria and Queensland



Note: The split of claims for Queensland into claims where the building business is trading and not trading is based on 26 months of data. NSW claims for 2018-19 is estimated based on half a year of data.

Data source: SIRA, *Dec 2018 - Home building compensation report Dec 2018_Data Tables*, accessed 10 September 2020; ESC, *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, correspondence with the ESC, 8 August 2020, Information provided by the QBCC, 24 July 2020; Correspondence with the QBCC, 11 September 2020.

3.4 icare's costs for operating the HBCF

As noted in the previous section, the costs of operating the HBCF make up around 20% of total costs (Figure 3.4), or around $33 million. The key costs include claims management, and building business eligibility assessments (together making up around 55% of costs).[58] These functions have been outsourced. icare's outsourced services have been competitively tendered and so should reflect the market price of delivering these services (Box 3.2).[59]

58 The remainder is made up of service fees to icare ($8.8 million), SIRA levies ($5.7 million) and expenses associated with system upgrades ($1.0 million); icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 15.

59 Note that as part of this review, IPART has not audited icare's procurement processes.

However there may also be efficiencies in having some of the functions administered centrally if it improves the flow of information. In particular, if the claims management experience is well understood, it can be used to inform risk factors, and incorporated into eligibility and premium models. VMIA, the Government insurer in Victoria, has managed claims in house from 2010.[60]

Box 3.2 How icare has managed its expenses

icare's procurement of the builder eligibility assessments and claims management were delivered under an open competitive tender process. Four response were received for eligibility services, and seven for claims services.

The actuarial services tender was closed to the pool of suppliers qualified under the NSW Pre-Qual scheme for Actuarial Services. Three quotes were received.

In each case we understand that probity advisors were appointed, procurement conduct plans and conflict of interest registers were in place, and the e-tender portal was used.

Source: Correspondence with icare, 31 August 2020.

We also considered how the operating costs of the NSW HBCF compares to the Queensland home warranty scheme (Table 3.1). There are several differences between expenses incurred in each scheme. In particular, the Queensland scheme does not include the equivalent of icare's eligibility risk management role which accounts for 36% of icare's operating costs.[61] A similar function is instead undertaken by the licencing function and so these costs are not recovered by premiums. However, the Queensland scheme includes other operating costs, such as dispute resolution services that are not captured by the NSW scheme. In NSW, these costs are incurred by NSW Fair Trading and NCAT. The Queensland scheme also has a larger function in relation to debt recovery because some claims are made in relation to businesses that are still solvent and so costs can be recovered from these businesses.[62]

Despite these significant differences, the total expense costs of the NSW and Queensland schemes are very similar ($33.3 million in NSW compared to $34.5 million in Queensland).[63]

Table 3.1 Expenses collected through premiums in NSW and Queensland

	NSW icare HBCF	Queensland QBCC Home Warranty insurance
Expenses include:	▼ Claims management ▼ Eligibility risk management ▼ Service fees to icare ▼ SIRA levies ▼ Expenses associated with system upgrades	▼ Claims Management ▼ Reinsurance costs ▼ Debt Recovery ▼ Underwriting ▼ Dispute Resolution (in relation to claims)
Expenses ($)	$33.3	$34.5
Expenses as % of 2019 contract value	0.2%	0.3%

Source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 45.

60 Correspondence with Victorian Managed Insurance Authority, September 2020.
61 icare, *Premium Filing January 2020, Home Building Compensation Fund*, p 15.
62 Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, pp 44-45.
63 *Ibid.*

4 Effectiveness of the scheme

As shown in Chapter 3, claims costs are by far the biggest cost driver of the HBCF. The high and uncertain claims costs (relative to icare's premiums) are one of the reasons why new entrant providers have not yet entered the market in NSW, particularly as a policy remains in place and subject to claims for up to 10 years.

Our Terms of Reference requires us to consider the scheme's efficiency and effectiveness in protecting consumers currently covered under the scheme. It also asks us to consider how the HBCF's incentives could encourage good business practices, and whether the scheme needs to further mitigate builders' insolvency risk.

icare's current approach to managing claims costs is to mitigate the risk that a builder will become insolvent. It does this primarily by requiring builders to meet a standard of financial performance, and restricting cover where builders have been involved in previous insolvencies. These factors are assessed under the builder eligibility process, which is explained in more detail in Chapter 9.

A key theme in submissions to our review is that greater enforcement of building standards is required to reduce building defects and claims under the HBCF. For example, Securebuild, a potential new entrant HBC provider, submitted that under its model, it would seek to manage the risk of potential claims by appointing a building inspector for each site, and overseeing that the work is free of defects before the builder is paid for the work.[64]

This chapter considers the types of changes that might reduce the costs of claims under the HBCF, and which body is best placed to deliver them.

4.1 Overview of our findings and recommendations

We do not recommend that additional risk mitigation measures should be mandated under the scheme. HBC providers should have flexibility in how they manage their risks and offer value to customers.

The HBCF is a "last-resort" scheme, which means that a claim can only be made if the building business can no longer be pursued – usually because it has become insolvent. This means that only a small number of building disputes (around 0.4% of all building works[65]) end up as HBCF claims. Therefore, while some providers may wish to focus on managing all defect risks, mandating that they do so is likely to discourage other providers from entering the market. This is because the overwhelming majority of building issues will not become claims under the scheme, and so the benefits of increased risk mitigation may outweigh the costs. We recommend that instead, improvements should be made through the broader regulatory framework to reduce the likelihood of defects and improve customer outcomes.

64 Securebuild submission to IPART Issues Paper, May 2020, p 12.
65 SIRA, Home building compensation scheme report – Data Tables, December 2018 and IPART calculations.

We have not set out to review the whole residential construction regulatory regime. Our recommendations should be considered alongside the ongoing work of the NSW Building Commissioner[66] and other related reforms. These aim to improve compliance with the building standards to bring confidence back to the sector.

Many of the changes that are underway are focused on the multi-storey segment of the residential market, where the more expensive and systematic problems have occurred. These reforms apply to the new multi-storey buildings three-storeys or less that are covered under the HBCF. We propose that these should apply more broadly to the low-rise residential building sector in future.

In addition, we recommend changes to the rules around how much building businesses can be paid at the beginning of a project and as it progresses to minimise homeowners' out of pocket costs when projects are not completed:

- deposits should be capped at 5% of the contract value, down from 10%, and
- progress payments should reflect the value of the work completed.

These rules should provide stronger incentives to complete projects, and reduce the costs of resulting non-completion claims under the scheme.

We also recommend that service standards should be introduced for Fair Trading for the time taken to resolve disputes, for example, 80% of disputes resolved within 28 days, average length of time to resolve disputes is 28 days or less. The service standards for NCAT hearing and resolving a dispute should deliver better customer service, for example, 80% of matters are finalised within 6 months (down from 18 months currently[67]). More timely and accessible dispute resolution mechanism would also present a more credible threat to building businesses that building standards would be enforced. This provides a greater incentive for builders to produce high quality work in the first-instance.

These recommendations largely replicate the corresponding arrangements in Victoria and Queensland, where the average claims costs are less than half of claims costs in NSW (as a proportion of contract costs).[68]

They should reduce the risk of severe defects and non-completion claims to exceptional, chance occurrences, rather than larger, more systematic problems. Reduced risks and increased certainty provides a better environment for new HBC providers to enter the market. In addition, the Building Commissioner's enhancements to data collection and information provision about buildings and builders will enable providers to more accurately determine the trustworthiness of buildings and building businesses.

66 The Building Commissioner was appointed in August 2019. See NSW Building Commissioner appointment, accessed 16 September 2020.

67 *Ibid.*

68 Based on information provided by icare, September 2020, *SIRA*, *Dec 2018 - Home building compensation report Dec 2018_Data Tables*, accessed 10 September 2020; *Domestic building insurance scheme performance reports from 2010-11 to 2018-19*, Correspondence with Taylor Fry, 24 July 2020; correspondence with the ESC, 8 August 2020.

If providers are able to rely on a trusted regulatory environment to mitigate defects risk, they are also more likely to allow claims to be made when a defect arises and a builder is still trading (that is, under a first-resort product). One of the aims of the Building Commissioner's reforms is to attract insurers to offer first-resort insurance with a 10 year warranty period ("decennial insurance") on a voluntary basis to trustworthy businesses and buildings.[69] This has the potential to significantly improve customer outcomes where a dispute arises, providing additional value to homeowners.

IPART findings

4 Compared to other states, the maximum allowed deposit is higher in NSW, and higher progress payments can occur sooner. This is likely to be driving higher costs of non-completion claims.

5 Building issues can be costly and take a long time to resolve through the dispute resolution mechanisms that apply when a building business is still trading (ie, has not become insolvent, died or disappeared, or has had their licence suspended).

Recommendations

2 That Fair Trading develop a program of proactive investigations and audits of building work in the low rise residential sector, similar to the approach being taken by the Building Commissioner in relation to apartment buildings.

3 Fair Trading and NCAT should collect information and publicly report on the number and type of complaints (including construction type, issue type, value of rectification and other costs), and the time taken to resolve them.

4 That the NSW Government amend section 8 of the Home Building Act to cap the deposits for residential works over $20,000 at 5%.

5 That the NSW amend section 8A (2)(a) of the Home Building Act so that the value of progress payments paid upon the completion of specified stage of work (as a proportion of the total value of the contract) must reflects the costs of completing that stage of work (as a proportion of total costs).

6 Service standards should be introduced for Fair Trading for the time taken to resolve disputes, for example, 80% of disputes resolved within 28 days, average length of time to resolve disputes is 28 days or less. The service standards for NCAT hearing and resolving a dispute should include shorter time frames, for example, 80% of matters are finalised within 6 months (instead of 18 months, as it currently the case).

7 The lodgement of a complaint or dispute with Fair Trading or NCAT for a specified defect within the warranty period preserve a claim for insurance in relation to that defect.

69 NSW Fair Trading, *NSW Building Commissioner Insights 006 - Office of the Building Commissioner*, accessed 27 November 2020.

4.2 What stakeholders have told us

Several stakeholders to our review noted that the scheme has been reviewed many times, with limited improvements observed.[70] One submission stated that bad builders are allowed to continue to operate for years, despite previous complaints and issues being raised about building work performance, before the public is made aware and the system catches up.[71]

Many stakeholders submitted that broader reforms are required in NSW to improve both the performance of the HBCF, and enhance consumer protections.

> Creating a costly system (ultimately every increase in insurance premiums will be passed on the home buyer) for fixing mistakes is not the answer when avoidance of mistakes in the first place should be the focus.[72]

> RSG has no issues with the methodology followed by IPART, but rather contends that the scope of its enquiry was too limited to be able to review the industry as a whole and provide recommendations about the whole-of-industry overhaul RSG believes is needed in order to provide a cost-effective and beneficial service to builders and homeowners, and demonstrate value for money to the Government of NSW and its taxpayers.[73]

Stakeholders considered that the following changes would reduce the risk profile of the construction industry and improve customer outcomes:

- Mandatory education,[74] including technical proficiency and knowledge of running small-to-medium size enterprises (including critical cash flow management)[75], access to clear best practice information (especially when complex work is undertaken),[76] higher qualifications for builders of medium density and high-rise buildings (similar to the tiered approach in Victoria and Queensland),[77] using industry data to target Continual Professional Development (CPD) courses for all building practitioners.[78]
- Better enforcement/compliance around licensing/certification,[79] including greater focus on sub-contractor accountability and capability.[80]
- Independent reviews of all [building specific] documentation prior to project start.[81]
- Periodic reviews conducted against builders' businesses, including Business Continuity Planning (BCP), compliance, privacy, quality assurance and adherence to critical service standards and contract obligations.[82]

70 For example, see Risk Specialist Group submission to IPART Draft Report, October 2020, p 1; Builders Collective of Australia, Submission to IPART Draft Report, October 2020, p 1.
71 P. Gurrier Jones, Submission to IPART Draft Report, October 2020, p 1.
72 T.Tyrell, submission to IPART Draft Report, October 2020, p 1.
73 Risk Specialist Group submission to IPART Draft Report, October 2020, p 2.
74 Barrington Homes, Submission to IPART Draft Report, October 2020, p 1.
75 Risk Specialist Group submission to IPART Draft Report, October 2020, p 9.
76 T.Tyrell, Submission to IPART Draft Report, October 2020, p 1.
77 Securebuild, Submission to IPART Issues Paper, May 2020, p 13.
78 Securebuild, Submission to IPART Issues Paper, May 2020, p 13.
79 Barrington Homes submission to IPART Draft Report, October 2020, p 1.
80 Securebuild, Submission to IPART Issues Paper, May 2020, p 13.
81 Risk Specialist Group submission to IPART Draft Report, Appendix B, A new government / private sector model for Home Building Compensation in NSW, October 2020, p 3.
82 Ibid, p 4.

- More independent inspections, for example for high risk work such as subsill, basement waterproofing, box gutter overflows,[83] and inspections that compelled builders to remedy defective work before proceeding to the next stage.[84]
- Improved certification processes, including random audits for compliance with certification stages of low rise home with penalties if required standards are not met (including licence restriction for serious breaches and multiple ongoing serious breaches),[85] the introduction of a certifier allocation scheme for developer projects to eliminate conflict of interest issues (currently the certifier is appointed by the developer),[86] the upskilling of existing certifiers across the board.[87]
- Independent approval of progress payments, so that funds are only released builders once an inspector has confirmed that the work has been completed free of defects.[88]

Some stakeholders also had views on how these improvements should be delivered and enforced. For example, the Risk Specialist Group submitted that the whole risk management regime (compliance, and dispute resolution) should be outsourced to a private provider, and funded by a levy on all building work (equal to around 1% of the contract price).[89]

Securebuild, a potential new entrant provider, submitted that its proposed HBC product would incorporate some of the risk management features outlined above. To manage the cost of claims, its approach focuses on mitigating the risk of a homeowners sustaining a loss as a result of building defects, overpaying or prepaying their builder. Under its model, it would allocate a building inspector to each building project, who would conduct inspections at critical stages. Where defects or incomplete building work are detected, the building inspector would advise the homeowner not to pay their builder's progress claim payment and provide the builder with a defects list. Payments would only be made once the work was completed without defects. The building inspector would assist in resolving disputes.[90]

Several stakeholders submitted that a "first-resort" scheme should be considered, such as the scheme in place in Queensland.[91]. One stakeholder referred to analysis conducted by the Master Builders. It considered that under a first-resort scheme, the provider is better incentivised to ensure that claims costs are minimised by via its compliance, dispute resolution, and audit inspection activities.[92] This is because all defects can lead to a claim under the scheme – not just where the builder is insolvent.

83 T.Tyrell, Submission to IPART Draft Report, October 2020, p 1.
84 Risk Specialist Group, Submission to IPART Draft Report, October 2020, p 5.
85 Barrington Homes, Submission to IPART Draft Report, October 2020, p 1.
86 Securebuild, Submission to IPART Issues Paper, May 2020, p 13.
87 Master Builders Association, Submission to IPART Draft Report, November 2020, p 1.
88 For example see, Securebuild, Submission to IPART Issues Paper, May 2020, p 13, May 2020, pp 4, 12, Barrington Homes, Submission to IPART Draft Report, October 2020, p 1, Risk Specialist Group, Submission to IPART Issues paper, May 2020, p 4.
89 The Risk Specialist proposes a levy equal to 5% of the contract value, with 20% of this allocated to administration costs. Risk Specialist Group, submission to IPART Draft Report, Appendix B, A new government / private sector model for Home Building Compensation in NSW, October 2020, p 5.
90 Securebuild, Submission to IPART Issues Paper, May 2020, p 12.
91 Builders Collective of Australia, Submission to IPART Draft Report, October 2020, p 1; AtticusNow, Submission to IPART Draft Report, September 2020, p 1.
92 AtticusNow, Submission to IPART Draft Report, September 2020, pp 1-2.

However, the HIA considered that a move towards a first resort model in NSW would require a dramatic shift in the regulatory framework with no guarantee that such a move would result in better outcomes. The HIA considered that it was inappropriate to use insurance as a dispute resolution mechanism and that it caused adverse impacts on the residential building industry by encouraging regulator-directed dispute resolution in the first instance. It would also act as a further disincentive for private sector entrants.[93]

Alternatively, the Risk Specialist Group submitted that the warranty scheme should be replaced by a refundable 4% bond (additional to a non-refundable 1% payable to fund the broader risk management regime) and applied to all residential buildings, including high rise buildings. Under its proposed model, these funds would be invested over the period of liability, with the interest earned paid to the builder in annual instalments. Unlike the current scheme where the premiums (averaging around 1%) are pooled, under the Risk Specialist Group's model, the 4% bond would only be available to rectify that builder's work. Where rectification work exceeds the value of the bond, taxpayers would fund the difference.[94]

The HIA stated that it is important to have mechanisms that are effective, prompt, low cost, and that reflect the consumer protection environment in which the builder operates. Ineffective methods for resolving disputes and dealing with consumer complaints not only affect the cash flow and business operations of affected contractors, they impact on the industry at large, may erode consumer confidence and affect its reputation.[95]

4.3 A stronger compliance and enforcement regime would reduce defects

The HBCF provides protection for homeowners as a last resort when they have not been able to seek recourse from their builder for defective or incomplete building work because they are insolvent, they have had their licence suspended, or have died or disappeared.

icare checks that building businesses have sufficient capital to undertake the building work through the HBCF eligibility process. However, it is limited in the incentives it can provide to building businesses to complete quality work in the first instance. This is because by the time a homeowner makes a claim through the scheme, the building business has become insolvent or has otherwise ceased trading. If a building business does have a history of complaints and NCAT claims, insurers can impose lower building limits on them, and increase the risk-based premium that it pays. However, the incentives under the HBCF have a much greater focus on good-financial management, because insolvency is the main reason that claims arise.

93 HIA submission to IPART Draft Report, October 2020, p 3.
94 Risk Specialist Group, submission to IPART Draft Report, Appendix B, A new government / private sector model for Home Building Compensation in NSW, October 2020.
95 HIA submission to IPART Draft Report, October 2020, p 12.

There are other checks and balances that apply to the residential construction sector to help prevent defects from arising, and work being left incomplete. These include:

- Licencing:
  - **Contractor licences** authorising a business (trading as an individual, partnership or corporation) to enter into contracts for residential buildings work, and which carries with it conditions (such as that some types of persons are excluded from operating such businesses; and that the business must have persons with relevant occupational licences to do or supervise the work), and places obligations and requirements on contracting practices (e.g. that the business must comply with statutory warranty obligations; restrictions on the amount of deposit that may be lawfully taken).
  - **Occupational licences**, or the '**supervisor certificate**' for individuals with relevant qualifications and/or experience and that authorises them to do relevant work within the scope of the licence or to supervise unlicensed labourers to do some work on a building site.[96]
- The Building Code of Australia which specifies the standard of building quality required.[97]
- Certification to check whether the construction is consistent with approved plans, and compliant and enforcement with legislative requirements and conditions of consent,[98] to address non-compliant work.

These regulatory arrangements are regularly reviewed and revised to help improve building quality in NSW.[99]

4.3.1 There are currently reforms to the enforcement regime underway

Improving building quality in the multi-unit sector is the focus of the newly appointed NSW Building Commissioner. These will apply to some residential buildings under the scheme – those apartment buildings that are three-storeys or less.

The "Construct NSW" reforms (Box 4.1) include a recently commenced a new audit regime for apartment developments which allows it to stop an occupation certificate from being issued, and require rectification works in the event that defects are discovered.[100] We are recommending that Fair Trading take a similarly proactive approach in enforcing building standards for low-rise residential building works.

96 Where an individual wants to contract business under their own name as well as supervising work, they can be issued an 'endorsed contractor licence' under section 26 of the HB Act, being a contractor licence endorsed as equivalent to a supervisor certificate (i.e. they need only be issued a single instrument that serves as both the business licence and occupational licence in that case). Email correspondence with SIRA, October 2020.

97 NSW Government, *National Construction Code*, accessed 10 September 2020.

98 NSW Fair Trading, *Certified Responsibilities*, accessed 10 September 2020.

99 For example, see *NSW Government Response to the Independent Review of the Building Professionals Act 2005*, September 2016, , accessed 10 September 2020; *NSW Government Response to the Shergold Weir Building Confidence Report*, February 2019, , accessed 10 September 2020.

100 NSW Fair Trading, *Building industry reforms*, accessed 10 September 2020.

This would also reflect the approach taken in Victoria. The Victorian Building Authority (VBA) commenced its proactive inspections program, 2015-16, which aims to inspect 10 per cent of all buildings for a range of building classes, focusing on the work of builders, building surveyors, plumbers and other building practitioners. Through this program the VBA has shifted its focus and resources to identify issues early so that it can prevent or reduce harm, instead of primarily focusing on trying to enforce matters that have already gone wrong. In 2018-19 around 8,300 building sites were inspected (a significant increase from 2017-18 of around 3,000 sites) and 3,676 rectification requests were made.[101]

Fair Trading has already taken some steps to improve compliance with the regulatory framework including:

- refocussing its efforts toward proactive compliance
- releasing a new practice standard for certifiers to set out the minimum expected conduct of registered certifiers, including around critical stage inspections and responsibilities around non-compliant work.[102]
- expanding the audit program of certifiers, broadening the grounds for disciplinary actions, and increased information for homeowners about a certifier's disciplinary record on an enhanced public register. [103]

More detail is provided in Appendix B.

It will take a number of years before the changes to Fair Trading's internal processes will be reflected in reduced number of complaints and the length of time it takes for Fair Trading to resolve disputes. Currently there is limited information available publicly on how Fair Trading performs its functions. More transparent reporting of its performance across its key functions in building regulation will provide better information on how effective its recent changes have been, and where greater efforts should be focussed to further improve home building quality in NSW. Specifically, complaints data should capture information on the construction type, issue type, value of rectification and other costs, and the time taken for resolution.

101 VBA, Annual Report 2018-19, September 2019, p 17; VBA, Annual Report 2016-17, September 2017, p 15.
102 NSW Fair Trading, *Changes to building and development certifier laws*, accessed 10 September 2020.
103 *Ibid.*

Box 4.1 How the NSW Building Commissioner is improving the quality of high-rise buildings in NSW

The Building Commissioner is currently undertaking a work program that aims to rebuild confidence in the market by 2025. A key part of this work is the creation of a public digital framework for capturing, storing, and sharing building-relating data. This platform will be used by Government to measure performance and inform compliance activity that is supported by new powers and penalties. It will also facilitate market settings to allow decennial liability insurance to be offered for high-quality apartment buildings.

More information and greater accountability

- A "single view of project" platform (SvOP), containing plans, variations, declarations, certifications, and practitioner information. From July 2021, registered designers must register building designs and variations through this platform, and declare their compliance with the Building Code of Australia.
- A digital assurance solution which will aggregate certificates of all building inputs and their risk profile to determine a trustworthy index for a building
- A new multi-party risk rating tool will provide information to government, project financiers, insurers, and client advisers on the trustworthiness of the key players delivering apartments in NSW.
- From 10 June 2020, owners of buildings with defects will benefit from the statutory duty of care that applies to new buildings, and existing buildings where an economic loss first became apparent in the previous 10 years.
- Roles and accountabilities will be clearly defined in template construction contracts.

More compliance checking

- From 1 September 2020, Fair Trading's inspection teams of engineers, architects and builders will be auditing apartment developments, and will be able to stop an occupation certificate from being issued, order developers to rectify defective buildings, and issue stop work orders. In time, the audits will be informed by the risk rating and the digital building assurance solution.

Registration of building professionals

- From 1 July 2021, there will be compulsory registration for practitioners involved in design and building work, including professional engineers.

Source: NSW Fair Trading, *Building industry reforms,* accessed 10 September 2020, NSW Government, *Tools for change,* , accessed 10 September 2020; NSW Government etendering, Customer Service / Building Assurance Solution - DICT691221, 5 May 2020; NSW Fair Trading, *NSW Building Commissioner Insights 006 - Office of the Building Commissioner*; *Building Confidence Report Jurisdictional Update,* December 2019, p 8; accessed 10 September 2020.

4.4 Requiring payments to builder to match costs incurred would reduce the costs of non-completion claims

As shown in Chapter 3, around 40% of claims in NSW are made because a builder has not completed a building (Figure 3.6). Like for defect claims, the costs of these "construction period" claims are significantly higher than in other states. In NSW the average costs of a claim for non-completions and associated defects is around $140,000, compared to around $80,000 each in Victoria and Queensland.

Of this $140,000, around $65,000 represents the cost to complete work that a homeowner has already paid for. This 'non-completion' portion of the claim are capped at 20% of the total contract value. The remainder, (around $75,000) represents the costs of rectifying defects that are identified in the incomplete work. Most non-completion claims have an associated defect.

Unlike in other states, NSW does not require progress payments to reflect the value of the work performed (Table 4.1). Stakeholders have told us that in NSW homeowners pay significantly earlier in the building process compared to other states. In addition, the cap on deposits in NSW was increased from 5% to 10%[104] in 2015, while it remains at 5% in other states.[105]

This is likely to party explain the higher construction period claims costs in NSW compared to other states. The more a homeowner pays compared to the work performed, the higher the potential value of the non-completion component of a claim. The flipside of this is that these non-completion claims would not occur at all if builders could not collect payment in excess of the value of the work performed. This would mean that the homeowner would not be left out of pocket.

Both Securebuild and the Risk Specialist Group submitted that allowing builders to receive payment only following the satisfactory completion of a building stage would significantly reduce claims.

- the insolvency risk could 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.[106]
- The simple fact is, if a builder cannot accept building progress payment in advance of the work that they complete; and that associated work is completed defect free then a home owner will never suffer a loss that would give rise to a claim under the scheme.[107]

Accordingly, a key component of the models proposed by both the Risk Specialist Group and Securebuild, is that a building inspector would verify that different stages of the work have been completed satisfactorily before approving a payment to be made.[108]

104 Section 8A of the *Home Building Act 1989*.
105 Schedule 1B, Cl 33 (1)(b) of the *Queensland Building and Construction Commission Act 1991.* Section 45 of the Queensland Building and Construction Commission Regulation 2018, Section 11 (1)(a) of the Domestic Building Contracts Act 1995 (Victoria).
106 Risk Specialist Group, Submission to IPART Issues paper, May 2020, p 4.
107 Securebuild, Submission to IPART Issues paper, May 2020, p 4
108 Securebuild, Submission to IPART Issues paper, May 2020, p 12.

In order to reduce non-completion claims costs, we recommend that the NSW Government make amendments to the legislation to align the payment requirements with Victoria (which clearly specify the payment stages and associated payments as a proportion of the contract value) and the maximum deposit allowed would be reduce to 5%.[109]

This would be a significant change for builders. It may mean that some may require additional credit from banks to conduct their operations, which could add to their upfront costs. However, we consider that additional oversight from financial institutions would provide additional assurance that the building business is viable.

Similar to our other recommended changes to the broader regulatory framework, this recommendation would benefit all homeowners, not just those who have an eligible claim under the scheme. As a result of our recommendations, there would be a stronger incentive for builders to complete the final stages of a project to the required standard.

109 Consistent with the current arrangements, these requirements would not apply to a separate contract for kit homes, which are not residential works under the HB Act.

Table 4.1 Current requirements relating to progress payments by State

<table>
<tr><th>State</th><th>Requirements</th><th>Citation</th></tr>
<tr><td>NSW</td><td>(2) A progress payment for residential building work under a contract to which this section applies is authorised only if it is one of the following kinds of authorised progress payments—
(a) a progress payment of a specified amount or specified percentage of the contract price that is payable following completion of a specified stage of the work, with the work that comprises that stage described in clear and plain language,
(b) a progress payment for labour and materials in respect of work already performed or costs already incurred (and which may include the addition of a margin), with provision for a claim for payment to be supported by such invoices, receipts or other documents as may be reasonably necessary to support the claim and with payment intervals fixed by the contract or on an “as invoiced” basis.
(c) a progress payment authorised by the regulations.</td><td>Section 8A of the Home Building Act 1989 NSW.</td></tr>
<tr><td>Queensland</td><td>The building contractor under a regulated contract must not claim an amount under the contract, other than a deposit, unless the amount
(a) is directly related to the progress of carrying out the subject work at the building site; and
(b) is proportionate to the value of the subject work that relates to the claim, or less than that value [emphasis added].
Example for paragraph (b)— The claimed amount is for half of the contract price for a regulated contract, less a 5% deposit, and is demanded after the completion of half of the subject work.</td><td>Schedule 1B, Cl 34 (1)(b) of the Queensland Building and Constructio n Commission Act 1991</td></tr>
<tr><td>Victoria</td><td>(2) A builder must not demand or recover or retain under a major domestic building contract of a type listed in column 1 of the Table more than the percentage of the contract price listed in column 2 at the completion of a stage referred to in column 3.
<table>
<tr><th>Type of contract</th><th>% of contract price</th><th>Stage</th></tr>
<tr><td>Contract to build to lock-up stage</td><td>20%</td><td>Base stage</td></tr>
<tr><td>"</td><td>25%</td><td>Frame stage</td></tr>
<tr><td>Contract to build to fixing stage</td><td>12%</td><td>Base stage</td></tr>
<tr><td>"</td><td>18%</td><td>Frame stage</td></tr>
<tr><td>"</td><td>40%</td><td>Lock-up stage</td></tr>
<tr><td>Contract to build all stages</td><td>10%</td><td>Base stage</td></tr>
<tr><td>"</td><td>15%</td><td>Frame stage</td></tr>
<tr><td>"</td><td>35%</td><td>Lock-up stage</td></tr>
<tr><td>"</td><td>25%</td><td>Fixing stage</td></tr>
</table>
"frame stage" means the stage when a home's frame is completed and approved by a building surveyor; "lock-up stage" means the stage when a home's external wall cladding and roof covering is fixed, the flooring is laid and external doors and external windows are fixed (even if those doors or windows are only temporary); "fixing stage" means the stage when all internal cladding, architraves, skirting, doors, built-in shelves, baths, basins, troughs, sinks, cabinets and cupboards of a home are fitted and fixed in position.
(3) In the case of a major domestic building contract that is not listed in the Table, a builder must not demand or receive any amount or instalment that is not directly related to the progress of the building work being carried out under the contract.</td><td>Section 40 of the Domestic Building Contracts Act 1995 (Victoria)</td></tr>
</table>

4.5 Improved dispute resolution processes would strengthen incentives on builders to produce high quality work

When a defect arises and the building business is still trading, homeowners are able to make a complaint to Fair Trading after seeking to resolve the issue first directly with their builder. They can then pursue the matter in NCAT if the issue remains unresolved or a building business does not comply with a rectification order from Fair Trading.

Resolving a claim through NCAT takes an average of almost nine months for disputes over $30,000.[110] However, some cases can take considerably longer. The service standard requires that 80% of matters are finalised within 18 months.[111] We understand that delays caused by COVID-19 has meant homeowners have faced a 10 month wait this year between lodging a claim and it proceeding to a hearing. A stakeholder to our review submitted that they are still pursuing their building business after five years for a non-completion claim for a build that should have taken 8 months.[112]

This process can also be very costly for homeowners. Many homeowners cannot afford a year or more of alternative accommodation costs while matters remain unresolved. In most cases homeowners will also have to engage expert advice (for example, engineering advice), to substantiate that the building business is at fault, and engage a lawyer. These services can cost several thousand or tens of thousands of dollars. The process can also be costly for building businesses, which may face cash flow issues while their contract payments are on hold pending finalisation of the dispute.

If the dispute resolution mechanisms in NSW were more timely and accessible, it would lead to significant improvement in outcomes for both homeowners and building businesses. It would also present a more credible threat to building businesses that building standards would be enforced. This provides a greater incentive for builders to produce high quality work in the first-instance.

In addition, claims could be made sooner under the scheme. If the building business does not comply with an NCAT order within a specified time period, their licence would be suspended, which would allow the homeowner to make a claim.

We recommend that shorter time frames are placed on Fair Trading and NCAT to resolve disputes. Ensuring that these bodies have sufficient resourcing with relevant expertise would allow these time frames to be met.

We also note the approach taken in Victoria, the independent dispute resolution body has its own in-house experts that produce building assessment reports for building work alleged to be defective or incomplete that can be used in proceedings (Box 4.2). Each homeowner undertaking residential building work contributes to the costs of these services through a levy equal to 0.065% of the value of the work.

110 Data provided by NCAT, 2 June 2020.
111 *Ibid.*
112 Gurrier Jones P, Submission to IPART Issues Paper, June 2020.

Box 4.2 Dispute resolution processes in Victoria

The Domestic Building Dispute Resolution Victoria (DBDRV) is an independent government agency that commenced in 2017-18 to resolve residential building disputes without the cost and time associated with courts and tribunals.[a] Its services are available to building owners, builders and other building practitioners such as surveyors and engineers. It has in-house building experts to provide building assessment reports for building work alleged to be defective or incomplete which are used in the dispute resolution service. These reports are admissible in evidence in VCAT or other proceedings. The DBDRV's costs are funded from a 0.065% levy applied on the cost of all building work for which a building permit is sought.

Since 2017-18, the DBDRV has provided about 6,000 dispute resolution services each year. The DBDRV has legislative power to issue binding orders to finalise disputes.[b] In 2018, the *Building Act 1993* (VIC) was amended so that non-compliance with a DBDRV binding order resulted in mandatory licence suspension for building practitioners.

Builders are able to make an application to VCAT to have the rectification order reviewed. If a builder fails to comply with the rectification order, the homeowner can apply to VCAT for appropriate orders. It is usually also a requirement to have first engaged the services of DBDRV before raising the matter at VCAT.

a Dispute resolution services were previously provided by Building Advice and Conciliation Victoria, with the VBA providing inspection services (VBA, Annual Report 2017-18, September 2018, p 83).

b Generally, the procedure is for homeowners to try and resolve their issue with their builder in the first instance before engaging the services of DBDRV.

Source: DBDRV webpage "About us", viewed 11 November 2020; DBDRV webpage "Binding orders", viewed 11 November 2020; CAV, Annual report 2018-19, October 2019, p 8; DBDRV webpage, "Is our service right for you", viewed 11 November 2020; VBA, Mandatory disciplinary action on breach of dispute resolution order notice – Fact sheet, May 2019, p 1.

4.6 Preserving a claim when the building business is still trading

A homeowner only has an eligible claim under the HBCF if the building business can no longer be pursued. In some instances, a defect occurs within the warranty period while the building business is still trading, but the building business later becomes insolvent.

In order to have an eligible claim with icare:

- a homeowner must notify icare that a defect has been identified within the warranty period, or within six months of the loss becoming apparent where it occurs in the last six months of the warranty period,[113] and
- the building business must become insolvent within 10 years of the work being completed.[114]

For example, if a structural defect is identified five years after the work has been completed, and the building business becomes insolvent seven years after the work is complete, the homeowner will have an eligible claim at this time, but only if they notified the insurer within the warranty period. If they wait until year seven to raise the issue with the insurer, then they will not have an eligible claim.

113 icare, *HBCF Claims Information for Homeowners*, January 2020, p 6, accessed 10 September 2020.

114 SIRA, *Home Building Compensation Scheme report - June 2018*, p 35, accessed 10 September 2020; *icare HBCF*, Policy of Insurance under Part 6 of the Home Building Act 7989 (NSW), June 2018, p 2, accessed 10 September 2020.

We consider that a claim for defects should be preserved if there is evidence of a complaint or dispute with Fair Trading or NCAT for a defect that has occurred within the warranty period, regardless of whether the insurer is notified. Otherwise homeowners face very different outcomes depending on their own actions taken.

Most stakeholders supported this recommendation.[115] However, the HIA stated that homeowners should be required to take steps to preserve their rights to make a claim, as is the case with other forms of insurance. If all complaints triggered a possible insurance claim, this could increase the insurance liability exponentially, which would be a disincentive for private insurers entering the market.[116]

Not all notifications will result in a HBC claim, as some will be resolved between the homeowner and building business, or through the Fair Trading or NCAT processes. We do not consider that a homeowner's compensation for a legitimate loss incurred should hinge on a technicality about whether they have notified of a pending claim.

4.7 First-resort HBC cover could be offered on a voluntary basis

A common theme in previous reviews is that the scheme should be operated on a "first-resort scheme" basis, so that if disputes are not resolved in a timely way, homeowners could make a claim to the insurer while the building business is still trading.[117]

Under the current arrangements in NSW, new entrant HBC providers could provide first-resort cover on a voluntary basis for those building businesses and homeowners that value additional cover.

While first-resort schemes are not uncommon outside of Australia,[118] Queensland is the only Australian jurisdiction that provides mandatory first-resort cover to homeowners.[119] The Queensland scheme is administered by the Queensland Building and Construction Commission (QBCC), which is both the building quality regulator (undertaking all functions relating to compliance and enforcement of building regulations), and the monopoly government insurer. This arrangement is often referred to as a 'one-stop shop'.

Claims costs are significantly lower under the Queensland scheme compared to NSW – leading to lower premiums - and even though claims can be made while a builder is still trading, most of Queensland's claims are related to insolvency (Box 4.3). Claims are relatively infrequent for builders that are not experiencing financial issues because there are strong incentives for building businesses rectify defects as they arise.

115 For example, Barrington Homes, Submission to IPART Draft Report, October 2020, p 1, The Law Society of NSW, Submission to IPART Draft Report, October 2020, p 2.

116 HIA submission to IPART Draft Report, October 2020, p 14.

117 For example, see Productivity Commission, *Review of Australia's Consumer Policy Framework*, 2008, pp 118-127; Senate Standing Committees on Economics, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, November 2008.

118 For example, first resort schemes operate in New Zealand, the UK, much of Canada and in some states of the US. Covec, *Guarantees and Insurance Products: market and policy analysis*, October 2018, Annex D, accessed 10 September 2020.

119 Fair Trading, *Reform of the Home Building Compensation Fund Discussion Paper - December 2015*, p 17.

While first-resort schemes can lead to better customer outcomes, we are not recommending that it should be mandatory to offer first-resort products.

In our view, maintaining a mandatory last-resort scheme, with the option to provide first-resort coverage on a voluntary basis, is more likely to improve the efficiency of the scheme, and lead to more product offerings to meet customers' needs. This is because it would better facilitate competition. Where competition is present in Victoria, claims costs and premiums are lower than all other jurisdictions, with the latest premium reductions coinciding with the entry of a new provider.[120]

Requiring providers to offer first-resort products would reduce the likelihood of new providers entering the market, because:

- the costs of mitigating all construction risks would be very high in the current environment, and
- providers would need to exercise capabilities across a broader spectrum of functions including building regulation, consumer advice, dispute resolution and insurance.

While we do not consider that first-resort HBC cover should be mandatory, the Building Commissioner's reforms should facilitate the provision of first-resort products on a voluntary basis. In particular, improving data collection and information about buildings and builders will enable providers to more accurately determine the trustworthiness of buildings and building businesses, and providers can choose to offer cover to these businesses accordingly. The Building Commissioner is aiming to create sufficient confidence in the market for these products to be available by 2023.[121]

In the meantime, the reforms should also strengthen the incentives for builders to produce high-quality work in the first instance, leading to outcomes for homeowners that are similar to those under a first-resort scheme.

We have also made recommendations to improve current dispute resolution processes outside of the scheme for consumers. This would bring about some of the benefits of a first resort scheme without requiring substantial changes to the regulatory framework.

120 ESC, Victoria's domestic building insurance scheme Performance report 2018-19, 29 November 2019, p vi.
121 NSW Fair Trading, NSW Building Commissioner Insights 006 - Office of the Building Commissioner, accessed 27 November 2020.

4.7.1 Providers of first resort-cover would have strong incentives to manage construction risks

Allowing homeowners to make claims in relation to any defects that arise—not just those where the building business was no longer trading, increases the interest of a HBC provider in managing construction risks (rather than just insolvency risks). This is because any defect could become a claim under the scheme and impact on the sustainability of the scheme.

Relative to the costs of potential claims, it might be cost-effective for the insurer to have a role in ensuring compliance with the building standards, particularly for higher risk building businesses (for example, conducting on-site inspections). A first-resort insurer is also able to penalise building businesses that performs poor quality work while they are still in business. It could increase the builder's premium for future work, restrict their job limits, or decide not to insure them in the future, which would provide additional incentives for builders to comply.

If building businesses do not rectify defects quickly, providers would engage a third party contractor to rectify defects, and recover the costs of doing so from the building business. The threat of legal action by a well-resourced insurer compared to a homeowner provides a strong incentive for builders to comply with building standards, and promptly rectify any defects.

Given the potential reductions in claims, one stakeholder emphasised the need to move to a first-resort scheme.[122]

We note that similar outcomes can result under a last-resort scheme, by strengthening incentives through the regulatory framework and improving the dispute resolution arrangements. For example:

- Licence suspension by Fair Trading for serious or repeated defects would function in the same way as cancelled eligibility under an insurance scheme - builders could not continue trading in either case until an issue has been rectified. This provides a strong incentive to rectify work.
- Shorter dispute resolution times could replicate the outcomes under a first-resort insurance scheme. If the builder does not comply with an NCAT order within a specified time period, their licence would be suspended. In line with the current HBCF arrangements, homeowners would be able to make a claim under the scheme.

We also note that the claims costs in Victoria, which operates a last resort-scheme, are lower than the claims costs under Queensland's first resort scheme. The recommendations made in this chapter seek to replicate aspects of the regulatory regime in Victoria, to deliver similar outcomes to homeowners.[123]

122 AtticusNow, Submission to IPART Draft Report, September 2020, p 2.
123 Based on icare, Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 23; Essential Services Commission, *Victoria's domestic building insurance scheme Performance report 2018-19*, 29 November 2019, p 14, accessed 10 September 2020.

4.7.2 Improvements to the enforcement and compliance regime would encourage insurers to offer HBC on a first-resort basis

From an insurer's perspective, if the risk of severe defects are high - as they are in NSW - they would need to devote substantial resources to managing this risk. The enforcement of building standards and certification would require significant specialist expertise, and would become the primary business of the provider. This would exclude most insurers from the market, reducing the likelihood of competition.

Where first-resort cover is available in other jurisdictions, the providers are either primarily a building assurance body (for example, the QBCC in Queensland[124], the NHBC in the UK, which is also a standards body[125], and the Master Builders Association in New Zealand[126]), or have partnered with an industry body (for example, the Halo insurance product in New Zealand is only available on a voluntary basis to homeowners who have engaged a builder that is a member of the New Zealand Certified Builder Association[127]).

However, implementing the current reforms, where the regulator undertakes strong compliance action, should reduce the risk of defect and non-completion claims to exceptional, chance occurrences, rather than larger, more systematic problems. In addition, the Building Commissioner's enhancements to data collection and information provision about buildings and builders will enable providers to more accurately determine the trustworthiness of buildings and building businesses.

If providers are able to rely on a trusted regulatory environment to mitigate defects risk, and they can decide which builders would be eligible for their product, they are more likely to offer first-resort products. The Building Commissioner considers that if offered on a voluntary basis, it would be feasible for providers to offer high-quality building businesses decennial liability insurance to builders operating in all segments of the residential market, including for high-risk buildings.[128] These buildings are currently excluded from the HBC scheme because their high risks would lead to unaffordable premiums (See Box 4.4)

Given the loss of confidence in this sector, there is likely to be an incentive on developers and building businesses to improve their building quality to become eligible for these types of products, enabling them to provide this high level of assurance to homeowners.

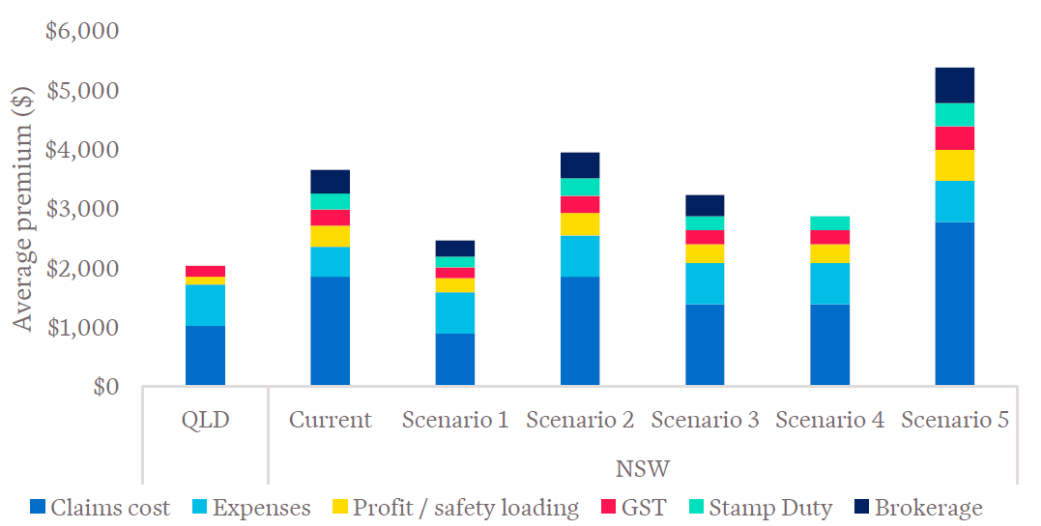
124 QBCC, About us, accessed 27 November 2020.
125 NHBC, We are NHBC, accessed 27 November 2020.
126 Master Builders, About Us, The Master Build 10-Year Guarantee, accessed 27 November 2020.
127 NZCB, Halo 10 year residential guarantee, accessed 27 November 2020.
128 Public Accountability Committee, *Regulation of building standards, building quality and building disputes*, p 40, accessed 10 September 2020.

Box 4.3 Potential premiums with mandatory first-resort coverage

We engaged actuarial consultants, Taylor Fry to consider the costs and benefit of introducing a first-resort scheme in NSW. Taylor Fry considered several different scenarios, based on the claims experience in Queensland (Figure 4.1). In several of the scenarios, premiums reduced as a result of lower claims costs. This reflects the experience in Queensland, where cover is provided at a lower cost compared to icare.

Taylor Fry also considered a scenario where NSW's average claim costs are maintained, but the number of claims costs increased, and expenses increased (Scenario 5). We consider this is a likely scenario in the short to medium term because it would take time for the insurer to develop new risk mitigation measures, and for building businesses to respond to incentives. In these circumstances, average premiums could increase from about $3,700 to about $5,500.

Figure 4.1 Average premium under scenarios for first-resort cover in NSW



Note: Scenario 1: NSW reduces claims costs to the level observed in Queensland; Scenario 2: NSW is not able to reduce claims costs and overheads (expenses) are slightly higher in line with Queensland; Scenario 3: NSW reduces claims costs by 25% and expenses are in line with Queensland; Scenario 4: NSW reduces claims costs by 25% and brokerage is removed; Scenario 5: NSW adopts a first resort scheme with increased claims costs and higher expenses in line with Queensland.

Data source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 47.

Most of Queensland's claims are due to insolvency. Around 40% of defect claims and 25% of non-completion claims relate to building businesses that are still trading. However, only a small proportion of costs are recovered from building businesses. This is because many of these building businesses become insolvent at a later date – that is, the reason that the contractor does not rectify the defects, or defaulted on the contract, is because of their financial incapacity, even though are were not formally insolvent at the time of the claim. This means that many of these claims may still have been made under a last-resort model, just at a later time.

In conducting its analysis, Taylor Fry sought information about the number and types of complaints and disputes brought to NSW Fair Trading and NCAT. However, NSW Fair Trading and NCAT were unable to provide the information in sufficient detail.

Source: Taylor Fry, *Effectiveness and efficiency of the NSW Home Building Compensation Fund*, August 2020, p 5, 56. Correspondence with QBCC, 11 September 2020.

Box 4.4 Multi-storey apartments over three storeys are not covered by the HBC scheme

Mandatory HBC cover for the construction of multi-storey apartments over three-storeys was removed from the Home building scheme in 2004. This was because private reinsurance was no longer available for this segment of the market, amid global issues confronting the insurance industry, including the collapse of HIH. Private insurers then indicated that they would also withdraw from offering insurance to this segment of the market. After the exemption was introduced, additional insurers entered the NSW home warranty insurance market in the following years, but by 2009 were again exiting the market.

High-rise residential buildings are still the most risky sector of the market. While this means that these homeowners are most in need of customer protections, it is also the most costly to provide these protections.

As shown in Chapter 3, the current average break-even premium for new multi-dwelling apartments under four storeys is around 5.5% (or almost $25,000 for a $350,000 contract including charges), reflecting the high risks of these buildings. This is six times the premium for new single dwellings. The risks for high-rise buildings are likely to be significantly higher again, which means that it is currently unaffordable to include these buildings under the scheme.

Source: SIRA, Home Building Compensation Scheme report - June 2018, p 43, accessed 10 September 2020, Carmel Donnelly, Chief Executive, SIRA, Answers to questions on notice, 12 August 2019, icare, Premium Filing January 2020, Home Building Compensation Fund, p 13.

5 Removing regulatory barriers to entry for alternative indemnity providers

In 2018, the NSW Government implemented changes to Part 6B of the *Home Building Act 1989* to allow private entry into the HBC scheme. The changes allowed for both insurers (licensed by APRA) and alternative indemnity product (AIP) providers (non-insurers regulated by SIRA only) to enter the scheme. The Government's intentions were to encourage competition, product innovation and choice by allowing for alternative indemnity products, such as fidelity fund schemes and specialised insurance arrangements.

Despite these changes, no private providers have entered the market. Two private providers have applied to SIRA for a licence to become an AIP provider, but SIRA has not granted any licences.[129]

Our terms of reference ask us to consider the impediments to private sector participation in providing insurance through the home building compensation (HBC) scheme.

This chapter considers whether regulatory barriers prevent insurers or AIP providers entering the market. It considers whether legislative or other changes are required to give effect to the Government's intentions of the 2018 reforms to allow non-APRA regulated providers to offer HBC contracts. It considers the impact that any recommended changes would have on consumer protection under the scheme.

5.1 Overview of our findings and recommendations

Under the provisions of the *Home Building Act 1989* (HB Act) it is very unlikely that a non-insurer could meet the legislative requirements to become a licensed AIP provider.

An AIP provider will almost always be carrying on an insurance business and so would need to be authorised by APRA under Part III of the *Insurance Act 1973* (Insurance Act). This is because an AIP would be characterised as a contract of insurance unless the provider of the indemnity has a discretion whether or not to pay an amount to a recipient. A discretionary scheme for indemnity would not currently satisfy section 104A of the HB Act, which requires an AIP to provide insurance-equivalent protection against loss.

To give effect to its original intention to open the scheme to non-insurers, we recommend that the Government amends the HB Act and Regulation to allow non-insurers to offer products that do not have insurance-equivalent protections.

129 One of these applicants was SecureBuild, which withdrew its application after it was not able to obtain a licence as a general insurer from APRA and had its application for an exemption from the *Insurance Act 1973* rejected.

It is evident that there are non-insurers that are interested in entering the market. Making this legislative change would allow them to do so, which could result in improved product choice and lower costs for homeowners under the scheme, through increased competition. Until improved regulation and governance in the residential building industry translates to reduced defect risk, the HBC market is unlikely to attract a lot of interest from private insurers. In the meantime, the market would benefit from having niche providers offering some building businesses a choice to compete with icare's insurance product.

Some stakeholders expressed concern that allowing discretionary AIPs into the market would introduce high-risk businesses that may not meet capital requirements, create an unequal playing field for insurers and reduce protection for homeowners if providers exercised their discretion not to pay out on a claim.

The Government decided to introduce AIP providers to increase competition in the market as part of its 2018 reforms. Our recommendation focusses on removing barriers to entry and providing certainty for these providers. Our recommendations gives prospective AIP providers greater certainty about whether their business model would likely result in a successful licence application, before expending resources developing their business case and application. It would allow for fidelity funds similar to those already in operation in the ACT and Northern Territory (see Box 5.1).

The current licensing framework for AIP providers ensures that only businesses that can meet specified prudential standards are permitted to operate in the scheme. AIP providers must meet prudential requirements, including capital adequacy requirements, before they can obtain a licence from SIRA to offer HBC products. This protects customers in the first instance, by allowing only viable and sustainable operators to offer HBC products.

While a discretionary AIP product may offer reduced certainty about claims, compared to an insurance product, it may also reduce defect risks for all homeowners that take out the product. For example, if an AIP's business model requires additional building inspections and certifications that are not currently included under icare's insurance model.

While we consider the difference in consumer protection between an insurance product and AIP product to be small in practice, there are measures the Government could take to mitigate this risk further:

- Limit a discretionary fidelity fund scheme to selected, low-risk construction types. For example, swimming pools. We understand that this type of industry-specific product has been developed for workers compensation products.
- Amend the HB Act and Regulation to provide guidance on how AIP providers could make discretionary decisions on a claim, and how relevant authorities, including SIRA and NCAT, would review this if a homeowner were to appeal the provider's decision. While NCAT currently has powers to review a claims decisions, there is no guidance on how should treat a decision where a provider has exercised its discretion to reduce a claim payment.

If the status quo was maintained, it is likely that this would entrench icare's position as a Government monopoly provider of HBC insurance, at least in the short-to-medium term. We consider that it would be more beneficial to introduce competition in the market to put downward pressure on icare's prices and give them an incentive to improve their service and compete for good risk building businesses.

IPART finding

6 There are regulatory barriers inhibiting entry for private providers. In particular, it is unlikely that fidelity funds, similar to those currently operating in other jurisdictions, which are not regulated by the Australian Prudential Regulation Authority (APRA), could offer HBC cover in NSW under the current drafting of the legislation.

Recommendation

8 The NSW Government amends section104A of the *Home Building Act 1989* and associated Regulation to allow alternative indemnity providers to offer a discretionary (non-insurance) product.

5.2 What stakeholders have told us

We received a number of submissions on this issue to our Issues Paper and Draft Report, as well as at our Public Hearing, including from icare, SecureBuild, the Risk Specialist Group, HIA Insurance Services (HIA), Master Builders Association of NSW (MBA), The Law Society and others.

Some stakeholders agreed that there were barriers to AIP providers entering the market, while others expressed concern that allowing AIP providers into the market would:

- Introduce high-risk entities into the market,[130] which cannot meet requirements, are exposed to larger (class type) claims, have limited reinsurance protection[131], and increase the risk of market failure if their capital bases are unable to cover claims.[132]
- Create an unequal playing field, because fidelity funds are not subject to the same oversight and regulation as APRA-approved insurance products, which would further discourage entry from insurers[133]
- Reduce consumer protection for homeowners by creating a discretionary entitlement for beneficiaries, so that if these providers exercised their discretion not to pay out on claims, there would be no legal recourse.[134]
  - There was also concern that homeowners have little influence over the type of cover purchased by the building business at the outset.[135]

130 MBA, Submission to IPART Draft Report, November 2020, p 2.
131 HIA submission to IPART Draft Report, October 2020, p 20.
132 Risk Specialist Group, Submission to IPART Draft Report, October 2020, p 9.
133 Risk Specialist Group, Submission to IPART Draft Report, October 2020, p 11; HIA submission to IPART Draft Report, October 2020, p 17.
134 icare discussions with IPART Secretariat, October 2020; HIA submission to IPART Draft Report, October 2020, p 7.
135 SIRA discussions with PART Secretariat, October 2020.

SecureBuild expressed the view that the current legislation does not allow non-insurers to offer HBC products in the market.[136] The Law Society supported allowing AIP providers to offer a discretionary product provided that the level of consumer protection afforded by such products is not reduced.[137] HIA stated that:

> Fidelity Funds are not APRA approved, regulated, or compliant they are able to operate with lower operating costs than licensed insurers. Superficially, this suggests that they will be able to offer lower premiums. This situation presents yet another barrier to entry to private insurers.[138]

We met with SIRA and APRA to discuss their interpretations of the regulatory arrangements for AIP providers and insurers. While SIRA does not have a role in advising applicants on the nature of their proposed product, it expressed the view that it could currently be legally possible to structure an AIP that would not be insurance (since the current legislative provisions have not been tested in a Court of Law).[139] However, it did not provide an example of a product that would meet the criteria.

We also received a number of submissions from building businesses and industry associations, which expressed dissatisfaction with the current monopoly insurer and considered that competition in the market could provide better service and product choice.

5.3 What is an insurance product?

'Insurance' is not defined under the Insurance Act,[140] but its meaning has been considered by case law.[141] While the precise boundaries of the definition may be somewhat of a grey area, generally a contract of insurance demonstrates the following three elements:

- the contract must provide that the insured will become entitled to something on the occurrence of some event, which entitlement reflects an obligation on the insurer to give some benefit to the insured
- the event must be one which involves some element of uncertainty
- the insured must have an insurable interest in the subject matter of the contract.

APRA does not advise businesses about whether their proposed product is insurance. They must seek independent legal advice. If a product is determined to be insurance, the product provider must obtain a licence from APRA to supply the product.

136 SecureBuild, Submission to IPART Issues Paper, May 2020, p 3.
137 The Law Society, Submission to IPART Draft Report, October 2020, p 2.
138 HIA, Submission to IPART Issues Paper, May 2020, p 6.
139 SIRA discussions with IPART Secretariat, May and October 2020.
140 The Insurance Act refers to the conduct of 'insurance business' rather than the provision of contracts of insurance. Section 3 of the Act includes a circular definition of insurance business as 'the business of undertaking liability, by way of insurance (including re-insurance) in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event and includes any business incidental to insurance business as so defined…' The Insurance Act specifies a number of products that are not insurance business for the purpose of the Insurance Act. These include products like life insurance and health insurance, which are not relevant to the HBC market.
141 See the working definition of a contract of insurance set out by Channel J in Prudential Insurance Company v Commissioners of Inland Revenue [1904] 2KV 658 @663-664. This working definition has been followed in a number of Australian cases including by the Full Federal Court in Todd v Alterra @ Lloyds Limited [2016] 330ALR 454, and Medical Defence Union Limited v Department of Trade [1980] CH 82.

5.4 What makes an alternative indemnity product an insurance product?

Under Part 6B, Section 104 of the HB Act, an AIP is defined as:

- a fidelity fund scheme; or
- a specialised insurance arrangement; or
- any other insurance product or arrangement prescribed by the Regulations for the purposes of this Act.

Currently, the *Home Building Regulation 2014* (Regulation) does not prescribe any other insurance product or arrangement so, for the purposes of the HB Act, a non-insurance AIP could be a fidelity fund only.

5.4.1 The HB Act requires an AIP to offer insurance-equivalent protection to policy holders

Whether a fidelity fund would be approved in NSW would depend on whether it met the regulatory requirements in section 104A of the HB Act. Section 104A states:

> (1) The Authority may approve the use of an alternative indemnity product to provide cover for loss of a kind that is required to be covered by an insurance contract under Part 6 for at least the period for which any such cover is required to be provided.
>
> (2) The Authority must not approve an alternative indemnity product unless it is satisfied that the product will provide cover for loss of that kind.
>
> (3) An approval may be unconditional or subject to conditions.

This is consistent with the purpose of the legislation which is to provide consumer protection for homeowners if their building business cannot complete or fix works on their home. The Minister's second reading speech for the amendments that introduced the concept of an alternative indemnity product stated that:

> The cover offered by these products [fidelity funds] will need to meet or exceed the minimum cover requirements of the legislation in the same way as insurance.[142]

This means that the HB Act does not permit a fidelity fund to refuse to pay a claim at its discretion. This is also apparent from the Regulations, which limit the grounds on which a fidelity fund provider may refuse to pay a claim and those grounds do not (and could not) include a refusal to pay by exercising a discretion. Accordingly, a discretionary scheme cannot meet the current requirements of the HB Act, and a fidelity fund could only obtain a licence to provide an AIP under the scheme if an APRA-licensed insurer was offering it.

142 Legislative Council Hansard, 20 June 2017, p 2. See Legislative Council Hansard – 20 June 2017 – Proof, accessed 16 September 2020.

5.4.2 Fidelity funds in other jurisdictions are discretionary funds

There are two fidelity funds that offer home building warranty products in other Australian jurisdictions: Master Building businesses operates funds in the NT and ACT as not-for-profit trust funds (Box 5.1).

Both of these are discretionary funds. In the NT, section 39(i) of the *Building (RBI and Fidelity Fund Schemes) Regulations 2012* provides that the scheme's trust deed must require a certificate issued under the scheme to specify that the following matters are in the discretion of the trustees in relation to a claim made under the certificate:

- whether the claimant is a beneficiary under the certificate, and
- if the claimant is a beneficiary – the amount of the payment to the beneficiary out of the assets of the scheme and the terms and conditions on which payment is to be made.

Section 54DA of the *Building Act 1993 (NT)* provides that the approval criteria for a fidelity fund scheme are to be prescribed by regulation. Although it also states that the approval criteria must include certain requirements, none of the specified requirements relate to the amount of cover.

In the ACT, under section 4(d)(4) of the *Building (Approval criteria) Determination 2002*, the trust deed must state that each of the following matters is at the discretion of the trustees when a request is made by an owner:

- whether any payment is to be paid to the owner from the assets of the fidelity fund scheme
- the amount of any such payment to be paid to the owner, and
- the terms and conditions on which any payment to the owner is to be paid by the trustees from the assets of the fidelity fund scheme.

Section 99 of the *Building Act 2004 (ACT)* provides that the Minister may determine the approval criteria for an approved fidelity fund scheme. Again, although it also states that the approval criteria must include certain requirements none of the specified requirements relate to the amount of cover.

This means that these fidelity funds would maintain an element of discretion on the amount to pay out on an eligible claim.

A discretionary scheme for indemnity is not a contract of insurance, because it does not provide an obligation for the insurer to give some entitlement to the insured on occurrence of an event. This is the case even if the discretion is must be exercised reasonably.

Box 5.1 Master Builders' fidelity funds in the ACT and NT

The Master Builders Association is an industry body representing key building construction sectors, including residential, commercial, engineering and civil construction.

The Master Builders Fidelity Fund was established in the ACT in 2002 and operates under requirements as set out in the ACT's *Building Act 2004* and is managed by an independent Board of Trustees. To be eligible to become a member of the fund, building businesses must meet specified financial benchmarks in its application.

It is mandatory for licensed building businesses to obtain either residential building work insurance or a fidelity fund certificate from the fidelity fund scheme before commencing building work over $12,000. The fidelity fund certificate must provide cover for up to $85,000 and remains valid for five years after completion (or occupation of the project).

In 2013, the NT Government replaced its home building certification fund with a fidelity fund, administered by the Master Builders Fidelity Fund, an independent not-for-profit trust for the benefit NT homeowners. The fund takes contributions from building businesses at a set rate and provides cover of 20% of the contract price up to $200,000 if a builder dies, disappears, loses registration or goes bankrupt. It covers structural defects for six years and non-structural defects for one year. This covers the cost of changing contracts, amending building permits and any other increases in costs associated with materials and labour.

The Master Builders Fidelity Fund is the sole form of home warranty insurance available to home owners in the NT and is mandatory, although it is open to entry by other private providers. When it commenced, the NT government provided a $750,000 interest-bearing loan and a guarantee regarding any claims that exceeded the balance of the fund. Both the loan and the guarantee required the Treasurer's approval under the NT's *Financial Management Act 1995*.

Source: See MBA (ACT), Fidelity Fund and NT Fidelity Fund, accessed 8 September 2020.

5.5 Our recommendation removes a key barrier to entry for AIP providers

In 2018, the Government made the decision to allow for AIP providers in the HBC market to increase competition, consumer choice and promote competitive and sustainable pricing.[143] In line with our terms of reference, we have considered whether there are impediments to their participation, having regard to the need for the scheme to provide an adequate level of protection for customers, the costs and benefits of any proposed changes to ensure an efficient and financially sustainable outcome, and the experiences of other jurisdictions.

Currently, an applicant would need to be licensed by APRA as a general insurer before it could meet the legislative requirements to become a licensed AIP provider. This is a significant barrier to entry and likely to reduce the potential for competition in the HBC market. The HBC market is unlikely to attract strong interest from APRA-regulated insurers, until changes to the regulation and governance of the residential construction market lower the risk of defects. However, there has been interest in the HBC market from non-insurer AIP providers.

143 Legislative Council Hansard, 20 June 2017, p 2. See Legislative Council Hansard – 20 June 2017 – Proof, accessed 16 September 2020.

Following the corporate collapse of insurance firm HIH, APRA strengthened its prudential standards for general insurers to reduce the likelihood of failure in the general insurance sector. In particular, APRA now requires insurers to hold high levels of capital to prevent under-capitalisation.[144] While SIRA's prudential guidelines are based on APRA's prudential requirements, there are differences in the way SIRA implements its guidelines, which provides more flexibility for AIP providers. For example:

- SIRA requires AIP providers to hold a minimum level of capital of $2 million in line with what APRA would require for a Category D insurer.[145] However, in many cases, APRA would not consider an AIP provider to be a Category D insurer, in which case it would require it to hold a minimum of $5 million in capital.[146]
- SIRA's application of the Insurance Concentration Risk Charge[147] requires the provider to estimate losses associated with a 1 in 200 year event and to hold capital (net of reinsurance) against this risk.[148] A 1 in 200 year event is not readily observable and must be modelled, which can lead to differences in modelling outputs.
- SIRA requires providers to demonstrate compliance to a *reasonable* degree with the prudential guidelines, whereas APRA does not include a similar caveat.

In addition to capital requirements, an application to obtain a licence from APRA as a general insurer requires payment of a $110,000 fee and may take at least 12 months to approve.[149] APRA requires more frequent quarterly compliance reporting on prudential matters,[150] while SIRA requires an annual submission.[151]

For non-insurance businesses that want to offer a niche, fidelity fund type of product in a small market like the NSW HBC market, it is not likely to be economic to meet APRA's initial and ongoing prudential requirements.

There is scope to seek a licence exemption from APRA, but businesses must meet specific criteria. Currently, there are few exemptions to the Insurance Act of this kind.[152] Businesses could apply for consideration by APRA as a special case, which is what SecureBuild did. However, APRA rejected SecureBuild's application for exemption because it did not consider SIRA's prudential requirements sufficient to prevent material detriment to policy holders and that SIRA had not operationalised the HBGF in NSW (see Box 5.2).

144 See Treasury, The HIH claims support scheme, aftermath of the hih collapse, Economic Roundup 1, 2015, accessed 8 September 2020.

145 Category D insurers are defined as industry or professional associations that underwrite the business risks of the members of the association under the constitution of the association. See APRA, GPS 110, *Capital Adequacy*, January 2015, Section 23(b).

146 This is only the minimum level of capital required. SIRA may determine that an AIP provider must hold more than the minimum level. See APRA, GPS 110, *Capital Adequacy*, January 2015, Section 23(a).

147 See APRA, *GPS 116: Capital Adequacy Standards*, June 2019.

148 SIRA discussions with IPART Secretariat, November 2020.

149 See APRAs licensing process FAQ and APRA lodging an application, accessed 8 September 2020.

150 See APRA reporting periods, accessed 26 November 2020.

151 SIRA, Home building compensation (prudential) insurance guidelines, January 2018, p 6.

152 Eg, The Export Finance and Insurance Corporation established by the *Export Finance and Insurance Corporation Act 1991*; Coal Mines Insurance Pty Limited, a company incorporated in New South Wales; The Motor Vehicle Insurance Trust constituted under the *Motor Vehicle (Third Party Insurance) Act 1943* of Western Australia. There are also exemptions for government insurers, described in the legislation as a "a body, not being a company, established or constituted under a law of the Commonwealth or of a State or Territory that is required under a law of the Commonwealth or of a State or Territory to carry on any business of insurance or to undertake liability under a contract of insurance."

Box 5.2 SecureBuild's experience applying to become an AIP provider in NSW

In 2018, SecureBuild sought to enter the HBC market as an AIP provider in the form of a fidelity fund, as provided for by Part 6B of the HB Act. It applied to SIRA for a licence to become an AIP provider. SecureBuild engaged independent legal advice that, despite the intent of Part 6B of the HB Act, alternative indemnity products constituted insurance business by way of a contract of insurance between parties.

It withdrew its application to SIRA because it would also need to be licensed by APRA as a general insurer.

SecureBuild then applied to APRA for determination under section 7 of the *Insurance Act 1973* that it should be exempt from the provisions of Part 3 of the Act (concerning authorisation to carry on an insurance business). While SecureBuild did not fit within any of the exemption categories specified in the Act and regulations, it argued that its insurance business would be regulated by SIRA, meet SIRA's prudential requirements and together with the Home Building Insurers Guarantee Fund (HBGF), would be more than sufficient to protect policy holder interests (ie, named beneficiaries under contracts issued by SecureBuild).

APRA rejected SecureBuild's application because it was not satisfied that there was a special case for an exemption on the basis that 'no amount of oversight by SIRA will suffice to protect policyholders unless SecureBuild is required to hold eligible capital of an amount which is adjusted in accordance with the scale, nature and inherent risks associated with its proposed insurance business.' APRA was not satisfied that the requirements imposed by SIRA were of an equivalent kind to those that apply to insurers authorised under the *Insurance Act 1973*. APRA noted that while the NSW Government could establish a fund to partially meet any shortfall in capital that may be required in the event that SecureBuild held insufficient funds to cover claims, the NSW Government did not have such a fund at the time.

Source: SecureBuild, Submission to IPART Issues Paper, May 2020; Correspondence between APRA and SecureBuild, tendered to IPART, May 2020.

5.6 Non-insurers should have greater certainty before applying for a licence to offer alternative indemnity products

While there have been two AIP licence applications made to SIRA, none have been approved to date.[153] Making our recommended changes to the HB Act and Regulation to allow discretionary products would give prospective AIP applicants greater certainty about the outcome of their application before they invest substantial resources into their business model and application.

Currently, the only way applicants could obtain certainty about the interpretation of the relevant provisions is to test them in a Court of Law. The cost and uncertainty of the outcome would be a substantial barrier to prospective AIP applicants. It is not reasonable to expect that applicants should be willing to take on the financial burden of pursuing the matter in court to obtain certainty about the status of their proposed product.

153 SIRA discussions with IPART Secretariat, November 2020.

No stakeholder to our review has been able to provide an example of a non-insurance AIP product that would meet the current legislative requirements. Through our analysis and consultation we have found that an AIP provider will almost always be carrying on an insurance business and so would need to be authorised by APRA under Part III of the Insurance Act.

5.7 SIRA's prudential framework protects the HBCF from the entry of unsustainable businesses

The current licensing framework for AIP providers ensures that only businesses that can meet specified minimum standards are permitted to operate in the scheme. AIP providers must meet prudential requirements, including capital adequacy requirements, before they can obtain a licence from SIRA to offer HBC products. This protects customers by allowing only viable and sustainable operators into the market to offer HBC products in the first instance.

While we have recommended that SIRA scale back its licensing requirements for APRA-regulated insurers are recommending no changes to SIRA's licensing of AIP providers, because they are not APRA-regulated.

As a last resort, SIRA is also responsible for administering the Home Building Insurers Guarantee Fund. The Fund is intended to serve as a safety net from which claims may be paid to beneficiaries, where a HBC provider has become insolvent. Currently, no contributions are being made to the Fund, because icare is the sole insurer in the scheme. However, should another insurer or AIP provider enter the scheme, SIRA has discretion to require them to make contributions to ensure the sufficiency of the Fund to manage the risk of insurers becoming insolvent.[154] SIRA also has discretion to determine different contributions for different classes of licensed insurers[155] and could determine these based on the relative risk posed to the scheme.

For clarity, the Government may wish to amend the relevant provisions of the HB Act to refer to AIP providers as well as insurers.

154 See *Home Building Act 1989*, Part 6A, Division 2, Section 103OB.
155 Ibid, Section 103OB(5).

5.8 AIP benefits may outweigh any difference in claims risk compared to an insurance product for homeowners

While a discretionary AIP product may offer reduced certainty about claim payments, compared to an insurance product, it may provide improved protection for all homeowners that take out the product.

Currently, the sole insurer under the scheme, icare, manages its exposure to claims by assessing the financial position of builders undertaking work covered by the scheme, and placing limits on their construction activity to mitigate insolvency risk. This does little to mitigate a defect risk occurring in the first instance. If an AIP's business model provided for additional building inspections and certifications of building businesses' work that are not currently included under icare's insurance model, this would reduce the risk of a defect occurring for the AIP provider's customers. This would benefit all homeowners that have cover with an AIP provider – not just those who would otherwise go on to make a claim under the scheme.

There are other measures the Government could take to mitigate the risk of allowing for a discretionary product:

- **Limit a discretionary fidelity fund scheme to low-risk building segments**. For example, build categories like swimming pool are historically low risk claim items. An industry-based fidelity fund could be established to cover the unique characteristics of that sub-market. We understand that this type of industry specific product has been developed for workers compensation products.
- **Rules governing how discretion would apply**. The Government could prescribe the circumstances in which a fund may exercise its discretion. This would provide greater transparency for homeowners. The Government would need to exercise caution to avoid watering down a provider's discretion to the point where it is indistinguishable from an insurance product.
- **Review powers for SIRA, NCAT and other relevant authorities**. The Government may need to give SIRA, NCAT or other courts, where the matter exceeds NCAT's jurisdictional limits, powers to review a claim decision where a provider has exercised its discretion to reduce payment on an eligible claim. While NCAT currently has powers to review a claims decision, there is no guidance on how it should treat a decision where a provider has exercised its discretion to reduce a claim payment.

To provide clarity for homeowners, certificates of insurance should include information about the discretionary nature of the cover. This is similar to the provisions other jurisdictions have adopted. It requires that certificates issued under a provider's trust deed to specify what matters are in the discretion of the trustees.

SIRA should also provide information on its website about the differences between types of cover, and advise homeowners to ask their builder about the type of cover that they offer.

6 Does the regulatory framework increase the costs of entry into the HBC market?

Part 6C of the *Home Building Act 1989* (HB Act) requires businesses to obtain a licence from SIRA to become either an insurer or an alternative indemnity product (AIP) provider to underwrite home building liabilities and manage claims in the HBC scheme. Applicants must meet SIRA's requirements for capacity, capability and processes to be legally authorised to carry out HBC business in NSW.

This licence places obligations on the provider to comply with the HBC legislative framework, including the HB Act and regulations, and any HBC guidelines made under it. SIRA has issued a number of guidelines setting out the conduct and reporting requirements for licenced insurers and AIP providers. These include guidelines on prudential management, determination of eligibility, premiums or contributions, and claims management.

SIRA's licensing regime applies in addition to Commonwealth regulations for insurers. Section 12 of the *Insurance Act 1973* requires businesses wanting to carry on an insurance business in Australia to be licensed by APRA. APRA does not regulate non-insurer providers, such as fidelity funds.

We asked stakeholders whether regulatory duplication and prescription increased the costs of entry into the NSW HBC market for insurers and AIP providers. This chapter discusses the issues stakeholders raised, our analysis of the effectiveness of the licensing and regulatory framework for insurers and AIP providers and our recommendations to reduce entry costs and increase competition and choice in the market.

6.1 Overview of our findings and recommendations

We consider that a less prescriptive approach to the regulation of private insurers and providers would promote greater competition in the HBC market and still ensure an adequate level of consumer protection.

The current regulatory framework applies to both icare and any new entrants. icare currently has a monopoly on the market and requires a prescriptive regulatory approach to ensure efficient outcomes for building businesses and homeowners. However, applying the same regulatory approach to new entrants is unnecessarily restrictive. New entrants do not have the same influence on the market and have commercial incentives to provide products that meet the market's needs. Otherwise, building businesses would remain with, or go back to, the incumbent provider.

Stakeholders have told us that some elements of the current regulatory framework discourage new entry, by duplicating Commonwealth regulations and restricting how insurers or providers manage their risk. Applying a more flexible regime to new insurers and providers would encourage market entry by lowering the costs to insurers and providers of entering and operating in the market.

In particular, in relation to insurers, we have found that requiring them to apply for a licence to provide HBC products duplicates APRA's prudential regulation. This increases costs of entry and does not provide additional protection for homeowners. Other jurisdictions that have a competitive home building insurance market, such as Victoria and the ACT do not require home building insurers to hold a separate state-based licence (see Box 6.1).

Licence requirements are set out in the HB Act and Regulation. We recommend that the Government amends section 105F of the HB Act to provide that SIRA is not required to consider specified prudential matters where such matters are also required to be considered by APRA in determining an authorisation to carry on an insurance business under the Insurance Act. SIRA should maintain its current licensing of non-insurer providers because APRA has no role in regulating fidelity funds.

We also recommend that the Government reduce regulatory obligations on both private insurers and AIP providers. In particular, they should not have to submit eligibility and premiums filings to SIRA for assessment. Instead, they should be guided by high level principles, rather than enforceable standards, similar to the General Insurance Code of Practice. SIRA should report annually on private insurers and providers' performance against those principles as part of its current annual reporting.

The current insurance guidelines for eligibility and premiums impose a degree of regulation on price setting and market practices that is more relevant to regulating a monopoly entity with substantial market power. In the short-to-medium term, icare is likely to remain the default provider for a majority of the market. This is largely because the market is small, and the product is low value and has a long payoff period. As such, the insurance guidelines should continue to apply to icare (as well as additional recommendations we have made to improve transparency and customer service). However, new entrants should have greater flexibility to determine what HBC liabilities they underwrite and how they price their risk.

We have amended our recommendation from our Draft Report to maintain SIRA's current regulation of claims handling, which applies to all providers. This is because we do not consider that there are sufficient market incentives for providers to offer good customer service to homeowners. Homeowners do not purchase the policy directly – it is taken out by the building business on behalf of the homeowner. The policy is not triggered until their building business can no longer be pursued (usually because they are insolvent, but also if they have died or disappeared) – at which time the building business does not have an interest in the service provided by the policy provider to their customers. In addition, for most homeowners, the purchase of HBC is unlikely to be a repeat purchase.

We consider that these changes would decrease the costs of entry into the NSW HBC market, making it more commercially viable for new entrants to provide product choice for building businesses and homeowners.

IPART findings

7 That the HBC licensing framework unnecessarily duplicates APRA's role in the prudential supervision of insurers, increasing costs of entry to the scheme for insurers.

8 That the regulatory framework deters entry by unnecessarily restricting how private insurers and providers compete in the market.

Recommendations

9 That the Government amends section 105F of the Home Building Act 1989 to provide that SIRA is not required to consider specified prudential matters where such matters are also required to be considered by APRA in determining an authorisation to carry on an insurance business under the Insurance Act .

10 That the NSW Government:

- limits the application of sections 103BD to 103BG of the Home Building Act 1989 that regulate premium pricing to the default market incumbent, icare
- removes the requirement for SIRA to approve private insurers and providers' eligibility models, in favour of a market monitoring arrangement where SIRA reports on market participants' performance against high-level principles

This should be reviewed in five years or earlier if the market composition has changed considerably.

Box 6.1 Other jurisdictions do not require home building warranty insurers to be licensed

NSW is the only state that requires insurers to hold an additional state-based licence to offer HBC products.

In Victoria, the domestic building insurance market is open to private insurers. They do not have to apply for a specific licence to offer insurance (other than a licence to conduct insurance business as required by APRA).

In the ACT, the market for residential building insurance is open to insurers and fidelity funds. Under the ACT *Building Act 2004*, an authorised insurer means a body corporate authorised to carry on insurance business under the *Insurance Act 1973*.[a] However, the Planning and Land Authority must approve a fidelity fund scheme. The Act sets out criteria for approving such schemes.[b]

In South Australia, building contractors must take out an insurance policy that complies with the requirements of the *Building Work Contractors Act 1995*. QBE is the sole distributor operating in SA.[c] It is not required to take out a specific licence to provide this product.

In WA, the Minister must approve an insurer or fund to provide building indemnity insurance.[d] Similarly, in the NT, the Minister must approve an insurer or fidelity fund provider, based on criteria set out in the *Building Act 1993* and associated regulations.[e]

a ACT Government, *Building Act 2004*, Dictionary.

b ACT Government, *Building Act 2004*, s99.

c HIA insurance, Changes to SA Building indemnity insurance premium, accessed 2 September 2020.

d WA Government, Home indemnity insurance, accessed 2 September 2020.

e NT Government, *Building Act 1993*, s54CA and Division 4.

6.2 Should businesses require a licence to offer HBC products?

Under section 105A of the HB Act, it is an offence for a business to provide HBC insurance or enter into a contract or arrangement to provide AIP cover unless it is a licensed insurer or AIP provider. A prospective insurer or AIP provider must apply to SIRA for such a licence.

A licence is a common instrument used by governments to regulate commercial activity. It authorises a business to carry out its functions in a specified market, and allows the regulator to set conditions and limitations, without the need to amend legislative instruments.

An effective licensing framework should be:

- The most reasonable option to address ongoing regulatory needs when compared with other options
- Appropriately designed to provide the minimum necessary coverage, reporting requirements, conduct rules and mandatory attributes
- Administered effectively and efficiently.

Licences can increase barriers to entry if:

- The licence application process is unnecessarily costly or restrictive
- The licence conditions impose an unnecessary regulatory or administrative burden on licensees.

6.2.1 What stakeholders told us

In our Issues Paper, we asked whether stakeholders considered that the requirements of the HB Act duplicated those of the *Insurance Act 1973* (Insurance Act). HIA stated that 'there should not be a need for SIRA to regulate this product. APRA has the overriding task of regulating the insurance industry and to then have a state body is simply a double up.[156]

SIRA did not consider that its licence framework was duplicative of APRA's, and considered that they served different purposes. It stated that the dual-licensing requirements are also a feature of both of the other insurance schemes that SIRA regulates, being: Compulsory Third Party (CTP) and workers compensation insurance.[157]

The Risk Specialist Group stated that it did not consider that there was direct duplication of requirements between the HB Act and the Insurance Act.[158] It stated that the Insurance Act sets out the requirements and obligations of an insurer including its compliance requirements with licensing, APRA prudential standards and monitoring and the roles of appointed actuaries and auditors. The HB Act prescribes the type of contracts that require insurance and the period and limits of liability. However, the costs of compliance for private insurers were already extensive.[159]

156 HIA, Submission to IPART Issues Paper, May 2020, p 15.
157 Discussions with IPART, June 2020.
158 Risk Specialist Group, Submission to IPART Issues Paper, May 2020, p 8.
159 Ibid.

In response to our Draft Report, there was general support for reducing duplication in the licensing arrangements for insurers, as long as it did not lower consumer protection.

6.2.2 The licence framework for insurers duplicates APRA's prudential requirements

Section 105C of the HB Act states that an application for a licence to be a licensed insurer under the HBC scheme may be made by any corporation that carries on insurance business within the meaning of the Insurance Act. Part 6C, Section 105F of the HB Act lists matters to which SIRA may have regard in approving a licence application, including any applicable insurance guidelines.

SIRA publishes guidelines on the prudential standards that it assesses licence applicants against. The guidelines aim to ensure licence holders maintain long-term financial viability, prudent claims reserving policies and sufficient financial resources at all times to meet their liabilities under the Act. SIRA ensures this by assessing an applicant's capacity, capability and processes against the standards (see Box 6.2). SIRA bases its prudential standards on APRA's General Insurance Prudential Standards (GPS).

Box 6.2 SIRA's licensing process for insurers

SIRA assesses insurers against a number of criteria, including:

1. The suitability of the applicant
2. The paid-up share capital and reserves of the applicant
3. The constitution of the applicant (if any)
4. The re-insurance arrangements of the applicant
5. The efficiency of the insurance scheme generally
6. Any applicable Insurance Guidelines
7. Any other matters that SIRA thinks fit.

Applicants must provide a number of documents to demonstrate how they meet these criteria including:

- A business case that establishes its capability to apply for a licence to provide HBC and demonstrates reasonable plausibility and viability of its proposal
- A three-year business plan and risk management and control framework
- An eligibility model
- A claims management model
- Premium filings to be submitted for the nominated product categories
- Complaint handling and review processes.

To assess an applicant's prudential capacity, SIRA requires an insurer applicant to provide:

- Evidence of APRA's authority or, if in the process of applying for an authority to carry on an insurance business, advice on the status of an applicant's negotiations with APRA and copies of any correspondence to/from APRA regarding the application
- Details of any other general insurance authorities held by related companies, if applicable
- Copies of the last two calculated minimum capital requirement multiples, as required and defined by APRA
- Copies of the last three audited annual returns lodged with APRA, together with auditor's certificates
- Copies of the latest returns lodged with APRA, if these are for a period after the latest annual return lodged under the requirement above
- Evidence of meeting SIRA's HBC Prudential Guidelines standards and requirements.

In addition to providing the documents outlined, applicants must also provide a letter authorising APRA and ASIC to release information pertaining to the applicant to SIRA.

Source: SIRA, *Licensee application guidelines – Home building compensation regulation*, January 2018. accessed 16 September 2020.

Duplication of APRA's prudential regulation increases the costs of entry for insurers

SIRA charges insurers a fee of $50,000 (ex-GST) to apply for a licence.[160] SIRA advised us that the licence fee covers the administrative and legal costs of assessing an applicant's eligibility.

Removing the requirement for SIRA to assess insurer applicants against the same standards as APRA, would reduce SIRA's assessment costs, while maintaining adequate customer protection in line with the requirements of our terms of reference. This should mean that SIRA could lower its licence application fee, and administration costs to insurers would also fall.

APRA's prudential regulation of insurers would meet the requirements of the HB Act

APRA's prudential framework for general insurers covers capital requirements, financial position, governance, risk management and any other relevant requirements. This contributes to the efficient and effective protection of customers, without an additional layer of regulation.

Following the collapse of HIH in 2001, the HIH Royal Commission recommended a number of reforms to improve the prudential, legal and regulatory regime governing the general insurance industry in Australia.[161] These included increasing the minimum entry-level capital requirements for general insurers and enabling APRA to make prudential standards for general insurance. APRA also strengthened its supervisory approach and practices.[162] This included introducing new prudential standards to address under-reserving by insurers, enhanced disclosure by actuaries as to methods used for calculating outstanding claims and improving the 'fit and proper' test for company directors.[163]

APRA takes at least 12 months to assess an application to become a general insurer. APRA requires licensed insurers to submit quarterly returns and audited returns annually to monitor compliance. Insurers must also submit individual claim and policy information.

Given that the insurer applicant must provide a letter of authorisation for SIRA to obtain any required evidence of an insurer's prudential status with APRA or ASIC, we consider that it is unnecessary duplication for applicants to provide the same information directly to SIRA.

However, SIRA should maintain its prudential regulation of non-insurer providers, because they are not licensed by APRA.

160 See SIRA, How to apply for a licence, Home building compensation insurance, accessed 16 September 2020.
161 Department of the Parliamentary Library, Report of the Royal Commission into HIH Insurance, May 2003, accessed 8 September 2020.
162 Australian Government, Treasury, Aftermath of the HIH collapse, Economic Roundup, 1, 2015, accessed 8 September 2020.
163 Ibid.

6.2.3 Legislative change is required to allow SIRA to substitute its consideration of a licence application with that of another body

Under section 105F of the HB Act, SIRA has discretion to grant or refuse a licence, but cannot substitute its consideration of an application – in whole or in part – with the consideration of another body.

Section 105C of the HB Act reinforces this view. It allows for an application to be made by a corporation that carries on insurance business within the meaning of the Insurance Act, provided that the corporation is authorised to do so. This indicates that Parliament considered the relevance of authorisation under the Insurance Act for the purposes of the HB Act, and made it a pre-requisite for making an application. However, it does not indicate that SIRA can deem such authorisation to satisfy the prudential requirements of a licence application to replace the need for SIRA to fully consider each application.

As such, we recommend that the HB Act be amended to provide that SIRA is not required to consider specified prudential matters where such matters are also required to be considered by APRA in determining an authorisation to carry on an insurance business under the Insurance Act.

6.3 Does the regulatory framework discourage entry through unnecessary prescription?

In undertaking their HBC business, licensed insurers and AIP providers must comply with the requirements of the HB Act, Regulation and relevant insurance guidelines published by SIRA.

Division 4 of the HB Act requires SIRA to issue insurance guidelines on:

- The requirements for approval of an insurance product or AIP
- The determination of premiums or contributions
- Market practices and claims handling procedures
- Prudential standards and their application to insurers and providers
- Eligibility requirements for obtaining cover and underwriting of products and compliance with eligibility requirements.

Insurers and providers must submit premiums (or contributions), eligibility models and claims models that comply with the guidelines to SIRA for approval each year. SIRA assesses compliance of these against the principles and requirements in its guidelines, the HB Act and HB Regulation before deciding whether to approve them.

6.3.1 What stakeholders told us

In our Issues Paper, we asked stakeholders:

- What changes to the scheme would encourage the supply of new, innovative products (both insurance and non-insurance)
- Whether providers should be allowed to mitigate risk by limiting their insurance offering to selected low-risk building businesses only, or other methods?

Stakeholders raised concerns that prescribing eligibility in a heavy-handed way would deter new entrants and product innovation. Stakeholders had mixed views about whether providers should be able to insure only selected low-risk building businesses.

Some stakeholders argued that insurers and providers should be allowed to refuse HBC cover to certain high-risk contractors because:

- It is the only way for a private insurer or provider to operate profitably in a market with significant losses and a Government incumbent.[164]
- It is a standard feature in many insurance markets where insurers are able to choose to whom they will provide insurance (and hence bear the responsibility of their decision).[165]

However, others stated that:

- Having insurers 'pick and choose' the organisations they insure in prior scheme iterations contributed to significant difficulty in obtaining cover and increased the cost of cover to consumers.[166]
- This will polarize the market and carry the risk that the State will have to carry the balance of that market. The market should retain the ability to spread the risk to enable a more even distribution of premium amounts that might otherwise be too spread out and overly penalize new building businesses.[167]
- Where insurers compete for the more desirable business of less risky building businesses, a price 'race to the bottom' could be created. 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.[168]

At our public hearing, stakeholders expressed support for reducing regulatory burden on new entrants, stating that it was unusual for the Government to have such control over how a commercial entity conducts its business in a market, including how it underwrites risk, sets premiums and manages claims. They noted that commercial providers in the Victorian market are not subject to the same regulation.

However, some stakeholders expressed concern that reducing prescription for private providers could lower consumer protection. MBA stated:

164 NIBA, Submission to IPART Issues Paper, May 2020, p 6.
165 Ibid.
166 Risk Specialist Group, Submission to IPART Issues Paper, May 2020, p 8.
167 Master Builders Association of NSW, Submission to IPART Issues Paper, June 2020, p 1.
168 icare, Submission to IPART Issues Paper, June 2020, p 15.

> We would encourage great care in deregulation of these sections of the Act. HBCF requires stable, safe insurers and insurance products to be viable, long term and effective in protecting consumers.[169]

The Law Society stated:

> We are not convinced that the restrictions are unnecessary, given the object of consumer protection and the difficulties in the sector following the collapse of HIH Insurance Limited…We suggest that the review take place in three years, or earlier if considered appropriate due to changes in market composition.[170]

SIRA told us that it was not clear how there would be commercial incentives to provide products and services to meet homeowners needs, because the obligation to purchase insurance sits with the building business contracting the work, not the homeowner.[171]

6.3.2 The eligibility guidelines discourage entry

SIRA's eligibility guidelines set minimum standards that insurers and AIP providers must incorporate into their eligibility assessments. Licensed insurers and AIP providers must submit an eligibility model to SIRA that shows how they will go about assessing contractor eligibility to do residential building work under the HBC scheme. The eligibility model must set out the assessment criteria, application procedures, service standards, forms, available website information and complaints and dispute management processes that the licensee will use when assessing a building business' eligibility for their HBC product.

In 2017, SIRA sought stakeholder feedback on its eligibility and premium standards (Box 6.3). Many stakeholders considered that insurers and providers should have the flexibility to set their own eligibility criteria and risk-based premiums. However, some were concerned that providers may compromise standards to attract greater market share, to the detriment of home owners.

One reason that SIRA may have received mixed stakeholder feedback is that the current guidelines apply equally to icare, as well as any new entrant. Because of its ongoing dominant market position, icare requires a more prescriptive regulatory approach to ensure competitive outcomes for contractors and homeowners. However, any new private insurers and providers would have commercial incentives to manage risk and price products to gain market share. Applying the same regulation to a private insurer or provider with a small market share imposes unnecessary regulatory costs.

169 MBA Submission to IPART Draft Report, November 2020, p 2.
170 The Law Society Submission to IPART Draft Report, October 2020, pp 1,4.
171 SIRA discussions with IPART Secretariat, October 2020.

We have examined some of the key problems below.

Box 6.3 SIRA's eligibility and premium standards review – stakeholder feedback

In 2017, SIRA consulted on key features of the HBC scheme, including eligibility and premium standards. Most stakeholders supported SIRA setting minimum standards, but had mixed views about whether the application of these should be more prescriptive, or whether providers should have more flexibility to determine a building business' eligibility according to their own risk management principles.

- The Small Business Commissioner stated that: providers should have flexibility to set their own standards as long as they meet certain principles. The pricing of 'high risk' contractors paying a loading of up to 30% on top of the premium would allow contractors additional scope [to provide services under the scheme], whilst ensuring a higher balance of funds to cover the excess risk.
- HIA stated that in order to be attractive to the private market HBC providers should be given the flexibility to set their own eligibility criteria. Those set by SIRA must be limited to a minimum set of requirements and set a flexible approach. HBC providers can and should manage their own risk criteria, to encourage a competitive market. The process for determining a building business' eligibility and appropriate risk-based premiums is time consuming and detailed, compared to what is required for other insurance products. Further, the premium principles should be used as a guide and not applied in a way that is unduly prescriptive or inflexible.
- SecureBuild considered that SIRA's eligibility and premium guidelines should not be overly prescriptive because:
  - It forces HBC providers to offer homogenous products, restricting innovation
  - It could act as a barrier to entry for new entrants
  - Insurers and AIP providers are in a better position to determine how to manage risks
  - It opens SIRA up to criticism or litigation if eligibility leads to poor outcomes.
- Building Partners stated that HBC providers should retain flexibility to set their own standards but SIRA should prescribe the principles and standards expected
- SPASA supported HBC providers being given flexibility to set their own standards within certain prescribed limits to issue an eligibility profile, if they can demonstrate they can meet certain stipulated and transparent principles.
- The Law Society stated that the minimum standard of eligibility should be uniform. The cost of insurance coverage is passed on from the builder/contractor to the homeowner. It is important for consumers to have the same protection that would flow from uniform eligibility criteria.
- Western Sydney Community Legal Centre considered that HBC providers may compromise standards with a view to attracting more insurance. It considered that first resort-type products, as well as other new and innovative products, should not require an eligibility profile and should be given flexibility to set their own standards as long as they meet certain principles.

Source: See SIRA HBC eligibility and premium guidelines consultation submissions, accessed 16 September 2020.

The eligibility guidelines do not allow an insurer or provider to insure low-risk building businesses

An insurer or provider cannot adopt an eligibility model that provides cover to a small pool of what it judges to be the lowest risk building businesses only. For example, a provider cannot have an eligibility model that denies HBC cover to all new building businesses on the basis that they have no prior building experience.

Principle 6 of the eligibility guidelines states:

> SIRA will consider the combined effect of the eligibility models for all licence holders on the building industry. It is important that the eligibility models (when viewed together) offer access to cover on terms that can be met by a sufficient range of contractors to supply a competitive, sustainable and viable market for residential building and trade services. The eligibility criteria must not unduly limit eligibility to the degree that only a small segment of contractors would be able to access building cover contracts. Eligibility models must provide reasonable access for new contractors entering the market. Examples of unacceptable criteria include limiting eligibility only to contractors that have previously entered into building cover contracts, or requiring contractors to have long continuous trading histories.[172]

The intent of this principle is to ensure that overall 'eligibility supports a strong and viable residential building industry'. SIRA considers that allowing providers and insurers to target what they judge to be a small group of low-risk contractors only would result in the incumbent retaining a greater proportion of high-risk contractors, potentially putting more pressure on its premiums.

Instead, the regulatory framework allows providers to price and mitigate their risks by:

- Requiring building businesses with low working capital to inject capital into their business so that they are able to withstand greater shocks to their business
- Providing building businesses with a lower job limit to mitigate their exposure if the building business were to go insolvent
- Charging a higher premium (up to 50% more than their base premium)
- Requiring new building businesses to enter into a mentoring program to assist the building business in managing its building contracts (ie, ensuring that the contract is priced correctly with sufficient margins and managing cashflow from projects etc).

In addition, providers may refuse to grant eligibility under certain circumstances, in accordance with their eligibility models. For example, if business financial measures indicate a high probability that a building business is trading whilst insolvent or there are current winding-up petitions by creditors. They may also engage in risk mitigation practices outside of the scheme, for example, conducting their own site inspections and stopping progress payments if work is not to standard.

[172] SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, Principle 6.

SIRA allows providers to offer HBC cover to specific types of contractors only (for example, swimming-pool building businesses or building businesses of single-dwelling residences) via a licence condition imposed on a new insurer/provider. Such a condition can be imposed under Section 105I(d) of the HB Act:

> (d) specifying the persons, or classes of persons, to whom the licence holder may provide insurance or cover by means of alternative indemnity products,"

However, the insurer/provider would need to make HBC available to all contractors that have eligibility under that category, subject to its risk-mitigation options above.

Allowing new entrants to restrict eligibility would not substantially affect market sustainability

icare has stated that if private providers were allowed to determine their own eligibility standards it could lead to unsustainable business practices. That is, they could allow higher job limits (or lower premiums) than a building business' level of risk would determine. This may lead to higher claim payouts in future and losses that cause providers to leave the market, leaving the Government to bear all the market risk.

Market sustainability problems can arise in a workably competitive market, where private providers hold considerable market share. For example, in 2001, when HIH collapsed, it had 30 to 40% share of the HBC market. With HIH no longer in the market, higher risk building businesses suddenly faced significant price increases or were unable to purchase insurance.

There are various reasons why icare is likely to remain the default incumbent insurer in the medium-term. The market is small with long payoff periods, average claims are relatively high, and premiums below breakeven levels for some construction types.

In terms of experiences in other jurisdictions, in the home warranty market in Victoria, which has been open to competition for the last decade, there are a small number of private insurers targeting low-risk and niche construction segments, such as pool building businesses (see Box 6.4). These private providers account for less than 20% of the market.

As such, it is unlikely that allowing new entrants greater flexibility to determine eligibility and select which contractors they offer HBC cover would have a substantial impact on the sustainability of the overall market. While icare's remains the incumbent, it would not affect a contractor's ability to obtain insurance. It would also not affect other contractors' premiums, because they are priced largely on the individual contractor's perceived risk.

In addition, competition in the market for low-risk contractors would give icare's an incentive to compete for those contracts, improving the product offering for these building businesses.

Box 6.4 Other competitive home building insurance markets do not prescribe eligibility standards

In Victoria's domestic building insurance market, which has always been open to competition, there is no obligation for private providers to incorporate minimum eligibility principles or standards. Private providers are not precluded from choosing to insure building businesses that they deem are low-risk only.

One of the Victorian providers, AssetInsure, has stated previously that it is only targeting what it considers to be good, experienced building businesses and will not provide home warranty insurance to new building businesses.[a]

The entry of these providers has not prevented VMIA, the government-operated market incumbent, from setting breakeven premiums, and operating on a viable basis. As shown in Chapter 4, for a market of a similar size and structure, premiums are around a third of the NSW rate. Private providers make up a small proportion of the market – too small to have an impact on overall sustainability.

a Assetinsure FAQs, accessed 16 September 2020.

6.3.3 Price regulation of private insurers and AIP providers is unnecessary

Sections 103BD to 103BG of the HB Act regulate premium pricing for all licensed insurers. An insurer must file the premium or set of premiums that it proposes to charge to SIRA for approval each year. Section 104C allows for regulations to made for the determination of and rejection of premiums or equivalent charges payable for cover by an AIP.

SIRA publishes guidelines about premiums that specify the manner in which premiums are to be determined and the factors to be taken into account when determining premiums. They require the insurer to provide evidence of how it has calculated the premium, including setting out risk factors providers must address. SIRA publishes similar guidelines for how AIP providers must calculate contributions for approval by SIRA.

Governments commonly use price regulation to restrict abuse of monopoly power where:

- There is a single producer in the market, because monopolistic supply is entrenched, or goods can be supplied most cheaply by one producer
- The market exhibits certain characteristics that allow some participants to acquire and exploit a high level of influence over prices.

While these characteristics are relevant to icare as a monopoly or default incumbent provider, new entrants are unlikely to exhibit influence over prices. If they did, they would lose market share to icare or other providers. It is in their commercial interest to set premiums at a competitive level.

One relevant concern that stakeholders have raised is the ability of providers to set prices too low in an effort to win customers without duly considering the appropriate return on risk.

While some insurers may offer cheaper premiums to win market share initially, this pricing behaviour would not be sustained in the longer-term under APRA's prudential framework for general insurers. APRA determines how much capital an insurer must hold in reserve to pay claims, which informs the premium an insurer can charge. An insurer that consistently under-prices its premiums would risk losing its licence to carry on an insurance business, because it does not hold adequate capital reserves to meet its liabilities. The equivalent regulatory regime for AIP providers, administered by SIRA, ensures that providers also have adequate capital reserves to meet their liabilities.

We recommend that new entrants are exempt from the requirements of the HB Act that regulate pricing of premiums and contributions.

6.3.4 SIRA should maintain its regulation of claims handling

In our Draft Report, we recommended that the Government remove the requirement for SIRA to approve private insurers and providers' eligibility *and claims models*, in favour of a market monitoring arrangement where SIRA reports on market participants' performance against high-level principles.

However, there may not be sufficient market incentives for providers to offer good customer service to homeowners, because they do not purchase the HBC policy directly. A policy is not triggered until a homeowner's building business is insolvent – at which time the business doesn't have an interest in the service that the insurer or provider provides to their customers. In addition, the purchase of HBC for many homeowners is unlikely to be a repeat purchase.

We have limited our recommendation to the deregulation of eligibility assessment and premiums for private providers, but maintain SIRA's current role in setting and enforcing minimum claims handling requirements for licence holders via their insurance guidelines.

7 Split HBC products

icare provides one HBC cover product that has a maximum claim amount of $340,000 for both:

- Construction period cover, and associated defects during construction
- Warranty period cover, for the risks of defects after completion.

If a homeowner does not use the maximum amount of $340,000 for a construction period claim, then they are able to use the residual amount towards a warranty period claim.

Changes made to the scheme in 2017 allow providers to offer separate products for each coverage period, with each providing at least $340,000 of cover.[173] Providers can choose to offer one or both types of cover ("a split product"), but a building business must have coverage for both periods for each project. A building businesses would need to engage with two providers if one provider only offered cover for one period.

Stakeholders consider there are still barriers to providers offering separate products in line with their preferred area of exposure. This chapter reviews whether changes are required to make it easier to offer split products.

7.1 Overview of our findings and recommendations

HBC is a 'long-tailed product' – a one-off premium is paid to the provider at the beginning of a project, while a liability can arise up to 10 years after the project is completed. This has discouraged providers from entering the market, particularly as HBC liabilities are uncertain and can vary from year to year over the business cycle.

The changes that allowing for split products enables providers to enter the market and provide coverage for a much shorter period of time (that is, by offering construction period cover only).[174] icare's claims data shows that the majority of construction period claims are finalised within 3 years after a certificate is purchased for a project (although some can take up to five years to resolve).[175, 176]

However, because icare (the only other insurer in the market) does not provide the remaining cover as a separate product, private providers cannot currently choose to offer coverage for just one of these periods.

173 Section 99(4) Home Building Act 1989.

174 We note that in other countries such as New Zealand there are providers that offer a warranty period cover only, and so we recommend that icare should also be required to offer a construction period product as well as a warranty product.

175 icare, *Premium Filing January 2020, Home Building Compensation Fund*, pp 20-36.

176 We have received a submission from an individual that they are still dealing with their building business for non-completion for a build that commenced in 2015 and was expected to be completed within 8 months.

To facilitate competition, we recommend that icare is required to make separate cost-reflective construction period and warranty period products available so that a new entrant could specialise in one product only.[177] To reduce administrative costs and for simplicity, icare should also be able to continue to offer the combined product with a combined coverage of $340,000.

If the HBC coverage for the construction period and warranty period are offered separately, the minimum coverage of $340,000 should continue to apply for each period, to ensure an adequate level of (or equivalent) protection to customers who take out split coverage products. The additional costs of providing $340,000 for each product are likely to be negligible, because claims very rarely occur in both periods.

IPART finding

9 Providers must hold capital to cover liabilities for up to 10 years (that is, it is a 'long-tailed product') which has discouraged providers from entering the market.

IPART recommendation

11 That the NSW Government requires icare to make available separate cost-reflective construction period and warranty period products so that a new entrant could provide cover for one period only.

7.2 What stakeholders have told us

Stakeholders had mixed views as to whether split products should be made available.

- The National Insurance Brokers Association (NIBA) submitted that the current [icare] product should be replaced with separate insolvency and defect products, so that each risk can be underwritten and priced according to the nature of the cover provided.[178]
- HIA submitted that inviting split cover products would encourage entry in the NSW market as it broadens the market beyond those providers who are prepared to take on both the risks of construction period and warranty periods encouraging competition.[179]
- The Risk Specialist Group, however, submitted that a multi-product 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.[180] It also submitted that it may not be appealing to homeowners as it would require them to take out and manage two policies.[181]

Some stakeholders also submitted that the requirement that each product offer a minimum insurance cover of $340,000 poses a significant barrier to entry. They submitted that offering the products separately would double their capital reserve requirements.[182]

177 The review of the reasonableness of icare's price for these separate products should be undertaken by SIRA, as part of its current role in reviewing icare's premium filings.
178 NIBA submission to IPART Issues Paper, May 2020, p 5.
179 HIA submission to IPART Issues Paper, May 2020, p 11.
180 Risk Specialist Group submission to IPART Issues Paper, May 2020, p 6.
181 Risk Specialist Group submission to IPART Draft Report, October 2020, p 11.
182 HIA submission to IPART Issues Paper, June 2020, p 5; HIA submission to IPART Draft Report, October 2020, p 21; MBIB submission to IPART Draft Report, October 2020, p 10.

7.3 The additional costs of offering HBC products separately are likely to be very small

It may be more costly for providers to offer products separately compared to offering a combined product, but we do not consider any additional costs would be significant. It is up to new entrants to decide whether it is in their commercial interests to enter the market to offer either one or both products. A new entrant may be able to provide favourable terms to attract building businesses/homeowners to their offering, for example, a more competitive price.

Overhead costs that need to be recovered from each policy might be slightly higher, compared with icare, which is able to spread its overheads over two products (both non-completion and defects). However, if the provider already provides home warranty insurance in another jurisdiction, it may be able to leverage its existing systems to minimise the overhead costs being recovered from HBC policies.

We engaged actuarial firm, Taylor Fry to provide advice on the additional capital requirements an insurer offering split cover would require compared with an insurer offering combined cover. Its expert paper is available on our website.

Taylor Fry advised that under APRA's capital requirements, doubling coverage to $680,000 under split cover does not require an insurer to hold double the amount of capital compared with an insurer offering combined cover of $340,000. This is because APRA does not require insurers to hold capital equal to the maximum level of coverage. Rather, the level of capital required is based on the expected claims cost per policy and the variability in claims cost.[183] Based on icare's historical claims data it is unlikely that the expected claims costs under split cover would be significantly higher than under combined cover.

icare's historical claims data shows that very few policies either:

- have a non-completion claim with associated defects, and then subsequently make another claim post-completion, that is, very few policies have both a construction period and warranty period claim[184]
- reach the cap of $340,000 for a construction period claim - under split cover these policies could seek another $340,000 under the warranty period cover, should additional defects become apparent in this period (warranty period claims would not cover defects already identified in the construction period).[185]

Therefore the potential additional capital costs would arise from a small number of policies only. Taylor Fry estimates that an insurer offering split cover is likely to face an additional capital requirement of less than 5% compared to if it were to offer a combined cover product.[186]

183 Taylor Fry, *Capital requirements for splitting the cover of home building compensation*, November 2020, pp 3-7.

184 Taylor Fry found that there was only once such instance in the past 4 years of claims data, out of 2,500 claims. However, more claims could potentially arise in future years given that the statutory warranty period is 6 years post completion of residential building works. Ibid, p 5.

185 Taylor Fry found that there were only 79 claims in the past 4 years of claims data that reached the maximum payout of $340,000 during the construction period. Ibid, p 4.

186 Ibid, p 3.

The actual capital requirements also differ depending on the size of the insurer:

- a large diversified insurer that already has a large capital base is better able to withstand extreme one-off events where a number of significant builders go insolvent, and so the additional capital required is likely to be minimal
- a smaller niche provider without a large capital base is less able to withstand extreme events and would require more capital in comparison to support its business.

However, the additional capital requirements that a small niche provider would incur is not an issue unique to split cover. It would also apply if a small niche provider were to enter the market to provide combined cover of $340,000.[187]

7.4 Eligibility where split cover is purchased separately from different providers

If a building business purchases split products from two different providers, they are likely to undergo two separate eligibility processes, which could be slightly different, for example, each provider requiring different information.

In addition, the providers may manage their risks differently, so that one provider allows more residential building work (that is, a higher job limit) compared to the other. Given that building businesses require both construction period and warranty period cover for projects, building businesses would not be able to make use of the new entrants' higher offering. This would mean the providers could not gain a competitive edge by providing for more work. Therefore, new entrants would need to consider other ways that they can provide a competitive offering, for example, the price that they offer for their product.

187 Ibid, pp 3,7-9.

8 Increasing SIRA's regulatory oversight of icare

Currently, icare is a monopoly provider of mandatory HBCF cover. Without other providers in the HBC market, icare does not face competitive pressure to either improve its services and/or deliver its services efficiently – as it does not risk losing customers.

In Chapter 5 we address potential barriers to entry to facilitate new entrants into the market to compete with icare. However, in the short to medium term it is likely that icare will continue to be the only provider of HBCF cover in NSW.

This chapter considers whether additional measures are needed to ensure that icare delivers an efficient service, and meets customer's needs. Stakeholders' specific concerns about icare's builder eligibility assessment are addressed in Chapter 9.

8.1 Overview of our findings and recommendations

We recommend that the NSW Government requires icare to be subject to independent price regulation, because it does not face competitive pressure to deliver its service efficiently. We also recommend that SIRA increases its regulatory oversight of icare by determining icare's builder eligibility assessment and claims handling process to reflect the outcomes that would reasonably be expected to prevail in a competitive market.

We have had regard to the costs and benefits of our proposed changes and consider that our recommendations would ensure that icare's services are efficient and would promote the financial sustainability of the HBCF.

We do not consider that the same regulatory oversight by SIRA is required for new entrants. This is because they will face competitive pressure from icare to provide better services to attract building businesses to their product offering.

Recommendations

12 That the NSW Government amends the Home Building Act 1989 to require an independent regulator to determine icare's premiums for the HBCF to ensure they reflect efficient costs. SIRA's role, as the scheme regulator, could be expanded to provide it with determination powers. Alternatively, IPART, as the NSW pricing regulator, could be given the on-going role of determining icare's HBCF premiums.

13 The NSW Government amends the Home Building Act 1989 to require SIRA to determine icare's builder eligibility assessment and claims handling processes.

14 SIRA establishes appropriate KPIs against which it can measure and publicly report on icare's performance in resolving eligibility issues and finalising claims in a timely manner.

8.2 icare's HBCF does not face competitive pressure to improve its services

In a competitive market, there would be pressure on providers to either improve services and/or deliver services efficiently:

- Builder eligibility – providers would be incentivised to only ask for information that is necessary (or critical) in determining a builder's eligibility, provide transparency to building businesses in how the information was used to determine their eligibility and resolve issues in a timely manner.
- Premiums – providers would charge premiums that reflect the reasonable cost of providing HBCF cover (ie, recover the reasonable expected cost of claims and the efficient costs of builder eligibility assessments, claims handling expenses, actuarial pricing and valuation services expenses, and overheads).

It would also be reasonable to expect providers to review their processes periodically and engage with their customers (building businesses and homeowners) to improve their services.

However, stakeholders have indicated that a variety of aspects of icare's services are not consistent with these outcomes. Without other providers in the HBCF market, icare does not face competitive pressures to improve its services as it does not risk losing customers.

A common theme has been building businesses finding icare's eligibility assessment too onerous and lacking in transparency, particularly how the information provided is actually used to determine an eligibility and any applicable conditions (such as injecting capital into their business).[188] Stakeholders also indicated that there can be considerable variability in the time taken to resolve eligibility issues.[189] We note that similar concerns were raised in previous consultation undertaken by SIRA in 2017 when establishing its current eligibility guideline (see below for further detail on the eligibility guideline).[190] Specific issues raised by stakeholders concerning icare's eligibility assessment are discussed in more detail in Chapter 8.

188 HIA submission to IPART Issues Paper, June 2020, p 18; NIBA submission to IPART Issues Paper, June 2020, p 7; The Landscape Association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, p 3.
189 Stakeholder meeting 17 June 2020; stakeholder meeting 30 July 2020.
190 SIRA, *Home building eligibility consultation summary*

Stakeholders also submitted that there is a lack of transparency over icare's premium changes:

- that it was difficult to reconcile icare's intention to reduce premiums for a range of building classes with its reported deficit of $636 million for the 2018-19 financial year[191]
- pricing is not consistent with risk, for example, prior to August 2019 the insurance price of duplexes was three times the current price[192]
- pricing of insurance for dual occupancy granny flats is inconsistent, causing confusion to building businesses and consumers.[193]

8.3 icare's HBCF requires further regulatory oversight

In 2017, reforms were undertaken to open the home building compensation market to competition. SIRA consulted on guidelines for how providers should price premiums, assess builder eligibility and undertake claims handling.[194]

The current guidelines were established in 2018 and generally set out the principles that providers are to adopt, factors that may be considered or must be adopted, and the minimum standards that providers should have in place in offering services (see Box 8.1).

Providers are required to submit premium, eligibility model and claims handling filings to SIRA annually.[195] SIRA decides whether it will reject them or not, based on whether they comply with the guidelines but does not publicly disclose its assessment of filings.[196]

191 NIBA submission to IPART Issues Paper, June 2020, pp 3-4.
192 Risk Specialist Group submission to IPART Issues Paper, May 2020, p 1.
193 Risk Specialist Group submission to IPART Issues Paper, May 2020, p 1.
194 SIRA also consulted on guidelines for how providers are to adopt good business practices and have the capacity to offer suitable products and services. SIRA, *Draft home building compensation business plan guidelines*
195 Unless SIRA authorises an extension of the current filing period. SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, p 10; SIRA, *Home building compensation (premium) insurance guidelines*, January 2018, p 11.
196 Eg, SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018, pp 10-11.

Box 8.1 SIRA's premium, eligibility and claims handling guidelines

SIRA's premium, eligibility and claims handling guidelines generally contain the following items:

Principles that providers must adhere to

- For premiums, they are to be fair and reflective of risk, not excessive or inadequate, not unreasonably volatile etc.
- For eligibility assessments, the criteria adopted in assessments are to be fair and reflective of risk, transparent, assessed reasonably, provides stability and is not unreasonably volatile etc.
- For claims handling, claims are to be processed efficiently in a timely manner; information provided to be claimants should be clear, accurate and expressed in plain language; claims and complaints procedures should be made available in an accessible format; and consistent service standards should be provided along with consistent decision making that is supported by evidence.

Factors that providers may consider or must adopt at a minimum

- For premiums, providers may consider the contract value, construction type, location of premises and contractor risk factors approved by SIRA.
- For eligibility assessments, providers must consider at a minimum net tangible assets of the building business, their net profit position, annual turnover, industry specific indicators, management structure, qualifications, business capacity, arrangements to support supervision of building work and quality assurance, trading history, existing exposure and existing eligibility (and conditions) imposed by other licence holders.

Minimum service standard levels

- For premiums, providers must have a process in place where a building business may appeal aspects of their premium determination. This must include at a minimum contact details for appeals and reviews within the provider, and timeframes for lodging and resolving disputes.
- For builder eligibility, eligibility reviews must be done within 30 business days. If the provider deems it necessary to revise/restrict or cancel an eligibility then at least 30 business days' notice must be provided (10 business days for suspensions), and there must be a process in place where building businesses may appeal aspects of their eligibility determination, similar to disputes relating to premium determinations.
- For claims handling, the provider must decide within 30 business days whether the claim will be accepted (or whether further information is required). Within 10 business days of accepting a claim, the provider must engage a service provider to inspect the property. The service provider must also have processes in place where a claimant may seek an internal review of the provider's claim decision.

Source: SIRA, *Home building compensation (premium) insurance guidelines*, January 2018; SIRA, *Home building compensation (eligibility) insurance guidelines*, January 2018; SIRA, *Home building compensation (claims handling) insurance guidelines*, January 2018;

SIRA's guidelines generally contain criteria that are broad to allow flexibility for providers to adopt different approaches. As such, they do not apply competitive pressure on providers to either improve their services and/or deliver services efficiently.

Given that icare is a monopoly provider of mandatory HBCF cover and faces no competition and does not risk losing customers, we recommend that icare should be subject to independent price regulation. SIRA currently has a role to review premiums so this could be expanded to require it to determine premiums that are sufficient and not excessive, and reflect the efficient cost of expected claims and expenses. SIRA would also undertake a public consultation process.

Alternatively, for assessing icare's HBCF premiums, given IPART's capability and current role in determining maximum prices for various monopoly providers, we could be requested to determine icare's maximum HBCF premiums.

Whilst the assessment of builder eligibility impacts pricing, we do not consider that both of these functions must be undertaken by the same regulator. Builder eligibility risk assessments determine a:

- builders' open job limit, which have implications for the likelihood and severity of claims, and
- builders' risk loadings/discounts, which affect how the revenue is collected from building businesses.

Once the builder eligibility risk assessment is determined, a separate regulator could consider any implications in its determination of icare's premiums.

In addition, we recommend that the NSW Government increases SIRA's regulatory oversight of icare's builder eligibility model, and claims handling process to ensure that they would give rise to outcomes that would reasonably be expected to prevail in a competitive market.

icare should be required to propose premiums, builder eligibility assessment model and claims handling process.

In its determinations, SIRA should assess:

- icare's proposed builder eligibility model – whether icare's builder eligibility model is reasonably what a commercial provider would adopt in a competitive market, for example,
  - that it can be substantiated by examining the financial position of previous builder insolvencies under the HBCF (and that icare only seeks information from building businesses that impact the eligibility outcome),
  - explains how builders' information has been used to determine their eligibility and individual building business loadings/discounts for use in setting risk-adjusted premiums,
  - explains how the information provided has led to any conditions such as injecting financial capital in their business, and
  - resolves eligibility disputes in a timely manner.
- icare's proposed claims handling process – whether icare's processes for establishing the actual claim payments is efficient, and it manages and finalises claims in a timely manner.

To reflect best practice independent regulation, a public review process should be established with reporting to disclose how it has made its decisions, including how it has considered icare's proposals and stakeholders' views.

We consider that icare would still have accountability if it is subject to independent price regulation. icare would be responsible for its proposals (including how it has consulted with customers) and how its HBCF offering performs - that is, whether its actual performance is different to its expected performance as implied by the regulator's determinations. If it submits well substantiated proposals, then it is reasonable to expect that these would be reflected in the regulator's determinations.

We also recommend that SIRA establishes appropriate Key Performance Indicators (KPIs) against which it can measure icare's performance in resolving eligibility issues and finalising claims in a timely manner[197]

In response to our Draft Report, stakeholders were supportive of our draft recommendations that icare be subject to increased scrutiny with an independent regulator determining its premiums, builder eligibility assessment process and claims handling process.[198]

197 ESC, *Domestic Building Insurance Premium Validation Review*, April 2019, p iv.

198 Barrington Homes submission to IPART Draft Report, October 2020, p 3; HIA submission to IPART Draft Report, October 2020, p 22; The Law Society submission to IPART Draft Report, October 2020, pp 3-4.

9 Builder eligibility assessments

Insolvency risks are primarily managed through the builder eligibility process. Building businesses are required to obtain eligibility from their provider before purchasing HBCF cover from them. The eligibility process allows the provider to manage its risks by:

- limiting the value and number of individual projects that the building business can have under construction at any time (also referred to as the 'open job limit')
- limiting the maximum contract value for any individual project, and
- imposing conditions, such as injecting additional capital into their business.

Providers of HBC cover are not required to provide eligibility to all building businesses and may refuse eligibility if the builder is deemed to be too high risk (for example, was involved in prior insolvencies in the past five years due to financial mismanagement).

This chapter outlines this eligibility process in detail, including the requirement for building businesses to use brokers accredited under the scheme to submit an eligibility application. It also considers whether more information is required to further mitigate builders' insolvency risk, the scheme's incentives for building industry participants to undertake good risk management and encourage good business practices.

9.1 Overview of our findings and recommendations

Building businesses find it difficult to understand icare's decisions on builder eligibility due to a lack of transparency, which also makes it difficult to provide builders incentives to undertake good risk management and encourage good business practices. We also found that when eligibility disputes arise, it can take considerable time for them to be resolved, impacting the building business significantly. Some building businesses indicated that they would prefer to engage directly with icare to resolve issues, rather than communicating via a broker, which is currently the case.

Therefore, we are recommending that icare provides greater transparency in its eligibility assessments, and review its dispute resolution processes to resolve eligibility issues in a timely manner. We are also recommending that building businesses are provided with more options on how they manage their HBCF obligations by allowing the use of brokers to be voluntary. We note that many building businesses would continue to use a broker.

We are also recommending that icare provides more transparency around the cost of HBCF cover that will be paid by individual building businesses. This is to help homeowners better manage their costs.

We have had regard to the costs and benefits of our proposed changes and consider that icare improving the transparency of its builder eligibility assessment process would assist in building industry participants undertaking good risk management and business practices, and would promote the financially sustainability of the HBCF.

Recommendations

15 icare provides greater transparency in how it undertakes its eligibility assessments and how it determines individual builder loading/discounts used in risk-adjusted premiums.

16 icare:

- Provides information in plain language in the Builder Eligibility/Change application form or the Builder Self Service Portal[199], why particular information is sought and how it would be used in determining a builder's eligibility.
- Provides information in plain language on how the information provided by building businesses was used to determine their eligibility profile and their individual loading/discount, including any conditions of eligibility.
- Makes clear any adjustments that have been made to take into account any industry specific circumstances, for example, the adjustment for a pool builder in determining their eligibility to account for 'sleeper pools'.
- Periodically updates the work undertaken by the Data Analytics Centre in 2016, to examine whether the factors previously identified and currently used, continue to be significant in predicting builder insolvency, and if there is scope to reduce the amount of information sought without necessarily increasing risk.

17 icare reviews its dispute resolution processes to resolve eligibility issues in a more streamlined and timely manner

18 icare's premium calculator provide the estimated premium for each building business to help homeowners better manage their costs.

19 icare changes its operating model to allow for building businesses to apply for eligibility and purchase certificates of insurance directly, rather than require that a broker is used for these functions. This would allow the use of brokers to become voluntary under the scheme, providing building businesses with more options on how they manage their HBCF obligations.

9.2 icare's approach to assessing eligibility is risk based

icare's approach to assessing builder eligibility is risk-based and is mainly aimed at investigating the factors that are likely to lead to builder insolvency, which accounts for over 90% of HBCF claims.[200] It involves assessing a builder's financial information (for example, adjusted net assets, gross margins and working capital) and non-financial information (including their previous experience, work history and whether there is any adverse information such as claims notifications) (see Box 9.1).

About 19,200 building businesses currently have eligibility with icare. Around 2,000 of these (or 10%)[201] have their eligibility reviewed at least once each year. These are building

199 The Builder Self Service Portal allows building businesses to input their financial information, purchase certificates of insurance, view their open job limits and view when their next eligibility review is scheduled.

200 icare submission to IPART Issues Paper, May 2020, Figure A1.2 Last resort, p 35.

201 icare, *Response to IPART section 22 data request*, June 2020; icare submission to IPART Issues Paper, May 2020, p 9.

businesses that have relatively high open job limits[202] or undertake projects deemed to be higher risk (such as the construction of multi-dwellings less than 4 storeys). The remaining building businesses are reviewed on a risk-basis only, for example, if any adverse information is received about the building business through mercantile alerts such as non-payment of subcontractors or suppliers.[203]

We considered whether icare should collect more information to further mitigate insolvency risk. Some further risk factors associated with insolvency include:

- Delays in a building business receiving progress payments could result in cash flow problems for their business.
- Issues arising from projects identified through critical stage inspections or delays in receiving compliance certificates, could indicate that a building business has liabilities relating to those projects. This could affect the builder's financial position and increase their risk of insolvency.

Stakeholders submitted mixed views about the effectiveness of these measures. Some considered information on these measures could be helpful.[204] Others questioned whether enhanced information collection would materially reduce insolvency risk. Stakeholders also cautioned against the imposition of onsite inspections to assess a builder's capability as it could add to costs and introduce significant complexity as to what is adequate or appropriate supervision to ensure that building work complies with plans and specifications and is of an appropriate standard. Submissions also noted that measures to improve residential building quality and compliance are currently in the process of being implemented in NSW.[205] In addition, stakeholders submitted that the current requirements were already onerous.[206]

As explained in chapter 4, we consider that icare (and any other potential providers in future) should be responsible for managing its own risks and not have measures prescribed. icare should be permitted to examine and decide whether enhanced information collection in relation to progress payments, critical stage inspections and issuance of compliance certificates are effective in mitigating insolvency risk. Any measures icare adopts should be substantiated, for example, there is evidence that the measure being assessed is effective in predicting the likelihood of a building business's insolvency.

202 Generally building businesses that have an open job limit greater than $3 million. icare, *HBCF Eligibility Manual*, March 2020, pp 19-20.

203 icare submission to IPART Issues Paper, May 2020, p 9; icare, *HBCF Eligibility Manual*, March 2020, pp 29, 52.

204 HIA submission to IPART Issues Paper, June 2020, p 17.

205 MBA NSW submission to IPART Issues Paper, June 2020, p 2; HIA submission to IPART Issues Paper, June 2020, p 17. The Law society submission to IPART Issues Paper, June 2020, p 4.

206 HIA submission to IPART Issues Paper, June 2020, p 18. NIBA submission to IPART Issues Paper, June 2020, p 7; The Landscape Association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, pp 3-8.

Box 9.1 icare's eligibility assessment

icare's eligibility assessment determines a builder's eligibility profile which identifies:

- Open job limit – total value and number of jobs permitted at any time
- Construction profile – the maximum contract amount for any job
- Eligibility conditions – if applicable, such as contributing more capital to the business or new builders entering into a review/mentoring program such as the Building Contract Review Program.

A builder nominates their open job limit and icare requires the following information to assess/review a builder's eligibility:

Financial information

- Adjusted net tangible assets (ANTA) – The amount of cash or assets that can readily be turned into cash, which a business has to withstand normal business disruptions or shocks. A minimum threshold of at least 3% of a builder's annual turnover is required.
- Gearing – Targets no more than 70%. If higher, can suggest that a building business may have difficulty in accessing additional working capital through external funding if need be.
- Gross margins – Inadequate gross margins has been identified as the primary cause of cashflow deficiency. Demonstrated weakness due to under-pricing may require the building business to enter into a Building Contract Review Program as a condition of eligibility.
- Expense days coverage – icare considers the benchmark to be at least 30 days (ability of a business to sustain normal overheads from retained equity).
- Current working capital – icare examines emerging trends to ascertain the builder's liquidity, ongoing viability and ability to undertake and complete projects.

Non-financial information

- Any adverse previous business history – Previous insolvencies within the past 5 years can be grounds to deny a building business eligibility, unless the building business can provide evidence that the causes of insolvency were not due to mismanagement. In such cases, builders are required to have ANTA of at least 10% in their business.

- Current claims notification/NCAT/court order – The number of notifications, and matters being referred to the Tribunal may be an indication that the building business is in difficulty. If non-complied NCAT/court orders arise then it may be grounds to suspend the builder's eligibility.

In order for icare to determine the above information, building businesses are typically required to provide a project pipeline forecast for the next 12 months, details of any franchise arrangements, current statement of personal assets and liabilities, details of any claims/NCAT/court actions above $50,000, tax returns, aged debtors/creditors listing, work in progress summaries, ATO integrated client account statements and details on any external funding facilities. Larger building businesses (open job limits greater than $3 million) may be required to submit operational plans, work in progress valuation statements and detailed breakdown of related party loan balances and transactions.

Under icare's eligibility manual, building businesses are to be notified of a review at least 40 business days prior to the review date, and if all the information has been received then the eligibility assessment/review with any conditions must be completed within 10 business days. The eligibility assessment is then required to be finalised within 40 business days. Building businesses are also able to view their eligibility profiles online to see their next eligibility review date.

Source: icare, *HBCF eligibility manual*, March 2020

9.3 icare should provide greater transparency in its eligibility assessments

Stakeholders submitted that a substantial amount of financial information is required for the eligibility assessment and it is unclear how the information is used to determine a builder's eligibility profile and why capital is required to be injected into their business.[207] A common theme was that icare has a one size fits all approach to assessing eligibility, and does not take into account the individual circumstances of a building business.[208] Stakeholders also said that icare's restrictions on a builder's open job limit impedes growth opportunities for a business.[209]

icare's approach to assessing eligibility is outlined in its HBCF eligibility manual. However, the manual does not explain how each of the information requested is actually used to determine a builder's eligibility. Although, it does explain that it uses a Builder Eligibility Assessment Tool (BEAT) that incorporates all the information provided by building businesses to generate an analysis of a builder's financials (including calculation of accounting ratios such as net tangible assets) and outputs risk warnings for consideration by the Eligibility Risk Manager[210] when deciding on a builder business' eligibility.[211] icare states that only in exceptional circumstances should the automatic result provided by the BEAT be over-ridden by the Eligibility Risk Manager (for example, if additional information is provided by the building business in support of their financial position).[212]

We found that without knowing how the information provided by building businesses is used in the BEAT, it is difficult to understand how a building business's eligibility assessment has been determined, including the building business's individual loading/discount and why certain conditions have been imposed. We note that icare does not submit its BEAT to SIRA as part of its eligibility model filing.

We recommend that icare provide more transparency in its eligibility assessment, including making clear adjustments that have been made to take into account any industry specific circumstances, for example, the adjustment for a pool builder in determining their eligibility to account for 'sleeper pools'.[213] Greater transparency would give building businesses stronger incentives to undertake good risk management and encourage good business practices as it would assist building businesses in better managing their business and reducing their own risk of insolvency. It would also assist those building businesses seeking

207 HIA submission to IPART Issues Paper, June 2020, p 18; NIBA submission to IPART Issues Paper, June 2020, p 7; The Landscape Association submission to IPART Issues Paper, June 2020, p 1; SPASA submission to IPART Issues Paper, June 2020, p 3.

208 SPASA submission to IPART Issues Paper, June 2020, p 4.

209 The Landscape Association submission to IPART Issues Paper, June 2020, p 1.

210 icare outsources its builder eligibility assessments to CorporateScorecard (accessed 10 September 2020).

211 icare, *HBCF Eligibility Manual*, March 2020, p 12.

212 icare, *HBCF Eligibility Manual*, March 2020, p 49.

213 SPASA submitted that icare's eligibility assessment does not consider the unique circumstances of the pool building industry eg, 'sleeper pools' - where a pool project is initially commenced at the beginning of a new house project but can only be completed once the house is finished. SPASA submitted that the pool project stays on the pool building business's open job limit during the entire period precluding the building business from taking on additional work, to the detriment of their business. However, we note that icare's eligibility manual explains that 'sleeper pools' are taken into account when determining a pool builder's eligibility and thus pool builders are allowed to undertaken significantly more projects at any time compared to other building businesses. For example, a medium building business constructing new homes can undertake 8 to 29 jobs at any time compared to a medium pool builder that can undertake 50 to 99 jobs at any time. SPASA submission to IPART Issues Paper, June 2020, p 3.

to increase their open job limits or wanting to reduce the need to have more frequent reviews of their eligibility.

In addition, in a competitive market, it would be reasonable to expect that if building businesses find that a provider has an assessment process where it is not explaining its eligibility decisions sufficiently and/or is perceived to be seeking information unnecessarily, then it is likely that building businesses would switch to an alternate provider, given the significant impact that eligibility can have on their business. This would be supported by our recommendation in Chapter 8, that SIRA review and determine icare's builder eligibility assessment to reflect what would be reasonably expected from a commercial provider operating in a competitive HBCF market.

9.3.1 Individual builder loading/discount used in risk-adjusted premiums

icare also uses the information provided in eligibility assessments in calculating risk-adjusted premiums for individual building businesses. When building businesses purchase a certificate of insurance for a particular project, icare applies its decision on the builder's individual loading/discount (of up to +/-30%) on to the base premium applicable to the project (see Box 9.2 below for further details).[214]

In its submission, icare explained that the basis of the factors used in setting individual builder loadings/discounts and its current eligibility assessment process was from work undertaken by the then Department of Finance, Services and Innovation's Data Analytics Centre (DAC) in 2016. icare advised that the DAC reported that the model it developed had an 84% accuracy in predicting the likelihood of the building business becoming insolvent.[215]

Over the course of the review, some stakeholders queried how their individual loading/discount had been determined. For example, we heard of an instance where the Eligibility Risk Manager informed them that they would be getting a discount, but then icare subsequently notified them that they would be receiving a loading instead (the stakeholder was still pursuing the reasons for the change).[216]

We found that whilst icare's information on the factors used to determine an individual builder's loading/discount is clear in terms of the rationale for its inclusion (that is, based on HBCF claims experience) it is not clear how the factors are weighted to determine the actual percentage loading/discount (and which factors are more significant). It is also not clear how effective the other financial information (for example, gearing, expense days coverage and current working capital[217]) sought in the eligibility assessment are in mitigating insolvency risk, if they are not used in calculating a builder's individual loading/discount for risk-adjusted premiums.

214 icare, *What risk factors impact on your HBCF premiums? – Fact Sheet*, June 2020, p 1. SIRA's premium guideline allows providers to apply an individual loading/discount of up to +/-50% (SIRA, Home building compensation (premium) insurance guidelines, January 2018, p 11).
215 icare submission to IPART Issues Paper, May 2020, pp 8-9.
216 Stakeholder meeting, 14 August 2020.
217 icare, *HBCF Eligibility Manual*, March 2020, pp 34-39.

We recommend that icare should provide greater transparency in how a builder's information is used to determine an individual builders' loading/discounts. Further, icare should periodically update the work undertaken by the DAC in 2016 to examine whether the current factors used to predict builder insolvency are still effective and remain relevant.

We do not consider there to be significant issues in disclosing to building businesses how the information provided has been used to determine an eligibility profile.

Stakeholders supported our Draft Report recommendations that icare improves the transparency of its builder eligibility assessments.[218]

Box 9.2 icare's individual builder loadings for risk-adjusted premiums

A building business' individual loading or discount rate is determined using the information provided as part of the eligibility assessment. It uses characteristics that have shown to either increase or decrease the likelihood of insolvency based on HBCF claims data. The following factors are considered by icare:

- Entity licence period and business structure (that is, sole trader, partnership, company) – icare HBCF's claims experience is that claims are significantly less likely where entities operate as sole traders (or partnerships) and the longer they have held their licence. Hence companies generally attract a loading whilst sole traders and partnerships attract a discount.
- Adjusted net tangible assets (ANTA) – claims data shows that the higher levels of retained ANTA as a percentage of forecast revenue, the lower the frequency of insolvency. Building businesses that choose to have a higher ANTA than the minimum of 3% will attract a discount, and a loading otherwise.
- Net profit before tax or taxable income – claims experience shows that entities that have generated strong net margins for each of the past three trading years have a lower likelihood of claims, and hence attract a discount. Entities that have generated losses in each of the past three years will attract a loading.
- Adverse history – where there is a significant and recent history of the building business being linked to failed entities which have generated HBCF claims or any other characteristics that are identified as imposing a substantial risk to icare HBCF, will attract a loading.
- Review not current – for those building businesses subject to annual reviews, if a scheduled review is 30 days overdue as a result of the building business not providing the information required then a loading will be applied
- Building Contract Review Program and audited accounts – participation in the program attracts a discount and so does audited accounts which increases icare HBCF's confidence in the information submitted.

Source: icare, *Risk factors impacting HBCF premiums*, June 2020.

218 The Law Society of NSW submission to IPART Draft Report, October 2020, pp 4-5; MBIB submission to IPART Draft Report, October 2020, p 1; Barrington Homes submission to IPART Draft Report, October 2020, p 3; MBA NSW submission to IPART Draft Report, November 2020, p 3; HIA submission to IPART Draft Report, October 2020, p 23.

9.3.2 Earlier disclosure of premiums for individual building businesses could lead to cost savings

icare provides a premium calculator on its website to provide information to building businesses and homeowners about the costs of HBC. The calculator shows the base rate premium for the specified construction and location. However, individual building businesses also attract a loading or a discount on the base premium rate of up to +/-30%, depending on risk factors such age of their business, and their business structure (that is, company, sole trader, or partnership), which is not shown in the estimated premium.

Currently a building business must disclose the estimated costs of HBC cover after a quote has been provided for the work, but before the contract is signed. In practice, this is too late for homeowners to consider the impact of these costs.

We are maintaining our draft recommendation that icare's premium calculator provide the estimated premium for each building business, so that homeowners can manage their costs in advance of engaging a builder.

Stakeholders did not support making individual builders' pricing information available.[219] They considered that homeowners may misinterpret this information. In particular, they were concerned that homeowners would interpret the premiums as being a reflection of work they produce.[220] As a result, they considered that high quality builders that are not financially strong would suffer.[221]

> We do not believe this is appropriate as we understand the financial rating of the builder is a material factor in the premium charged, and this would just cause further confusion to homeowners and questions of their builder as to why they are not charging a certain price.[222]

> We are concerned that given the complex factors that determine loading and discounts, publication of the risk factor analysis may be confusing for homeowners and it may not be of assistance. Publication may create more problems than it solves.[223]

We agree with stakeholders that homeowners may misinterpret the premium information where no explanation is provided. The calculator should clearly explain that the premium is set based primarily on the financial position of a builder, their business type (for example, sole trader, partnership, or company) and the length of time they have been in business. It should also emphasise that even builders with the highest premium can have a very low likelihood of becoming insolvent.

9.4 icare should resolve eligibility issues in a more streamlined and timely manner

icare has a complaint and dispute handling procedure that includes processes for dealing with issues raised by building businesses about their eligibility.

219 MBIB submission to IPART Draft Report, October 2020, p 9; Barrington Homes submission to IPART Draft Report, October 2020, p 2; MBA Submission to IPART Draft Report, November 2020, p 2.
220 MBIB submission to IPART Draft Report, October 2020, p 9.
221 For example, see Barrington Homes submission to IPART Draft Report, p 3.
222 Risk Specialist Group submission to IPART Draft Report, October 2020, p 10.
223 The Law Society submission to IPART Draft Report, October 2020, p 2

Based on stakeholder discussions and submissions, some examples of issues raised are:

- not understanding why a restriction has been placed on a builder's eligibility,
- querying why a certain amount of capital is required to be injected into the business, and
- not receiving information on why an individual risk loading/discount differs from what was previously advised.

Generally the procedure for a building business to obtain a resolution is:

- in the first instance, contact the Eligibility Risk Manager (Corporate Scorecard) through their broker to have the matter resolved
- if the building business is not satisfied with the outcome then the issue is referred to icare HBCF for further consideration (Corporate Scorecard may also decide to refer the matter to icare HBCF for resolution), and then
- icare HBCF's decision on the matter is final and binding.[224]

At any time, building businesses can also contact SIRA for a regulatory compliance review to investigate potential breaches of the Home Building Act, the Regulation or the Insurance Guidelines.[225] However, a regulatory compliance review is not a mechanism of appeal to review the merits of a particular builder's eligibility, and does not overturn icare's eligibility decision. It is focused on whether the procedures outlined in the Act have been followed.

Based on stakeholder feedback and submissions, we found that there can be significant delays in issues being resolved. Under icare's complaints and disputes handling procedures, depending on the matter, it can take building businesses up to 7 weeks to have their issues resolved if they are not satisfied with the outcome provided by Corporate Scorecard and the matter is referred to icare HBCF.[226]

Where the outcome of an eligibility review is for the builder's eligibility profile to be modified, the new building limits apply immediately if the new terms are unfavourable to the building business. The building business is then provided with at least 20 business days to meet any new conditions (such as additional capital).

It may be appropriate to impose restrictions/conditions on a builder's eligibility if their circumstances suggest that they are likely to be a significant risk to the HBCF. However, stakeholders consider that in some cases they have been unreasonably imposed (as they were eventually lifted after several weeks of discussions without requiring the building business to inject financial capital or meet any other eligibility conditions). While such situations may be infrequent, they can adversely impact a builder's business resulting in

224 icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, pp 21-23.
225 icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, p 25.
226 Under icare's HBCF complaint and dispute handling procedures, the Eligibility Risk Manager is to have its own underwriting committee and convene within 10 business days of receipt of a complaint. Its determination is then to be advised to the building business within 5 business days of the committee having considered the complaint. If the building business is dissatisfied with the outcome, the matter is to be escalated to icare HBCF by the Eligibility Risk Manager within 3 business days. Complaints or disputes referred to HBCF should generally have HBCF's determination communicated to the Eligibility Risk Manager and the Builder's Distributor within 15 business days. This can take a total of 33 business days or about 7 weeks. icare, *HBCF Complaint and Dispute Handling Procedures*, August 2019, section 7.3 and 7.4, pp 21-23.

them being unable to contract new work covered under the HBCF for some considerable time.

We recommend that icare should review its dispute resolution processes to resolve issues in a more streamlined and timely manner. This is what we expect would reasonably prevail in a competitive market as building businesses are likely to choose providers that address eligibility issues expediently, given the potential impact on their business can be significant. In addition, if it allows building businesses to better understand how the information provided has been used and why it has led to a certain eligibility profile outcome, then over time we expect there to be less need for building businesses to raise issues.

Stakeholders supported our Draft Report recommendations that icare improves the transparency of its dispute resolution processes.[227]

9.5 Icare should accept eligibility applications directly from builders

Currently, it is mandatory for building businesses to use brokers under the HBC scheme. Their main role is to assist building businesses through the eligibility process, which involves the submission of complex financial information tailored to the requirements of the scheme. They also purchase certificates on behalf of a builder. As such, they are the customer interface between building businesses and icare.[228]

In Queensland, building businesses are able to purchase insurance from the QBCC directly.[229] Similar to NSW, the government insurer in Victoria outsources the distribution of insurance. However, after selecting an insurance distributor, builders can manage and buy the insurance themselves through an online portal.[230] Building businesses in Victoria can also use brokers to help them manage their obligations in relation to the insurance, but these are optional.

We are maintaining our recommendation from our draft report that the use of brokers should be voluntary. This would mean that icare's systems would allow the receipt of eligibility applications directly from builders, and sell certificates of insurance directly to builders.

We received a number of submissions that strongly disagree with our recommendation. They consider that as a competitively delivered service with specialist expertise, brokers are the most cost effective way of managing builder's eligibility assessment applications.[231]

227 MBA NSW submission to IPART Draft Report, November 2020, p 4; Barrington Homes submission to IPART Draft Report, October 2020, p 3; MBIB submission to IPART Draft Report, October 2020, p 15; The Law Society of NSW submission to IPART Draft Report, October 2020, p 5.

228 icare submission to IPART Issues Paper, May 2020, p 19.

229 Taylor Fry, *Taylor Fry, Effectiveness and efficiency of the NSW Home Building Compensation Fund, August 2020*, p 23.

230 VMIA, *VMIA Domestic Building Insurance*, Video VMIA Domestic Building Insurance, June 2017.

231 For example, see NIBA submission to IPART Draft Report, October 2020, p 1, 5 and MBIB submission to IPART Draft Report, October 2020, p 5; and HIA submission to IPART Draft Report, October 2020, p 15.

Brokerage costs are estimated to add around 15% to premium costs. Some brokers operate a 'fee for service' model, where their costs are primarily recovered through a fee for completing and submitting the eligibility application to icare. Other brokers recoup their costs by adding a margin to the insurance certificates.[232]

Under our recommendation, building businesses could use an accountant or other business professionals if they require assistance with their application, or they could complete it themselves (as occurs in Queensland). This should put downward pressure on brokerage costs, because brokers would have to demonstrate value for money, and provide greater choice to builders.

Where eligibility issues do arise, building businesses would be able to communicate with icare directly. Some stakeholders said that this would be helpful. Some building businesses felt that the current requirement to go through a broker, prolonged the resolution, and they were not sure if the correct information was being conveyed between all parties. They considered that the experience and outcomes could have been improved if they were able to communicate directly with icare regarding these issues.[233]

We acknowledge that under our recommendation their might be small increases to icare's costs as a result of having to interact with building businesses. However some of these costs would displace the existing costs of interacting with brokers. We also consider that many building businesses would continue to use a broker, given the additional value a broker can provide to building businesses. If new providers enter the market, building businesses could engage their services to help them choose the product that best suits their needs.

We note icare's submission that it already has the technology for direct builder engagement, eligibility assessment, and underwriting risk control and reporting. It also submitted that it already has technological systems in place to allow for insurance policy processing and issuing, and premium collection.[234]

Lastly, stakeholders also considered that brokers play an important role in ensuring that builders meet their obligations to purchase insurance.[235] In our view, there are several other opportunities through the building process to verify that the correct insurance has been purchased (that is, reflecting the correct construction type, and contract price). For example, it should be one of the documents sighted by the certifier in undertaking their other obligations.[236] A certifier would be well placed to do this, because they have a direct connection to individual building sites.

232 Correspondence with icare, 25 March 2020 and 13 October 2020.

233 Barrington Homes submission to IPART Draft Report, October 2020, p 2.

234 icare submission to IPART Issues Paper, June 2020, p 19.

235 For example, see NIBA submission to IPART Draft Report, October 2020, p 1, 5 and MBIB submission to IPART Draft Report, October 2020, p 5.

236 Certifiers ensure that the planned design and construction of the development is consistent with the development consent (provided by the Council), that the proposed development will comply with the relevant requirements of the Building Code of Australia and that any preconditions to the issuing of a Construction Certificate has been complied with. See Fair Trading's webpage titled "Certifier responsibilities", viewed on 3 November 2020. NSW Department of Planning and Environment, *Your guide to the Development Application Process – Small housing development*, May 2018, p 30.

10 HBCF product specifications

We received submissions from stakeholders about a number of issues concerning the scope and requirements of the HBC product, including whether HBC cover could be made voluntary for certain construction types. We have also considered whether HBCF cover should be voluntary for high value single dwellings, for example, in excess of $2 million. In this chapter we discuss these issues.

10.1 Overview of our findings and recommendations

Stakeholders have numerous concerns about certain requirements of the HBCF and how they apply to particular aspects of residential building works and home building contracts. These include:

- for contracts that require HBCF cover, whether items such as soft-scape landscape works and pool equipment can be excluded from HBC requirements
- how to allow for variations in the cost of HBCF in contracts, if the precise contract price is not known at the time the contract is signed
- whether head contractors can require subcontractors to also purchase HBCF cover for subcontracted residential works exceeding $20,000, and
- whether HBCF cover is required for alterations and renovations for multi-units above three-storeys.

We recommend that the NSW Government amends the *Home Building Act 1989* to make clear that soft-scape landscaping works are not residential building works and that contracts can be separated or itemised so that HBCF cover is only required for residential building works. We also recommend that SIRA produces guidance for the building industry (for example, via a fact sheet) that explains the requirements for the issues raised.

We consider that providing building industry participants clarity over the issues raised would ensure that appropriate HBCF cover is purchased, promoting an efficient and financially sustainable HBCF.

We are also recommending that HBCF cover is voluntary for the construction of high value new single dwellings, for example, over $2 million. This is to provide homeowners, that would otherwise pay substantially high premiums, with more options on how to mitigate risks of non-completion and defects.

Some stakeholders submitted that work undertaken by owner-builders should be covered by the scheme. However, we have been asked to review protections for consumers currently covered under the scheme, and therefore this is outside of the scope of this review.

Recommendations

20 The NSW Government amends the *Home Building Act 1989*:

- to make clear that soft-scape landscaping works are not residential building works
- to make clear that contracts can be separated or itemised so that HBCF cover is only required for residential building works
- so that the threshold for requiring HBCF cover refers to the value of residential building works, rather than the contract price.

21 SIRA produces guidance for the building industry that addresses the following questions:

- For contracts that require HBCF cover, whether items such as soft-scape landscape works and pool equipment can be excluded from HBC requirements
- How to allow for variations in the cost of HBCF in contracts, if the exact contract price is not known at the time the contract is signed
- Whether head contractors can require subcontractors to also purchase HBCF cover for subcontracted residential works exceeding $20,000
- Whether HBCF cover is required for alterations and renovations for multi-units above three storeys.

22 The NSW Government exempts single dwellings from mandatory HBCF cover if the value of residential building works is greater than $2 million, or other amount as determined by the Minister. icare would continue to offer cover for these dwellings, which could be purchased on a voluntary basis.

10.1.1 Items in building contracts potentially not requiring HBCF cover

The Landscape Association and the Swimming Pool and Spa Association (SPASA) identified certain works that should be excluded from HBCF cover.[237] The Landscape Association considered that soft-scape works should be excluded from the scheme, because they do not represent a risk that needs to be covered by the HBCF.[238] It submitted that soft-scape works are complete once installed, can be taken over at any stage by a new contractor, and do not have any lingering warranty insurance. It noted that they can represent a substantial proportion of the overall contract price for residential works. Hence, these items should be excluded from the calculation related to eligibility for HBC insurance, maximum caps on the value of works a contractor can carry out and in the $20,000 threshold per contract over which HBCF insurance is required.

Similarly, the Swimming Pool and Spa Association (SPASA) submitted that swimming pool and spa equipment (which can account for 10%-15% on average for a basic pool) are already covered by manufacturers' own statutory warranties and so should be removed from the requirement to obtain HBCF cover.[239]

237 SPASA submission to IPART Issues Paper, June 2020, p 3; The Landscape Association submission to IPART Issues Paper, June 2020, pp 1-2.
238 The Landscape Association submission to IPART Issues Paper, June 2020, pp 1-2.
239 SPASA submission to IPART Issues Paper, June 2020, p 3.

Soft-scape landscaping works

Under the Home Building Act, HBCF cover is only required for **residential building works**[240] where the contract price is over $20,000, and our understanding is that claims are only payable in relation to these residential building works even for non-completion claims.[241]

Soft-scape landscaping works are not defined in the Home Building Act. However, we understand that soft-scape landscaping works are not residential building works under the Home Building Act as they do not relate to the installation or repair of a dwelling. Hence, we consider that soft-scape landscaping works do not require HBCF cover whether done as stand-alone works or as part of residential building works.

We recommend that the Home Building Act is amended to make clear that soft-scape landscaping works are not residential building works. This is to ensure that a HBCF premium is not paid on soft-scape landscaping works which cannot give rise to a claim under the scheme.

We also recommend that the Home Building Act is amended to make clear that contracts can be separated or itemised so that HBCF cover is only required for residential building works. This would clarify that building businesses are able to:

- Have two separate contracts with homeowners - one that includes items that require HBCF cover if it exceeds $20,000, and another separate contract that includes all items that do not require HBCF cover.
- Have a single building contract that clearly separately identifies the items that require HBCF cover and their corresponding costs, and those that do not.

Under either of the above approaches, it would be important for homeowners to understand the implications of items being allocated incorrectly, either under the wrong contract or under the wrong section (if a single contract option is adopted) - homeowners may not have sufficient HBCF cover as a result.

Further, we recommend that the threshold for requiring HBCF cover refers to the **value** of residential building works rather than the contract price. This is to make clear that HBCF cover is for residential building works only.[242]

240 Residential building works is defined in Schedule 1 of the *Home Building Act 1989*.

241 *Home Building Act 1989*, Section 92; *Home Building Regulation 2014*, Clause 5. Certain residential building work is exempt from HBCF cover e.g. Clause 56 and 58 of the *Home Building Regulation 2014*. Section 42(1)(j) of the *Home Building Regulation 2014*.

242 Whilst supporting our draft recommendation that SIRA provide guidance on issues raised, the Law Society considered that the appropriate vehicle for providing such guidance and clarification is the Act and the Regulation. The Law Society of NSW submission to IPART Draft Report, October 2020, p 5.

Spa and pool equipment

We understand that while the actual spa and pool equipment are not residential building works, the installation work undertaken by the builder is. There is risk that the building business damages the equipment by installing it incorrectly and hence the cost of the equipment would be claimable in the event that a HBCF claim is made. Therefore, a HBCF premium should be paid on spa and pool equipment. Currently, spa and pool projects pay a lower premium (0.6% of contract value), reflecting their lower risk (including that claims historically have not reflected costs associated with pool equipment) compared to other residential construction types (for example, 1.1% of contract value for new single dwellings).[243]

10.1.2 Requirement to include the cost of HBCF cover in contracts

SPASA noted that under section 7(2)(f1) of the Home Building Act, contractors are required to include in their contracts with homeowners, the cost of HBCF cover if applicable.[244] It submitted that pool builders enter into pool contracts frequently (25 to 50 contracts per year for small businesses and over 300 projects per year for very large businesses) and that the details of a pool specification are negotiated and settled with a consumer quickly. Given how quickly a pool contract can be agreed upon, (a pool builder may sign up four out of every ten customers they visit daily) it is not feasible or practicable for HBCF quotes to be obtained prior to and at every visit.

It also submitted that there appears to be an inconsistency in the Home Building Act where section 7(2)(e) requires a contract to contain the contract price if known, but section 7(2)(f1) requires that the contract must contain the cost of HBCF cover, irrespective of whether the contract price is known or not.[245] HIA also raised this same concern.[246]

We understand that building businesses are allowed to specify the cost of HBCF cover in their contract along with a disclaimer that this amount may be varied following confirmation of the cost of HBCF cover with their insurer. This in effect, allows builders to include an estimate of the cost of HBCF cover and then to vary the contract to reflect the actual cost of HBCF coverage.[247] We note that the 'NSW Fair Trading Home building contract template for work valued over $20,000' includes an example clause that building businesses can include in contracts to allow them to vary the contract price to reflect any differences (between the estimated HBCF cost and the actual cost).[248]

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243 See icare webpage showing premium rates, viewed 3 November 2020.
244 SPASA submission to IPART Issues Paper, June 2020, pp 7-8.
245 SPASA submission to IPART Issues Paper, June 2020, p 8.
246 HIA submission to IPART Draft Report, October 2020, pp 24-25.
247 Section 7(2) of the *Home Building Act 1989* specifies that the contract must contain the cost of HBCF cover. Section 7(5) of the *Home Building Act 1989* specifies that the contract price may be varied under the contract but must include a warning to that effect. Schedule 1(1) of the *Home Building Act 1989* defines the contract price as the total amount payable under a contract to do work. Given that HBCF cover is a part of the contract price, our understanding is that the contract price may be varied if the cost of HBCF cover needs to be varied (as long as a warning is included in the contract to that effect).
248 NSW Government, *Home building contract for work over $20,000*, clause 13 variations, p 14.

To assist building businesses in estimating the cost of HBCF readily, icare has an online premium calculator where building businesses are able to input the construction type, contract sum, postcode of works and the individual builder's loading/discount.[249]

10.1.3 Only head contractors are required to purchase HBCF cover

The National Electrical and Communications Association (NECA) submitted that head contractors often require subcontractors to also purchase HBCF cover, for subcontracted residential building works that exceed $20,000.[250] It stated that there is a lack of clarity in the market about whether or not a lead contractor can require subcontractors to also purchase HBCF.

NECA submitted that HBCF cover should be the sole responsibility of the head contractor and that subcontractors should not also be required to purchase HBCF cover.[251] It submitted that such an approach would be in line with contractual agreements, as subcontractors are liable to the head contractor who is then liable to the homeowner.

Under the requirements, HBCF cover is the sole responsibility of the head contractor.[252] Subcontractors are not required to purchase HBCF cover irrespective of the value of the subcontracted residential works.

10.1.4 Requiring HBCF cover for renovations and alterations for multi-units above three storeys

In discussions, some stakeholders indicated that there is a lack of clarity over whether HBCF cover is required for renovations and alterations done in multi-units above three storeys.

Only the construction of multi-units above three storeys is exempt from requiring HBCF cover.[253] Hence, renovations and alterations undertaken in multi-units (irrespective of the number of storeys) would require HBCF cover if exceeding $20,000.

249 icare, *HBCF premium calculator*, accessed 1 September 2020.
250 NECA submission to IPART Issues Paper, June 2020, p 3.
251 NECA submission to IPART Issues Paper, June 2020, p 3.
252 *Home Building Act 1989*, sections 98(1) and 92.
253 *Home Building Regulation 2014*, cl 56.

10.2 Swimming pool and spa works should continue to be covered by mandatory HBCF cover

SPASA submitted that home warranty insurance should be made voluntary for the swimming pool and spa industry.[254] It suggested that the current HBCF was not suitable for its construction type given icare's eligibility process requirements. In particular:

- it is too onerous on smaller building businesses (in terms of the frequency, cost and resourcing of the reviews for smaller building businesses),
- it is a burden on new entrants as they are required to meet icare's capital requirements, and
- it does not factor in unique circumstances particular to its industry such as 'sleeper pools'.[255]

We address SPASA's concerns about icare's eligibility process requirements in Chapter 7 and Chapter 8.

We consider that mandatory HBCF cover should continue for swimming pools and spa works:

- Whilst consumers should be undertaking due diligence before engaging a particular pool/landscaping business there can be substantial information asymmetry about the quality of work that they undertake. Further, it is difficult for a consumer to assess the risk that the building business would not be able to rectify any defects due to insolvency.
- It can provide valuable consumer protection for a potentially significant purchase that is related to the residential home when there is no other recourse available because the builder has died, disappeared, gone insolvent or had their licence suspended – for example, average claims for stand-alone pool works was about $22,000 on average over the past 5 years.[256]

In Chapter 5, we make recommendations to reduce the barriers to AIP providers entering the market to offer HBC cover, for example, to lower risk construction types such as swimming pools. If AIP providers were to enter the market they could provide a competitive offering that addresses the concerns raised by building businesses about icare's requirements.

10.3 HBCF cover should be voluntary for high value single dwellings

icare sets premiums as a percentage of contract value. This can result in very high value contracts having a very high premium, relative to the coverage of $340,000 provided by icare's HBC. For example, a $10 million contract to build a new single dwelling would be charged a premium between $70,000 to $140,000 (about 0.7% to 1.4% of the contract price). Depending on the homeowner's risk appetite, this may provide very poor value for money, particularly given that the claims rate is less than 0.5%, and few of these claims are for the maximum coverage amount.

254 SPASA submission to IPART Issues Paper, June 2020, p 8.
255 SPASA submission to IPART Issues Paper, June 2020, pp 3-4.
256 In nominal dollars; icare, *Response to IPART section 22 data request*, June 2020.

Therefore, we recommend that HBCF cover is be voluntary for high-value single dwellings, where the contract price is greater than $2 million (or any other amount specified by the Minister). Above $2 million, the $340,000 coverage is less than 20% of the contract price (and as a result, homeowners could not receive the maximum value of a potential non-completion claim, which are capped at 20%).

This recommendation would affect very few homeowners. To illustrate, less than 2.4% of new single dwellings have contract values greater than $0.75 million.[257]

Under our recommendation, homeowners could continue to purchase HBCF cover for their high value single dwellings on a voluntary basis. Alternatively, they could choose to manage their risks in other ways. For example, they could have an independent inspector regularly assess the works, and ensure that progress payments reflect the value of the work undertaken. This would mitigate the risks of being out of pocket if a builder becomes insolvent, and also the risks of defects occurring. In contrast, the cost of such options may not outweigh the benefits for homeowners who have contracted for relatively lower value works (for example, the average premium for pool and spa works is about $500).[258]

10.4 Owner-builder work is exempt from mandatory HBCF cover

A number of stakeholders submitted that homes built by owner-builders should be covered under mandatory HBCF cover.[259] They indicated that consumers who purchase owner-built homes have reduced protections as a result.

In 2015, the NSW Government made owner-built homes ineligible to obtain home warranty insurance under the HBCF. It stated that "this is to focus home warranty insurance on the licensed building sector, and to make clear distinction between homes that are built by qualified licensed builders and those built by owner-builders".[260]

The NSW Government also implemented measures to protect consumers purchasing owner-built homes. It requires that contracts for the sale of all properties, on which owner-builder work has been carried out in the 6 years preceding the sale, must include a consumer warning that the work has been undertaken by an owner-builder and that the owner-builder is not providing statutory insurance.[261]

Our terms of reference requires us to investigate the effectiveness and efficiency of the HBCF in protecting consumers currently covered under the scheme. Owner-builder work is exempt from the HBC requirements and so is outside the scope of our terms of reference.

In response to stakeholder submissions, we note that:

257 Information provided by icare, 18 June 2020.

258 The average contract value for pool and spa projects from icare's claims data from 2015 was about $60,000. The premium payable on a pool and spa contract for $60,000 is about $500 (including GST and Stamp duty).

259 BuildSafe Insurance Brokers submission to IPART's draft Terms of Reference, December 2019; Australian Owner Builders submission to IPART's draft Terms of Reference, December 2019.

260 Home amendment bill 2014, second reading, discussing owner-builders being ineligible to take out home HBCF cover, accessed 14 September 2020, pp 4-5.

261 Home amendment bill 2014, second reading, discussing owner-builders being ineligible to take out home HBCF cover, accessed 14 September 2020, pp 4-5.

- The NSW Government has implemented consumer protection measures so that consumers are aware if they are purchasing an owner-built home which does not have HBCF cover.
- As part of obtaining an owner-builder permit, owner-builders are aware that if they build their home or undertake work themselves and not engage a qualified licensed builder, then they have no statutory home warranty insurance.[262]
- The HBCF current deficit of $637 million and so including owner-builder cover would subject it to greater risk.[263] Where performance reporting of owner-builder insurance is available, it shows that owner-builders pose greater risk compared with licensed builders. For example, in Victoria where owner-builder insurance is mandatory, they pay higher premiums ($4.50 per $1,000 of project value) compared to licensed builders ($3.00 per $1,000 of project value).[264]
- Owner-builders have the option of purchasing home warranty insurance voluntarily from private providers, for example, BuildSafe and AOBIS.[265]

262 NSW Fair Trading, *Becoming an owner-builder,* accessed 10 September 2020.
263 icare, *Annual Report 2018-19*, p 59.
264 ESC, *Victoria's domestic building insurance scheme – performance report 2018-19*, November 2019, pp 31-32, The most common reason for claims on owner-builder policies in Victoria is disappearance of the previous owner (it is reported that it is difficult for the owners of a property to track down the original owner-builder to rectify any faults) (ESC, *Victoria's domestic building insurance scheme*, November 2019, p 33).
265 Buildsafe, Owner builder home warranty insurance NSW, accessed 14 September 2020; AOBIS, Owner builder warranty insurance in NSW, accessed 14 September 2020.

Appendix

A Terms of reference

Effectiveness and efficiency of the Home Building Compensation Fund in NSW

The Home building compensation fund is established under the *Home Building Act 1989*. The scheme compensates homeowners if their builder is unable to complete building work or fix defects because of insolvency, death, disappearance or licence suspension for non-compliance with a money order made by a court or the tribunal in favour of the homeowner.

The scheme applies to residential building work projects over $20,000 (including GST) unless exempt, such as the construction of new houses, terraces, villas, multi-units up to three storeys in height, as well as home renovations and swimming pool building.

The scheme is regulated by the State Insurance Regulatory Authority (SIRA). The sole insurer currently offering cover under the scheme is Insurance and Care NSW (icare) on behalf of the NSW Self Insurance Corporation. Legislative amendments mean that since 2018, new providers can apply to SIRA for a licence to join the scheme.

The NSW Government is currently undertaking extensive work to reform the building and construction industry. The Building Commissioner has been appointed to lead the implementation of the reforms and advise Government on any additional reforms that may be needed to ensure better protections for homeowners and to lift building standards across NSW.

IPART review

I, Victor Dominello, Minister for Customer Service, pursuant to Section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992*, request that the Independent Pricing and Regulatory Tribunal (IPART) conduct an investigation in accordance with these 'terms of reference'.

Task

IPART should review the effectiveness and efficiency of the home building compensation fund in protecting consumers who are currently covered under the scheme.

In particular, IPART should investigate:

- the scheme's incentives for building industry participants to undertake good risk management and encourages good business practices
- whether the scheme needs to further mitigate builders' insolvency risk, for example through enhanced information collection in relation to builder progress payments, critical stage inspections, and issuance of compliance certificates or other measures
- any other impediments to private sector participation in providing insurance through the home building compensation scheme
- whether there are unnecessary regulatory or administrative burdens and barriers to entry for building industry participants

In investigating and making recommendations on the scheme, IPART should have regard to:

a) the need for the scheme to provide an adequate level of protection to customers having regard to the other measures that are likely to contribute to the efficient and effective protection of customers

b) the need to encourage confidence in the market for construction of residential dwellings

c) the costs and benefits of any proposed changes to ensure an efficient and financially sustainable outcome

d) the coordinated approach by the NSW Government to fix the failures of the statutory warranty and home building compensation schemes

e) developments in other jurisdictions.

Procedure

IPART should undertake public consultation. IPART will consult stakeholders on the draft terms of reference and recommend final terms of reference to the Minister within six weeks of receipt of the draft.

A draft report should be publicly released for comment with a final report to be provided to the Minister for Customer Service within six months after finalisation of the terms of reference.

The Hon. Victor Michael Dominello, MP

B Improving regulation of the building industry

In this Appendix we outline Fair Trading's improvements to:

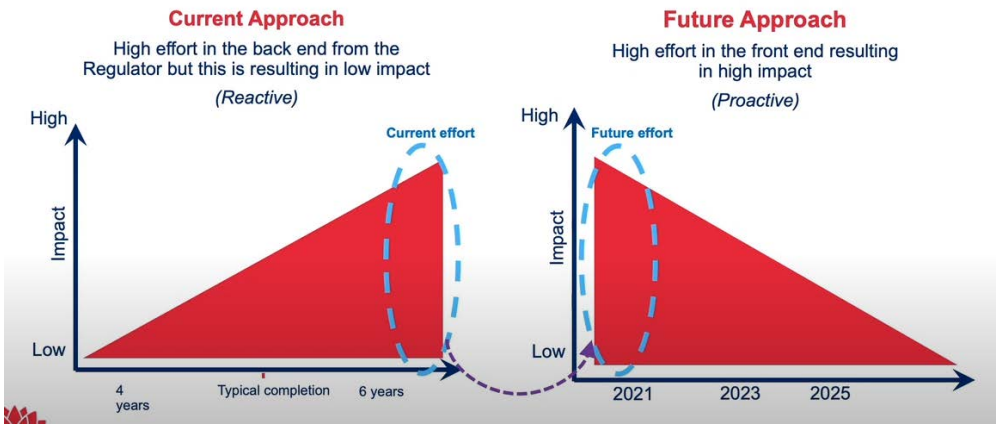
- increase building quality through proactive compliance
- use better information when renewing/assessing builder licences
- increase the accountability of registered certifiers, and
- undertake greater enforcement and compliance of builders in meeting their licence conditions.

We also discuss NSW Fair Trading's dispute resolution process and compare it to the Queensland Building and Construction Commission (QBCC) which stakeholders have submitted as being effective in resolving disputes in a timely manner.

B.1 Improving building quality through proactive compliance

Fair Trading is in the process of transitioning its approach to compliance and enforcement to be more proactive in enforcing building regulations and standards, rather than being reactive to complaints (Figure B.1).[266] It aims to improve building quality and reduce the overall number of complaints by focussing effort prior to the completion of works. It plans to use data-driven risk based intelligence to target proactive inspections of residential construction sites in Sydney and metropolitan areas.[267] This is to ensure operators in the residential home building industry comply with relevant legislation and building standards.

Figure B.1 Fair Trading's change to proactive regulation



Data source: YouTube Link to the NSW Building Commissioner Insights 008 – Better Regulations Division

266 Fair Trading's existing Home Building Service, which covered all functions relating to the home building market, has been split across functional areas within the Better Regulation Division, with dedicated functions for 'compliance and dispute resolution' and 'investigations and enforcement'. Email from Fair Trading, 19 October 2020.

267 Department of Finance, Services and Innovation, *Annual Report 2018/19*, p 73.

Fair Trading is also working with the Building Commissioner for the administration of the *Residential Apartment Buildings (Compliance and Enforcement powers) Act 2020*. Fair Trading aims to audit 10% of occupation certificate notifications.[268] The current focus is on high risk multi-level units and some townhouse developments (Class 2 residential apartment buildings). The sites that are under four-storeys are captured by the Home Building Compensation Scheme, which are a large driver of costs. In addition, many contractors work across both Class 2 and Class 1 buildings (single residential buildings). To the extent that the audits change behaviour of contractors more generally, it should help improve overall building standards across the industry.[269]

B.2 Improvements to builder licensing

Fair Trading has made improvements to the home building licensing system. These include:

- Better use of relevant information from NCAT and ASIC to inform its licensing assessment, and making this information available as part of the licensing public register. Examples of relevant information include a building not having complied with or has an existing NCAT order, and that they have been involved in an insolvent company.[270]
- Better use of existing intelligence (such as complaints, compliance actions and insurance claims) in assessing licence applications. System changes have also been made to automatically raise alerts (e.g. if there are complaints or non-compliance actions) on licence renewal applications that should be reviewed manually. Previously, an alert would need to be raised manually against a licence.[271]
- Improvements to the home building licensing public register. This includes linking all relevant licence records so that consumers are better able to see a builder's history (including associated companies that have become insolvent and in which they have been a director).[272]

268 Developers must give Fair Trading at least 6 months' notice before applying for an Occupation Certificate. The audit involves a review of designs and documents (including contracts) for building work as well as a physical inspection. The focus during inspections is on the key building elements of structure, waterproofing, fire rating systems, building services and external closures. The Residential Apartment Buildings (Compliance and Enforcement Powers) Act provides information gathering powers and power of entry which are relied on to carry out the audit. See Fair Trading's webpage titled "Notice of intended completion of building work", viewed on 6 November 2020.

269 Correspondence from NSW Fair Trading, 19 October 2020.

270 Email from Fair Trading received on 28 October 2020.

271 NSW Ombudsman, *Is your builder 'fit and proper': the weaknesses of the home building licensing scheme in NSW*, May 2018, p 9; Correspondence from NSW Fair Trading, 19 October 2020.

272 Prior to 2018, the public register had individualised records of contractor licences and did not identify if the director of a particular company was also (or had previously been) a director of other companies with contractor licences. This meant that individuals with a poor track record could set up a new company and obtain a new contractor licence without their unfavourable history being visible to the public. Changes were made so that if a consumer searches a particular contractor licence which is held by a company, then all directors of that company are listed along with any other companies that each director is associated with. NSW Ombudsman, *Is your builder 'fit and proper': the weaknesses of the home building licensing scheme in NSW*, May 2018, p 9.

As a result of these improvements, builders who perform poorly against the requirements are more likely to face consequences as Fair Trading will have better information when assessing builder licences.[273] Also, a builder's poor performance against the regulations will be available on the public record, providing greater transparency to consumers when they are choosing a builder. Over time, these will provide incentives to builders to comply with all the relevant regulatory requirements.

B.3 Improving the accountability of registered certifiers

Registered certifiers[274] are public officials and independent regulators of building construction work. They are regulated by NSW Fair Trading and their roles involve issuing construction certificates[275], undertaking critical stage inspections[276] and issuing occupation certificates[277].

Certifiers do not supervise or manage building work and are on site for only relatively short periods of time to inspect critical stages of work. Whilst they have a responsibility to ensure that development is being built in accordance with relevant approvals, the builder is responsible and accountable for the actual quality of the building work.

On 1 July 2020, the regulatory framework was strengthened in relation to certifiers[278], including:

- improvements to registration (certifiers being registered rather than accredited; a new online register to provide more details about each certifier including any previous disciplinary action),
- making clearer the conflict of interest provisions that govern their role[279] and

273 Licences can be granted for 1, 3 or 5 year durations. See Fair Trading's webpage titled "Building (general building work)", viewed on 3 November 2020.

274 If the work requires approval (e.g. development consent from council), the homeowner is required to hire a principal certifier before work starts. They may choose either the council or a registered certifier as their principal certifier. It is illegal for a builder to influence the homeowner's choice of certifier. See Fair Trading's webpage titled "Approvals", viewed on 5 November 2020.

275 Certifiers ensure that the planned design and construction of the development is consistent with the development consent (provided by the Council), that the proposed development will comply with the relevant requirements of the Building Code of Australia and that any preconditions to the issuing of a Construction Certificate has been complied with. See Fair Trading's webpage titled "Certifier responsibilities", viewed on 3 November 2020. NSW Department of Planning and Environment, *Your guide to the Development Application Process – Small housing development*, May 2018, p 30.

276 Certifiers ensure that construction is inspected at key stages (e.g. piers, slab, frame, wet areas and the final inspection) to inform them as to whether an Occupation Certificate should be issued when the building is completed. This involves assessing whether the development is being built in accordance with relevant approvals i.e. the development consent, Construction Certificate, endorsed plans and specifications. See Fair Trading's webpage titled "Certifier responsibilities", viewed on 3 November 2020. NSW Department of Planning and Environment, *Your guide to the Development Application Process – Small housing development*, May 2018, p 31.

277 Certifiers attest that the design and construction of the building is consistent with development consent (and any preconditions have been complied with) and that the building is suitable for occupation (in accordance with its BCA classification). See Fair Trading's webpage titled "Certifier responsibilities", viewed on 3 November 2020. NSW Department of Planning and Environment, *Your guide to the Development Application Process – Small housing development*, May 2018, p 31.

278 The changes commenced under the *Building and Development Certifiers Act and Regulation.*

279 The Building and Development Certifiers Regulation prescribes certain scenarios as conflicts of interest. For example, issuing a strata certificate for a strata plan, strata plan of subdivision or notice of conversion if the plan or notice was prepared by the certifier or someone related to them (clause 24 of the B&DC Regulation).

- providing Fair Trading with broader powers to investigate and audit certifiers (including new powers to suspend a certifier's registration until a monetary penalty is paid, and to issue public warnings about certifiers).[280]

Further, in September 2020, Fair Trading released a Practice standard for registered certifiers for new residential apartment buildings. This was in response to various reviews in building regulation that highlighted the need for a standard to set out the expected conduct of registered certifiers in carrying out building certification work. The Practice standard also makes clear that certifiers have a duty to take action[281] on any observable non-compliant work and that necessary rectification work is carried before issuing an Occupation Certificate. They are not required to consider unobservable non-compliances, unless a potential non-compliance is observable.[282]

Fair Trading's aim is to produce practice standards covering other building classes (noting that the first two chapters of the standard apply generally to all certifiers as they cover the role of certifiers as public officials and conflicts of interest).

The new Act and Regulations have only recently come into force, including the Practice Standard (applies to Class 2 buildings which include multi-units up to 3 storeys, which are a large driver of claims costs in the HBCF). As the regulation of the building industry improves, including the role of registered certifiers, we expect the frequency and severity of building defects to reduce.

B.4 Improvements to enforcement

Fair Trading has established a dedicated team for enforcements and investigations and is undertaking 'enforceable undertakings and investigation' review as a high priority program.[283] By undertaking targeted enforcement actions across the home building industry, its aim is to provide better incentives for builders to provide high quality building work.

Fair Trading's systems have also been improved to better link enforcement actions back to the licensing assessment process. In 2015, complying with rectification orders became a condition of a builder's licence.[284] Hence, it became easier for Fair Trading to take action against builders for non-compliance.

280 NSW Fair Trading, "Changes to building and development certifier laws", viewed on 3 November 2020.
281 The certifier is required to provide the builder with a written direction notice. The certifier must be satisfied that the builder has addressed the identified issues before issuing an Occupation Certificate.
282 The Practice standard provides an example of a certifier not being able to determine BCA compliance for an automatic sprinkler system from a visual inspection, but they could visually identify during an inspection potential non-compliance such as the absence of sprinkler heads from an area required to be sprinkler protected. Construct NSW, *Practice standard for registered certifiers: 1 - New residential apartment buildings*, September 2020, p 55.
283 Email from Fair Trading, received 28 October 2020.
284 See "Home Building Amendment Act 2014 No 24", p 22 (viewed on 3 November 2020).

B.5 How effective is Fair Trading's dispute resolution service?

When a consumer and builder are unable to resolve their dispute, Fair Trading's dispute resolution service will attempt to mediate an outcome suitable to everyone. The dispute resolution process includes the following steps.

- Inspection process – Fair Trading's building inspector will either issue a Rectification Order (including a date for completion) if there are matters that the contractor needs to rectify, or conclude the builder is not responsible for the alleged defects.
- Penalty Infringement Notice - If a Rectification Order is not complied with the matter is escalated for a Penalty Infringement Notice (PIN) to be issued. The consumer will be advised to proceed with legal advice or lodge a claim with NCAT.
- NSW Civil and Administrative Tribunal (NCAT) - If an agreement cannot be reached and the inspector is not satisfied on the 'balance of probabilities' that it's the traders fault, a consumer can lodge an application with NCAT.[285]

Homeowners would have improved outcomes if the dispute resolution process was resolved in a timely manner – they would either have their builder rectifying any defective work or pursue their matter further at NCAT sooner rather than later.

However, it is not clear how long Fair Trading's dispute resolution process typically takes as there is no public reporting on timeframes. Stakeholders submitted that the QBCC has an effective dispute resolution process that aims to address issues within set timeframes - see Table B.1 below.

Table B.1 QBCC key performance indicators

Indicator	Measure	Target, Actual
Perception of fairness in decision making: % of survey respondents agree the final decision was fair	Feedback surveys are completed after closure of matters in Licensing, Early Dispute Resolution, Resolution Services, Insurance Claims (Approved), Insurance Claims (Declined) and Internal Review.	65%, 55.8%
Quality decision making: % of internal review decisions overturned by QCAT	Quality assurance framework Process redesigns Staff training	10%, 0%
Early Dispute Resolution		
% early dispute resolution cases finalised within 28 days		80%, 83%
Average processing time for an early dispute resolution case		28 working days, 18 working days

Source: Queensland Building and Construction Annual Report 2019-2020, pp 23-24,

We previously recommended that Fair Trading publicly reports on the time taken to resolve complaints. However, we are now proposing that Fair Trading adopts the targets used by the QBCC in resolving dispute resolution cases: 80% finalised within 28 days, and average time taken less than 28 days.

285 See Fair Trading, "Resolving a dispute", viewed on 25 September 2020.

Further, we are also recommending that the service standards for NCAT hearing and resolving a complaint are improved, for example, 80% of matters are to be finalised within 6 months. The current service standard is that 80% of matters are finalised within 18 months.[286] If a builder does not comply with an NCAT order then it is grounds for a licence suspension and a HBCF claim can be triggered. By having timely NCAT dispute resolution, homeowners are potentially able to receive compensation sooner rather than later.

286 Data provided by NCAT, 2 June 2020.