

SUBMISSION

Inquiry into Western Australia's Home Indemnity Insurance

Are we asking the right question?

To better understand the question with Indemnity Insurance we need to ask ourselves these questions –

“What is Indemnity Insurance?”

“Why do we need Indemnity Insurance?”

“Who does Indemnity Insurance Protect?”

Indemnity Insurance was introduced, in short, to protect consumers. This concept in theory is brilliant & provides peace of mind to consumers, but what we have failed to address is why are consumers at risk for us to introduce Indemnity Insurance in the first place?

The answer, in short, is that the industry was concerned with Builders becoming insolvent, deceased or they have had enough & want to close their doors. The issue with all of these items is that every house carry's a 6 year structural guarantee & if the Builder no longer existed, how would the consumer be protected?

Therefore should the question we really need to be asking ourselves is –

“Is Indemnity Insurance reactive or proactive?”

Under the current Indemnity Insurance Scheme, Indemnity Insurance is very reactive. It seems Indemnity Insurance is engaged to rescue situations as opposed to assist in the situation. Indemnity Insurance shouldn't be a last resort & it shouldn't be up to Insurance Companies to take the risk on an industry they do not fully understand.

The Residential Construction Industry needs to address what causes the risk so as to understand how we can improve the Indemnity Insurance System.

What Creates The Risk?

To improve the Indemnity Insurance System we must first begin to understand the risk. When discussing risk we need to ask the following questions –

“Who is responsible for the risk?”

“What creates the risk?”

“How can we minimize the risk?”

The person or persons that are responsible for the risk associated with Indemnity Insurance is the Builder. The Builder is responsible to ensure that they price & construct projects in a timely & effective manner to create profit for their business to survive. However as simple as this may sound, this is not as simple as it is said.

As stipulated in the consultation, there are approximately 5,800 registered builders in WA. This is quite a high concentration of builders in a relatively low populated state. This is a huge benefit to consumers as there is an abundance of competition & options for them to shop around to get the best price, but on the flip side, it is more detrimental to the builder as to win work they are required more times than not to work on low margins to secure the work.

It would be simple to say, Builders should increase their margins, but that is easier said than done. The builder runs the risk of not generating any new business or income if they increase margin, thus crippling cash flow. For a builder not to be a risk it is required to generate enough cash flow, not only to operate their business, but to profit their business to ensure they reduce their risk by being financially stable.

So what creates the risk, the answer is simply Cash Flow.

What Creates Poor Cash Flow?

If we are truly seeking the answer to reducing risk to ease the burden on Insurers & State Government we need to address Builders cash flow.

Why do Builders have poor cash flow? The answer is simply that there are varied external influences that reduce Builders ability to generate a continuous cash flow to ensure their business survival. The biggest factor associated with poor cash flow is time or delays. These delays are commonly associated with –

Finance Approval

Planning Approval

Building/Demolition License Approval

Settlement Time Frames

Strata Approval Time Frames

Power Design, Approval & Connection

Water Corporation Approval

Engineering Design & Plans

Some of these delays also cause a financial burden as in many cases not only do these take time, but also upfront costs to the Builder that in many cases do not have the funds to cover the costs imposed by certain entities.

With every delay & imposed cost, it penalizes the builder dramatically as for every day they do not get a job to site to generate income, they are paying for their fixed overheads. However if you ask a Builder to reduce their fixed overhead, will they then be able to meet the required service levels for their clients?

Overdrafts

An overdraft can be a useful tool, but if misused, can be fatal to a business. Many builders carry overdrafts to meet the shortfall of their income. This is because generally due to poor or slow cash flow

Progress claims, though useful for a standard project home, is harmful in other forms of developments such unit developments & special or one off homes. In many cases with progress claims, builders will need to cover the shortfall of funds to pay subcontractors & suppliers from their own finances until such time funds are recuperated from the client at the next progress claim.

Even then, when a claim is made, under the current system a client has up to 10 working days to pay, which in affect is an additional 2 weeks before the builder receives their funds.

Where builders run into strife is when they have several jobs on the ground at various stages where they begin to lose sight of their payables & receivables. This is where the Builder then turns to their overdraft facilities to rescue them only to find that they are spending more than they are making, which in turn makes them spiral further into debt with their overdrafts.

Complaints Increase the Risk

Before we commence discussing solutions for Indemnity Insurance it is important to fully understand all the risks imposed on the Builder.

Builders are responsible for a 6 year structural warranty of a house they build. This is in no way unfair or unreasonable. Structural defects, in the grander scheme of things, do not occur on a regular basis.

What affects Builders more so is the weight of complaints by clients, nonrelated contractual parties like neighbours & buyers that hurt builders financially. The system that is currently in place does not provide equality in a dispute. If a client, neighbour or buyer wishes to make a complaint against a builder with what they believe is defective work but it meets the industry standards, builders are not compensated for their time or expense as the current SAT system is not a fair judicial system.

We must first look at providing a fair & equal judicial system whereby if a client or buyer wishes to make a complaint against a builder & wish to go to a hearing, the hearing must be equal in the sense that if a client has made a claim for which they were wrong & lose, the builder should be able to redeem lost monies for time & be reimbursed all relevant fees from the client or buyer.

This is where the Builder is at risk more so than the structural warranty. It is the constant misunderstanding of clients & buyers that make complaints under the belief the Builder is fully responsible for their home outside the Structural Warranty. These complaints burden the Builder financially thus putting them at a higher risk of insolvency as there is no compensation if the builder is found not guilty of any wrong doing.

Maintenance

Under the current various forms of Building Contracts, there is a clause for a Maintenance Period. Maintenance is as vague as Indemnity Insurance & has always been misunderstood by the consumers. It is due to the misunderstanding of the Maintenance Period that causes substantial amount of grief to the Builder & burdens the Builder financially with the cost of administration & at times legal fees to explain to clients what is a maintenance issue or not.

Clients are reluctant to believe Builders with their explanation with respect to their maintenance list & often believe that the Builder has an ongoing responsibility to address any minor items that may arise which are not structural.

Removing maintenance as a standard contractual obligation will have a 2 fold affect. One, it will ensure when builders hand over the house it is fully complete & have met their contractual obligations. Two, it will make clients responsible for frivolous matters & the maintenance & upkeep of their new home.

If we move towards a no maintenance period, it will remove the inefficiencies & the common practise of many supervisors (particularly in the Project Market) of handing over homes with minor outstanding items they advise clients that can be handled at maintenance.

Putting the onus on Builders to complete the development with no outstanding items & handing over with a signature from the owner/client that they are satisfied with the end product should eliminate the need for compulsory maintenance.

Responsibilities

There a very few licenced people associated with residential building. The few that are licensed on a residential site are as follows –

Registered Builder

Plumber

Electrician

Scaffold & Riggers

Painters

Under the current system Builders are fully responsible for the poor workmanship of qualified trades except for those mentioned. It seems completely unfair that the trades that are responsible for the structural integrity of the house are not licensed & can walk away if they please from their poor workmanship & not be accountable for their work. The trades I speak of are –

Concreters

Bricklayers

Roof & Wall Carpenters

In many cases if any of these trades carry out poor work, the burden falls onto the builder to rectify any of their defective work at their cost. These trades have zero responsibility if they choose because there is no recourse for rectifying faulty work. Even though the builder is registered & is required to supervise the works, not every component can be supervised every step of the way. Builders employ these trades in good faith for their expertise to complete the works as per the standards required.

This is not only isolated to trades, but there needs to be some responsibility to the structural Engineers if they fail to provide correct details & information & the building is built in accordance to the engineers specification & drawings & the structure fails, the engineer doesn't seem to have any responsibility financially to rectify the fault & again the cost burden falls upon the builder.

Prevention Not Recession

As we can see, Builders face many facets of risk. They must be prepared to work on low margins, with fixed overheads, take full responsibility & have no support when it comes to disputes.

Therefore if builders carry all this risk, is it fair that Insurance Companies should underpin builders with Indemnity Insurance?

The answer is simply “No”

Indemnity Insurance in its current form is a last resort after once the situation gets to point of no return. What we must look to achieve is for Builders to be solvent.

For this to be achieved we need to rethink the whole premise of Indemnity Insurance & abolish it from being a last resort rescue package to creating a Mutual Fund that assists

builders to understand their financial position better for them to trade their own way out of insolvency.

Mutual Fund

A Mutual Fund would be far more beneficial to the Housing Industry than Indemnity Insurance. The advantages of a State Based Mutual Fund run by the State Government through the Building Commission are -

- All Builders will contribute equally
- Monies will be kept in the Industry
- Removes private organization (Insurance Companies)
- Provides greater stability (IE. Insurers coming in & out of the market place)
- Standardize Fees
- Easier to set & standardize rules for all Builders
- Remove State Government from underpinning the industry

I do not believe the State Government should underpin an Industry in the event that things go horribly wrong. For the risk to be reduced, State Government needs to work much more closely with the Industry Bodies to address the many issues that affect builders.

Indemnity Insurance is a handout & it certainly doesn't cover anywhere near the costs that are required to pay out to trades & suppliers. State Government needs to ensure that Builders are getting a fair go & are given every opportunity to trade themselves out of insolvency so that no person is put out.

The monies from the Mutual Fund should be used to engage for example Business Brokers, to sit down with Builders to check through their business structure. This is a far less expensive alternative to the current system & makes the Builder responsible to resolve their situation.

How Will It Work

The Mutual Fund will work as follows –

1. State Government appoints & creates a new Ministerial position - The new Ministerial position to be named Minister for Housing & Housing Affordability. This Minister will be responsible to work with the industry & to implement all new regulations associated with the Building Industry & take certain sections of other Ministers portfolios that directly affect the Building Industry.
2. The Minister along with the Building Commission to be responsible for the implementation & legislation of a new Mutual Fund. Both parties are to work closely

with the Industry Bodies & members for their approval of any legislation prior to its release.

3. Builders & Owner Builders pay a standard fee, into the Mutual Fund based on a percentage of the contract works. Owner Builders under a new Mutual Fund will not be exempt from paying monies into the Mutual Fund. The percentage of contribution for Owner Builders will be twice that of a registered builder as they are a pose a higher risk than a qualified builder.
4. The monies are to be deposited into an investment portfolio that yields reasonable but safe returns.
5. Builders are to be audited every year or 2nd year
6. Builders are to appoint an executor to their business
7. Building Commission to be responsible for distribution of funds.
8. Mutual Fund to be underwritten by Insurance Company/Companies – By having an Insurer underwriting a Mutual Fund, it eliminates the risk of Insurers coming in & out of the market & reduces the risk to one Fund as opposed to several companies.
9. Turnover limits to remain – Builders will be provided with a turnover limit based on the same model as the current Indemnity Insurance Scheme
10. Building Commission to provide Industry Bodies with reports of the Mutual Fund. The Industry Bodies can then pass on information to their members to keep them updates
11. Legislation to be written to ensure the funds cannot be accessed for any other purpose than what they were originally deemed to be used for.
12. License Lending – If a Builder is found guilty of License Lending, 75% of the fine issued is to be contributed to the Mutual Fund for the consumer's protection of the 6 year warranty.

The funds are to be used in the following situations –

- **Death** - In the case of death, the Building Commission is to take an audit of the Builder/Owner Builder in question & to assist that Building Entity to complete all remaining works. The Mutual Fund is to be used to appoint an Auditor or a Business

Broker to work with the Executor to ensure that the Company can fulfil its duties to complete all remaining works.

If the Executor wishes to close the business after all works are completed, the Mutual Fund will reimburse those funds contributed by the Builder/Owner Builder for the specific works on the ground to also assist with the business trading out including the interest that those funds have matured.

In the event the Executor wishes to continue with the business, the Mutual Fund will be used to assist with the company's audit & ensuring they are capable of continuing to trade. If the Building Commission assess the company cannot trade after their initial audit, the Building Commission will force the completion of all works & the close of the business.

- **Insolvency Prevention** – Builders have an obligation & duty to ensure they complete all of their contract works. Under the current system, it is far too easy for a Builder to become insolvent with uncompleted works, only to have other builders tender on the remaining works. This becomes very unfair on the Builder that wins the tender, especially if the works have been completed to plate high, as the new Builder then must take on the responsibility of the 6 year structural warranty when they did not complete the major structure of the work to begin with.

To ensure that builders meet their obligations, a Mutual Fund can be used to assist & educate Builders to be self-reliant so that they can trade themselves out of insolvency. For example, the Mutual Fund will cover the cost of education & the audit plus be reimbursed 35% of the contributed funds to works still on ground to assist with Builders cash flow to meet their obligations to trades & suppliers.

This however does not apply automatically to everyone. Owner Builders & newly established builders trading less than 2 years are not entitled to assistance. These entities must show that they are financially capable prior to making any claims but must still contribute to the fund. These contributions will be utilized in the event of Death as outlined.

- **6 Year Structural Warranty** – The 6 Year Structural Warranty is probably the most complex item to provide a reasonable solution for. The issue being is that a Builder, whether dead or alive & no longer trading, is still responsible for the structural warranty of any structure they have built.

The problem with the structural warranty is in many cases, is the fault due to the Builder, Engineer or Ground Subsidence? After several years, it always become increasingly difficult to assess the cause of the structural damage & if it is found that the builder has built everything in accordance to engineers plans & all associated

regulations, it seems absurd that the fund or indemnity insurance should pay all associated cost or any costs towards repairs.

A solution to resolve this issue is to appoint an Administrator that oversees & assesses all Structural Warranty Claims. The Administrator will take the place of the insurance assessor & will provide a full assessment & report on any structural damage. If the Administrator finds that the Builder was at fault, they will approach the Building Commission to access the Mutual Fund for funds to repair the damages to a maximum sum of \$50,000.

If the Administrator finds that the Builder had completed all works in accordance to plans & regulations & the fault was due to a lack of engineering for instance, the Administrator is to then to provide a claim to the underwriting insurer to claim costs against those other parties & not utilize any of the Mutual Funds monies.

In the event that the Builder has built everything in accordance to plans, regulations & specifications & the structure has failed in the event of Ground Subsidence, the Administrator is to liaise with the underwriting insurer & negotiate for costs to be shared equally by the Insurer & Mutual Fund.

If we take a proactive approach to ensure Builders remain trading & reduce the risk that currently exists with the Indemnity Insurance Scheme, there would be far greater protection to consumers.

Eliminating red tape & large amount of bureaucratic systems & paperwork will enable to Builders to reduce their risk & ensure that Building Companies can remain open for trading & not put burden on Insurers or State Government to underpin the industry.

State Government's role is to look at the holistic issues of the Building Industry & to provide legislation that protects & assists Builders to allow them to get work on the ground in a reasonable time frame that does not burden them financially to reduce the risk of insolvency.

As part of this process, State Government is to discuss with all the sectors that are not directly related to the Building Industry but impact the costs & time frames to Builders (IE. Western Power, Water Corporation, Local Government, WAPC & other relevant Government Agencies etc) to improve their departments to reduce time frames & cost structures so not to burden Builders ability to get their works completed more efficiently.

For a Builder to remain solvent they must have the ability to process new works quickly & efficiently so not to burden them financially by paying their fixed overheads while waiting for several external departments to get their work completed. Builders are also required to pay many upfront costs prior to receiving any income.

The Benefits

The benefits of a proactive Mutual Fund as opposed to a reactive Indemnity Insurance Scheme, is to keep Builders trading.

The benefit of keeping Builders trading is significant as it allows people to keep jobs. Keeping people in jobs assists with the unemployment rate. It is cheaper for the State Government to assist the Building Industry by setting up a Mutual Fund that will assist with Builders than to pay unemployment benefits to those that lose their jobs. More significantly, if Builders remain trading it also assists with jobs to trades, suppliers & encourages manufacturing which again will produce jobs.

If the State Government also appointed a Minister that directly works with the Building Industry to address all the issues associated with process through to affordability, the outcome will see more investors come into the market place, which in turn creates work for the Building Industry & all associated with the Building Industry & will also provide an increase in revenue streams for The State Government, Local Government & Utility Companies.

The benefit of creating greater revenue for all concerned parties will enable the State Government to use funding wiser & assist in creating more affordable living especially to the inner city areas & reduce the amount of urban sprawl that puts pressure on State Government to provide increased infrastructure to these areas. If we concentrate on providing more high density living & allowing developments to be processed in much more efficient time frames, we will be able to create a far more sustainable economy as opposed to the boom & bust speculative economy we have endured for many years.

This can only be achieved if State Government becomes more proactive & looks to resolve & assist the Building Industry by appointing a Minister for Housing & Housing Affordability that will work with all parties concerned so that as an Industry, it all moves forward in the same direction to achieve the common goal for consumers by providing better service & price & eliminating many aspects of bureaucratic waste that we currently endure today.