NATIONAL INSURANCE BROKERS ASSOCIATION OF AUSTRALIA (NIBA)

SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY

INQUIRY INTO WESTERN AUSTRALIA'S HOME INDEMNITY INSURANCE ARRANGEMENTS

16 August 2012

ABOUT NIBA

NIBA is the voice of the insurance broking industry in Australia. NIBA represents 500 member firms and over 2000 individual Qualified Practising Insurance Brokers (QPIBs) throughout Australia.

Brokers handle almost 90% of the commercial insurance transacted in Australia, and play a major role in insurance distribution, handling an estimated $16 billion in premiums annually and placing around half of Australia's total insurance business. Insurance brokers also place substantial insurance business into overseas markets for large and special risks.

Over a number of years NIBA has been a driving force for change in the Australian insurance broking industry. It has supported financial services reforms, encouraged higher educational standards for insurance brokers and introduced a strong independently administered and monitored code of practice for members. The 500 member firms all hold an Australian financial services (AFS) licence under the Corporations Act that enables them to deal in or advise on Risk Insurance products.

ABOUT INSURANCE BROKERS

The traditional role of insurance brokers is to:

- assist customers to assess and manage their risks, and provide advice on what insurance is appropriate for the customer's needs;
- assist customers to arrange and acquire insurance; and
- assist the customer in relation to any claim that may be made by them under the insurance.

In doing the above the insurance broker acts on behalf of the customer as their agent. Insurance brokers offer many benefits to customers and consumers:

- assistance with selecting and arranging appropriate, tailored insurance policies and packages
- detailed technical expertise including knowledge of prices, terms and conditions, benefits and pitfalls of the wide range of insurance policies on the market;
- assistance in interpreting, arranging and completing insurance documentation;
- experience in predicting, managing and reducing risks; and

- Assistance with claims and a higher success rate with settlements (about 10 per cent higher than claims made without a broker).

In limited cases insurance brokers may act as agent of the insurer and not the insured. Where such a relationship exists the customer is clearly advised up front, before any business is transacted.

EXECUTIVE SUMMARY

NIBA is pleased to be able to make a submission to the Inquiry in Western Australia's Home Indemnity Insurance Arrangements.

NIBA submits that in order to thoroughly review the effectiveness and operation of home indemnity insurance in Western Australia, it is necessary to identify and articulate the public policy objectives for this insurance, and to examine the recent market experience to determine whether those objectives are met.

NIBA also submits that home indemnity insurance is part of a broader regulatory framework for the regulation of builders and home building. All aspects of the regulatory framework must be operating at maximum efficiency in order for the insurance components to operate in a cost effective manner for insurers, builders and, most importantly, home owners.

PRINCIPLES OF SOUND REGULATION

NIBA strongly agrees with the Productivity Commission commentary1 that "Regulation provides key foundations for a well-functioning economy. But regulation generally comes with costs as well as benefits for society."2

The Productivity Commission cites the Organisation for Economic Cooperation and Development's observation that "good" regulation should:

- Serve clearly identified policy goals, and be effective in achieving those goals
- Have a sound legal and empirical basis
- Produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account
- Minimise costs and market distortions
- Promote innovation through market incentives and goal-based approaches
- Be clear, simple, and practical for users
- Be consistent with other regulations and policies
- Be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels3.

1 This discussion is taken from commentary in the Productivity Commission Research Report Identifying and Evaluating Regulation Reforms, December 2011

2 Productivity Commission 2011, page 9

3 Productivity Commission 2011, page 10

Australian Governments have agreed that these principles are appropriate for this country, and have expressed this agreement in the COAG National Partnership Agreement to Deliver a Seamless National Economy.
Unfortunately, not all regulation complies with these core principles. In 2006 the Federal Government Regulation Taskforce identified five features of regulations that contribute to compliance burdens on business that are not justified by the intent of the regulation.

They are:

- Excessive coverage, including 'regulatory creep' – regulations that appear to influence more activity than originally intended or warranted, overly prescriptive, or where the reach of regulation impacting on business, including smaller businesses, has become more extensive over time.
- Regulation that is redundant – regulations that have become ineffective or unnecessary as circumstances have changed over time.
- Excessive reporting or recording requirements – multiple demands from different areas of government for similar information.
- Variation in definitions and reporting requirements –these variations can generate confusion and extra work for businesses than would otherwise be the case.
- Inconsistent and overlapping regulatory requirements – regulatory requirements that are inconsistently applied, or overlap with other requirements, either within governments or across jurisdictions.[4]

The Productivity Commission also notes the policy of the Australian Government to develop and publish a Regulatory Impact Statement for any new proposed regulation. This is important, because regulation can impose costs on the Government and on businesses directly affected by the regulations, and can also result in economic distortions and benefits being forgone through unintended consequences and other perverse effects[5]. NIBA believes it is important and appropriate that all Australian Governments adopt a similar approach when considering new regulatory or reviewing existing regulatory processes.

Where a comprehensive Regulatory Impact Statement has not been prepared or is not sufficiently comprehensive, Australian Government policy requires a Post Implementation Review, which is to be undertaken within one to two years of the regulations being implemented. Once again, NIBA believes it is important that all Australian Governments adopt a similar approach.

HOME INDEMNITY INSURANCE IN WESTERN AUSTRALIA

Home indemnity insurance forms part of a comprehensive regulatory process for the protection of home owners in Western Australia. That process includes –

- The registration and licensing of builders;
- A comprehensive system of building control under the Building Act 2011; and

4 Productivity Commission 2011, page xiv

5 For discussion of the need to properly assess the benefits and costs of regulation, see Productivity

- Mandatory home indemnity insurance for certain building work conducted in the State.

Home indemnity insurance provides protection for home owners in circumstances where the builder disappears, dies or becomes insolvent. The primary risk being insured is the risk of financial loss arising out of insolvency.

There are two key aspects that arise because of the nature of the insurance.

Firstly, the risk of insolvency should be diminished if the registration and licensing of builders only permits competent, qualified and well capitalized builders to operate in Western Australia. Hence, the effectiveness of the registration and licensing process is likely to have a direct on the nature of the home indemnity risk being insured, so that the more effect the process, the lower the risk and ultimately the lower the premium.

Conversely, if the registration and licensing process is not operating effectively, the risk of insolvency is likely to increase, and thereby place pressure on the level of claims and therefore the level of premiums.

It is essential, therefore, that any review of home indemnity insurance arrangements carefully examines the effectiveness of the builder registration and licensing process in order to ensure the ultimate risk being insured is managed and reduced as far as practicable.

The second aspect of the nature of the insurance is the impact it has on the underwriting process. Because an insurer is indemnifying the home owner against the insolvency of the builder, the insurer will want to examine the financial affairs of the builder, the capital backing available to ensure the ongoing viability of the builder's business, and the overall likelihood of insolvency or other default by the builder. This is a reasonably complex process, and one which needs to be undertaken on a case by case basis.

Fortunately, a very large proportion of home indemnity insurance is purchased by builders via their insurance broker. As noted at the start of this submission, the insurance broker will be familiar with the nature and operations of their client's business, and will be able to assist with the provision of the necessary information which will enable the insurer to assess the risk and determine an appropriate premium.

POLICY OBJECTIVES OF HOME INDEMNITY INSURANCE

As noted above, the key features of sound regulation require legislative intervention which will –

- Serve clearly identified policy goals, and be effective in achieving those goals
- Have a sound legal and empirical basis
- Produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account
- Minimise costs and market distortions.

NIBA respectfully submits that in order for a thorough review of home indemnity insurance arrangements to be undertaken, it is necessary for the Economic Regulation Authority to identify and confirm the public policy objectives of the home indemnity insurance requirements, and to undertake some analysis of the extent to which those objectives are being met.

The Issues Paper identifies the current arrangements as required by the Home Building Contracts Act 1991, but does not clearly articulate the public policy objectives the legislation is intended to achieve. Articulation of these objectives will be crucial in determining the extent to which changes should be made.

RESPONSE TO ISSUES PAPER

1. Operation of the Home Indemnity Insurance Market

An effective insurance market requires a clear statement of the risk being insured, and a capacity to underwrite the risk – in other words, to determine the correct price at which the risk is transferred from the builder to the insurer.

Insurers are required to support the business they underwrite with shareholder capital. In return for providing that capital, they require confidence that the operation of the business will give them an opportunity to provide a return on that capital to their shareholders, while meeting Australian Prudential Regulation Authority requirements that sufficient funds be held to meet the cost of expected claims.

If it is difficult to price the risk with confidence, it becomes less likely that the insurer will put their capital at risk by providing the insurance cover. If the insurer is reasonably confident that they can price the risk adequately, it is more likely they will participate in the business.

Insurers prefer an insurance market with a number of insurance companies providing cover, thereby providing the benefits of a measure of competition between the insurers. Even if the product itself (the indemnity insurance prescribed by the statute) is similar or even identical, insurers are still likely to compete on price and service.

NIBA notes that there is one inherent contradiction in relation to building companies and home indemnity insurance. On the one hand, builders may prefer to reduce the profitability of their companies, and to minimize the amount of capital invested and held in the business, for tax management purposes. On the other hand, insurers will wish to test the extent to which the builder might be strong and secure, and avoid the possibility of insolvency.

As noted above, cost effective home indemnity insurance requires a strong and effective builder registration and licensing regime, so that only strong, financially viable companies, are allowed to operate in the market.

2. Interstate Schemes

NIBA would strongly urge Western Australia NOT adopt the Queensland model of "first resort" insurance. The onus of quality work must be placed fairly and squarely on the builder, who should be made responsible for the work they perform. Serious moral hazard issues are likely to arise if this responsibility is able to be avoided.

3. Presence of other insurance companies

As noted above, the main impediment to insurers entering the market relates to their confidence in being able to achieve a commercial return on the capital they must invest in the business. NIBA prefers a competitive market with a number of insurance providers offering cover. NIBA respectfully suggests the Economic Regulation Authority have confidential discussions with leading Australian insurers in relation to their views regarding, and their readiness to enter, the Western Australian home indemnity insurance market.

4. Pricing of home indemnity insurance

NIBA accepts that insurers should have the opportunity to charge a premium they believe is commensurate with the risk they are insuring.

At the same time, NIBA notes that with a limited involvement by insurers, there is little effective competitive pressure in the Western Australian home indemnity insurance market. NIBA members have expressed concern that some premiums may be excessive in certain circumstances, and NIBA therefore again emphasizes the preference to have a greater number of insurers operating in this market.

Whether the cost of home indemnity insurance adds an unnecessary cost to the price of building a home will depend very much on the overall public policy objectives the legislation is trying to achieve. As noted above, any regulatory intervention should produce benefits that outweigh the costs. The benefits can only be tested against the public policy objectives of the legislation.

5. Risks to the State Government

From the information set out in the Issues Paper, it would appear that some of the insured risk is transferred from QBE Insurance to the State Government. Any risk transfer process needs to be fully understood and prudentially managed by the parties involved.

On the information available, NIBA is unable to comment on the extent to which the State Government is managing the risks it accepts. As noted above, the cost to the Government should be weighed against the benefits the arrangements provide to the Western Australian community.

6. Is the State adequately compensated for the risk it carries?

In the normal course of events, the State would charge a fee for the risk it carries and the security it provides. The cost of this charge would add to the ultimate cost of home indemnity insurance, so a careful balance needs to be taken in this regard.

As agents of their clients who take out home indemnity insurance, insurance brokers would argue that the cost be kept at a minimum.

7. Should the State continue to play a role in the market?

In order to address this question, NIBA respectfully submits it is necessary to –

- Determine and clearly state the public policy objectives of the legislation;
- Examine the experience to date in terms of the risk being underwritten, the claims being made, and the extent to which greater involvement in the market by new insurers can be achieved;
- Understand the risk appetite of current and potential new insurers in relation to the cover required by the legislation (ie the extent to which insurers are prepared to participate in the market, and the extent to which any market participant wishes to limit their claims cost exposure through reinsurance or other mechanisms);
- Understand the preparedness of reinsurers to support the home indemnity insurance market in Western Australia, and the likely cost of any such support;
- Determine the extent to which it is necessary for the State to be involved, bearing in mind the policy objectives, the amount of risk insurers are prepared to underwrite, and the ability of the private reinsurance to support the business – and the cost of any such support.

The Federal Government has recently conducted a further review of the Terrorism insurance scheme, administered by the Australian Reinsurance Pool Corporation. The review examined the matters that have been mentioned, and concluded that Government support for the scheme was desirable for a further three years, given the absence of affordable terrorism reinsurance on the world markets. That review is available at:

http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/Terrorism-Insurance-Act-Review-2012

8. Does the insurance provide the intended level of protection?

As noted above, it is only possible to answer this question after the public policy objectives of the scheme are identified and articulated, and the recent experience of the scheme is studied and understood.

9. Should home indemnity insurance remain mandatory?

NIBA suspects that if this type of cover becomes voluntary, there may be even less availability of cover in the insurance market. The issues identified in relation to question 9 therefore need to be discussed very carefully with insurers and other key stakeholders.

10. Is there a heavy red tape burden?

The nature of home indemnity insurance is such that underwriters require detailed financial information in order to assist the risk and price the cover they are providing to builders. Insurance brokers assist in this process, and report that the information being sought by insurers can sometimes be excessive, thereby possibly delaying the commencement of building until cover is in place.

11. 12. 13. Alternative regulatory regimes

NIBA respectfully submits that extreme care should be taken in relation to the introduction of alternative regulatory regimes.

For example, any move to a Fidelity Fund process would raise serious moral hazard issues, as the better and more secure builders (and their clients) would very quickly finding themselves paying the cost of the less well managed and less well capitalized competitors. This would have a detrimental impact on the building market in Western Australia.

Earlier in this submission NIBA noted strong concerns in relation to the potential move towards a "first resort" scheme. The Issues Paper notes there would be serious moral hazard risks with such an approach.

14. Ground Subsidence

Earlier in this submission, NIBA noted the elements needed for a strong and effective insurance market – the ability to define the risk, the ability to price the risk, and the ability to provide a commercial rate of return on the capital applied to the business. Any move towards the introduction of subsidence insurance would require a very careful examination of these issues by relevant experts.

NIBA looks forward to the opportunity to review and comment upon the Draft Report when it is published. If, in the meantime, the Authority would like to discuss any aspect of this submission, we would be pleased to do so.

Further contact can be made as follows:

Dallas Booth
Chief Executive Officer
National Insurance Brokers Association of Australia

Email: dbooth@niba.com.au
Telephone: (02) 9964 9400