



Government of **Western Australia**  
Department of **Treasury**

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Dear Mr Sarawat

**INQUIRY INTO WESTERN AUSTRALIA'S HOME INDEMNITY INSURANCE  
ARRANGEMENTS**

Please find enclosed a submission from the Department of Treasury in response to the Issues Paper on the Inquiry into Western Australia's Home Indemnity Insurance Arrangements, released on 5 July 2012.

If you have any queries please contact Jennifer Bryant, A/Director Economic Reform on 6551 2707.

Yours sincerely

  
Timothy Marney  
UNDER TREASURER

30 August 2012

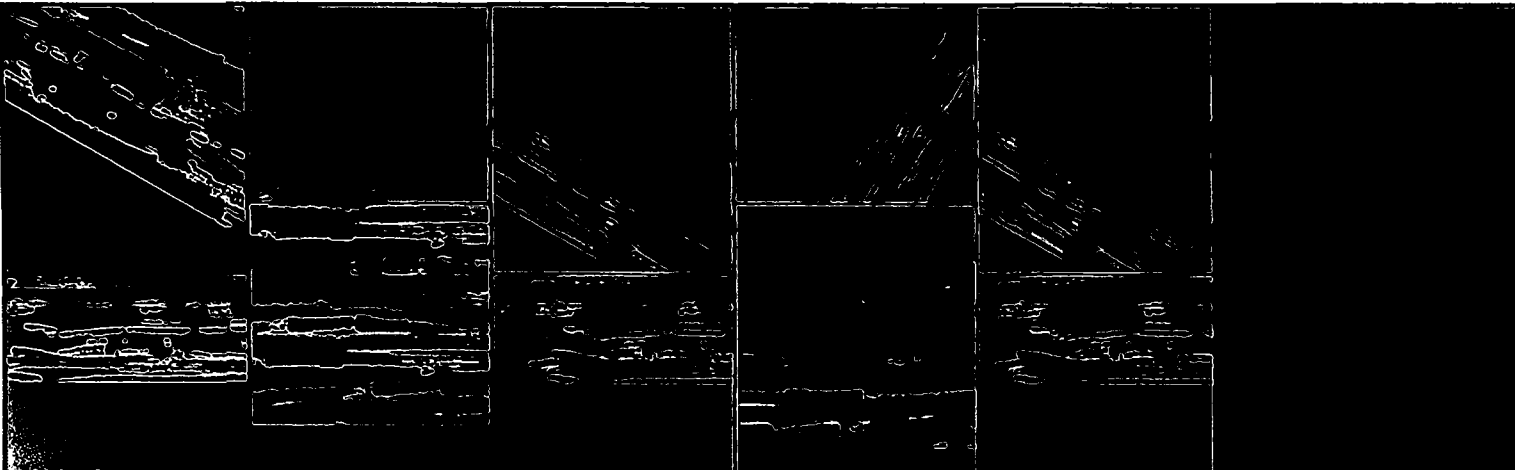


Government of Western Australia  
Department of Treasury

Department of Treasury's Submission to the  
**Economic Regulation  
Authority's Issues Paper  
on the Inquiry into  
Western Australia's  
Home Indemnity  
Insurance Arrangements**

August 2012

Economic



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## **Introduction**

Government intervenes in the Western Australian market for home indemnity insurance in two important ways. The primary intervention is through a requirement that builders hold home indemnity insurance before being able to undertake residential work above a specified value. The market failure rationale for this is to address the information asymmetry between builder and consumer, where the implications of builder default have potentially serious financial implications for home owners.

In addition, since the early 2000s, government has had a significant if indirect role in the home indemnity insurance market by indemnifying insurance providers for losses in specified circumstances or above specified amounts.

In this submission, some preliminary views on the costs, benefits and effectiveness of both forms of government involvement in the home indemnity insurance market are outlined. Some of the advantages and disadvantages of the alternative regulatory options proposed in the Issues Paper are also discussed.

## Assessing Western Australia's home indemnity insurance requirements

Mandatory home indemnity insurance requirements were introduced in 1996 to increase protection against financial loss for consumers who build or buy new homes or renovate existing homes. The scheme was intended to act "as a safety net to consumer complaints by way of a competitive system through private insurers".<sup>1</sup> Mandatory home indemnity insurance extended consumer protection measures already established under the *Home Building Contracts Act 1991* (the Act), which included improvements to housing contract requirements and dispute resolution mechanisms.

As noted in the Issues Paper, there have been changes to the scope of the home indemnity insurance scheme since it was introduced. In 2002, mandatory requirements for major developers were removed and builders who were members of an approved mutual fund were permitted to use financial cover of the fund in place of home indemnity insurance.

In assessing the merits of the current approach, the Economic Regulation Authority (ERA) needs first to determine the nature and significance of the underlying problem, and whether this, in itself, warrants government intervention. It also needs to determine how effective the current scheme is in addressing this problem.

However, making an assessment on the overall effectiveness of the current mandatory home indemnity insurance scheme is difficult because of a lack of public data on the incidence of builder insolvency, death or disappearance, associated costs for home owners, and claims against the scheme. The Building Commission, as the State's building regulator and administrator of the mandatory scheme, should be able to provide this data to the ERA.

Without a good understanding of the size and risk of the underlying issue, and the current coverage of the scheme, it is difficult to assess the key threshold issue for this Inquiry. That is, whether mandatory home indemnity insurance is an appropriate regulatory response.

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<sup>1</sup> Western Australia, Parliamentary Debates, Legislative Assembly, 27 June 1996, p. 3474 (Cheryl Edwardes).

The ERA's views on the risk and significance of builder default, death and disappearance are anticipated with interest. There are also a number of other issues that will need to be taken into consideration when assessing the overall effectiveness of the home indemnity insurance scheme, including:

- *how effective mandatory home indemnity insurance is in compensating consumers for loss in the event of builder default.* In reviews of home indemnity (or similar) schemes in other jurisdictions, issues have been raised regarding the difficulty in settling claims.
  - In 2012, it was reported in relation to Victoria's home indemnity insurance scheme that the average time from receiving a notification to a claim being finalised was 596 days.<sup>2</sup> Difficulties in progressing claims where a builder had ceased trading but was not technically insolvent may have contributed to these extended timeframes. In this scenario, a homeowner would need to instigate bankruptcy proceedings against the builder before an insurer would accept their claim.<sup>3</sup>
- *whether there is misunderstanding over the level of protection provided by home indemnity insurance.*<sup>4</sup> Evidence has been provided in other reviews that homeowners mistakenly expect the current home indemnity insurance arrangements to act as a first resort scheme or a dispute resolution channel when issues arise.<sup>5</sup>
  - This could lead to a situation similar to what might be described as 'moral hazard' - where a homeowner's motivation for due diligence in selecting a reliable builder is lessened in the belief that they will be indemnified for their loss.
- *the 'red tape' implications of mandatory home indemnity insurance.* In addition to paying premiums (direct costs), builders may also face significant administration and other indirect costs when complying with home indemnity insurance requirements.
  - Submissions to interstate inquiries indicate that some builders have been required to restructure their asset holdings or obtain bank guarantees in order to be approved for indemnity insurance.<sup>6</sup>

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<sup>2</sup> Essential Services Commission (2012), *Performance of Victoria's Domestic Building Insurance Scheme 2010-2011*, p. 32.

<sup>3</sup> Essential Services Commission (2012), p. 33.

<sup>4</sup> QBE Insurance (Australia) Ltd (2010), *Inquiry into Builders Warranty Insurance: Transcript of evidence*, p. 4.

<sup>5</sup> Legislative Council Standing Committee on Finance and Public Administration (2010), *Inquiry into Builders Warranty Insurance Final Report*, p. 27.

<sup>6</sup> Victorian Competitive and Efficiency Commission (2005), *Housing Regulation in Victoria: Building Better Outcomes*, October 2005, p. 210.

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- While direct costs would be expected to be passed on to homeowners and are likely to be relatively small in terms of the overall cost of a home, the regulatory compliance costs of the home indemnity insurance scheme are additional to a vast range of other regulatory obligations. These include, for example, building service provider registration, building permit applications and notice of completion. Given concerns in recent years over the impact of regulation on housing affordability, it is important to consider whether the State's home indemnity insurance scheme *unnecessarily* adds to the regulatory burden on the building industry.
- *whether the minimum value of work, maximum value payable and coverage periods specified in Western Australia's scheme are appropriate and meet the objectives of the Act.* As noted in the Issues Paper (Table 2.1) there is some variation in threshold values for home indemnity insurance schemes across jurisdictions. If the ERA were to recommend an ongoing mandatory scheme, it should also assess the appropriateness of the current thresholds.

## **Government intervention in the home indemnity insurance market**

Since the early 2000s, the Western Australian Government has been indirectly involved in the provision of home indemnity insurance by indemnifying insurance providers for losses in specified circumstances or above specified amounts. This type of intervention was not envisaged when the mandatory home indemnity insurance scheme was established; instead home indemnity insurance was intended to be provided competitively by private insurers without the assistance of government.

Most Australian jurisdictions have mandatory indemnity insurance requirements of some form and in all of these jurisdictions there is some type of government involvement underpinning the provision of insurance. A number of reasons have been cited for the inability of insurance companies to provide this product at an affordable price without government assistance. These include difficulty in obtaining reinsurance for home indemnity insurance and low profitability as a result of high claims and rising administration costs.

In 2010, Vero Insurance Ltd. (Vero) stated that its decision to withdraw from the market for home indemnity insurance nationally, was a result of the New South Wales Government's decision to take a greater role in the underwriting of insurance. Consequently, Vero considered that it had "no choice but to withdraw from the national home warranty market"<sup>7</sup> because it would not be sufficiently profitable without access to the New South Wales market. Vero's decision to exit the market followed the exit of CGU Insurance and Lumley Insurance in 2009.

There has been some debate as to whether government indemnification for insurers is required to address a fundamental market failure (the information asymmetry between builder and insurer) or is more of an equity measure (government involvement ensures that home indemnity insurance is provided at an affordable price).

Regardless of the underlying rationale, recent experience in Western Australia and in other jurisdictions suggests that if home indemnity insurance schemes are mandated (and as noted in the previous section, a threshold issue for the ERA to consider in this Inquiry is whether the mandatory requirement should be continued), some form of ongoing government intervention will be required to underpin the provision of insurance. However, ongoing participation in the home indemnity insurance market poses challenges for government and may have implications for the overall effectiveness of the regime.

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<sup>7</sup> Vero Insurance Limited (2010), *Vero to cease providing home warranty insurance*, Media Release, 3 February.



When Vero decided to exit the market in 2010, the government was placed in the difficult position of quickly having to find a replacement provider and negotiate entry, including the level of indemnity that government would need to provide. The process was administratively costly, as government agencies were required to devote time and resources to negotiating with replacement providers and investigating contingency arrangements. The situation also created uncertainty for the building industry, as there were concerns builders might need to delay residential construction activity until a new provider entered the market.<sup>8</sup>

While the State Government was successful in negotiating new arrangements, the level of indemnity provided increased following Vero's exit. If QBE Insurance Ltd. decides to withdraw from the market at the expiration of the current agreements in June 2013, there is the risk that the government would be in a similar position to 2010 (when Vero exited the market).

Government indemnifying potential losses of insurers above a threshold value also raises questions about the effectiveness of the consumer protection elements of the scheme. Under the home indemnity insurance scheme, insurers review builders' operations as part of the due diligence involved in issuing insurance. As noted in the Issues Paper, in offering home indemnity insurance, insurers must account for risks that are specific to individual builders and risks that are related to the building industry as a whole. Risks specific to builders include the financial position of the builder, the types of projects the builder is involved in and the quality of work of the builder.

There is a possibility that with government carrying much of the risk of builder failure in some instances, the incentive for insurers to undertake appropriate due diligence in these cases may be weakened. If this is the case, then some of the underlying consumer protection benefits of the scheme may be compromised. The Building Commission, as the administrator of the current home indemnity insurance arrangements, should be able to provide information to the ERA on the extent to which insurers are conducting appropriate due diligence and managing builder risk.

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<sup>8</sup> Treasurer's Reassurance for Home Buyers, ABC News, February 9, 2010, accessed July 28, 2012, <http://www.abc.net.au/news/2010-02-09/treasurers-reassurance-for-home-buyers/325128>.

## Assessment of alternative options

The preceding two sections have raised some issues associated with the current, or status quo, home indemnity insurance arrangements. The Issues Paper raises a number of potential options that could replace the current scheme for mandatory home indemnity insurance in Western Australia, including the establishment of a:

- voluntary home indemnity insurance scheme;
- fidelity fund;
- national home indemnity insurance scheme; or a
- separated insurance product.

Another option that may come up in this Inquiry is for government to provide insurance in-house, rather than underwriting private insurers. This is the approach taken in New South Wales, Victoria and Queensland. Part of this option could be to potentially outsource certain operational functions to an external insurance provider (or providers), as is done in New South Wales and Victoria, if it were found to be more cost-effective than setting up and operating these functions completely in-house.

Some preliminary views on the strengths and weaknesses of each option are outlined below.

If home indemnity insurance were to be introduced now, it would have to be assessed in accordance with the State Government's *Regulatory Impact Assessment Guidelines*,<sup>9</sup> which outline best practice in the assessment of new regulatory proposals ahead of a decision to introduce them. This process would require a clear and robust assessment of the problem to be addressed by new regulation and the costs and benefits of all feasible regulatory and non-regulatory options.

The starting position in the analysis is always 'no regulation'. Any proposal for new regulatory intervention is expected to be justified by clear evidence that the problem it will address is significantly large to warrant intervention, and that the costs of the intervention are outweighed by the benefits to society.

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<sup>9</sup> Department of Treasury and Finance (2010), *Regulatory Impact Assessment Guidelines for Western Australia*, p. 1.

Thus, a threshold issue is the significance of the problem addressed by home indemnity insurance and the effectiveness of the current mandatory scheme in addressing this problem. If the potential costs and risks to consumers from builders becoming insolvent, dying or disappearing and leaving behind incomplete or faulty building work are small overall, then having a specific consumer protection regime, especially a mandatory one, may not be warranted.

If a home indemnity insurance scheme was to be maintained, important considerations in the design of the scheme include:

- whether it offers first or last resort coverage;
- whether it should be delivered by government, the private sector, or both; and
- if private sector involvement in home indemnity insurance is to be retained, the appropriate risk-sharing, governance and accountability mechanisms, and returns to government for providing reinsurance.

## **Voluntary home indemnity insurance scheme**

This option involves making home indemnity insurance optional, by repealing the legislative provisions that require builders to take out home indemnity insurance. A voluntary scheme would mean that government would no longer play a role in underwriting the private provision of insurance, as private insurance would no longer be a prerequisite for a builder operating in the residential construction market. As indicated in the discussion above, the default option should be a voluntary scheme ('no regulation'), with the case for other options requiring a robust analysis showing that the benefits outweigh the costs.

The main strengths of this option include the:

- removal (over time) of government's ongoing contingent liability (as government would no longer indemnify private insurers);
- removal of costs and red tape on builders from having to obtain and hold insurance, and meet associated restrictions on their building portfolio to maintain their coverage;
- potential reduction in housing costs, as builders will no longer need to pass on insurance premiums to the consumer; and
- freedom for consumers to choose whether or not to purchase cover.

The main weaknesses of this option include the:

- potential gap in consumer protection if home indemnity insurance were not offered under a voluntary scheme, or if only the strongest builders take it out, as a point of brand differentiation, protecting mainly high-end consumers; and
- risk for government that if a major builder becomes insolvent, homebuyers that are affected are likely to look to government for assistance.

In practice, if Tasmania's experience is taken as a guide, there is likely to be limited or no private provision of home indemnity insurance unless it is mandatory. However, one or more of the building industry associations may offer it to their members as a tool for brand differentiation from uninsured competitors.

Other laws and legal processes already protect consumers in a variety of ways. Laws covering builder's registration, building work, dispute resolution, insolvency and generic consumer protection all act to protect consumers. A number of previous reviews<sup>10</sup> into this issue from other jurisdictions have indicated that (regardless of whether they recommended the retention of mandatory home indemnity insurance or not) significant gains to consumers would come from improvements to building registration and dispute resolution processes.

Improvements in building registration and dispute resolution systems (including changes to complaint mechanisms under the *Building Services (Complaint Resolution and Administration) Act 2011*) may alleviate at least some of the reduction in consumer protection from removing the mandatory requirement for home indemnity insurance.

### **A first resort scheme**

Under this option a consumer can trigger an insurance claim against a builder while the builder is still trading and available and, presumably, would include faulty workmanship (this is in addition to providing insurance for last resort issues, when a builder has died, disappeared or become insolvent).

As outlined by the ERA, under this option consumers would have greater ability to claim for recompense for incomplete or faulty work, but builders and consumers would potentially face higher costs as insurers charge larger premiums to cover the broader risks.

Queensland is the only jurisdiction in Australia operating a first resort scheme. Close analysis of the costs, benefits, and risks of that scheme, and how this would play out in Western Australia would be required before this could be considered a viable option.

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<sup>10</sup> Legislative Council Standing Committee on Finance and Public Administration (2010) p. 45-48; Productivity Commission (2008), Review of Australia's Consumer Policy Framework Inquiry Report, p.123-127.

## A fidelity fund scheme

The option raised in the Issues Paper involves establishing a fund based on contributions from industry to act as a 'safety net' for consumers and replace the current mandatory home indemnity insurance scheme. It is unclear how this would operate in practice, though it is likely that it would be funded through a levy attached to building approvals, and that the Building Commission and/or another government authority would manage the fund and deal with applications from consumers for assistance.

The main strengths of this option are that it would:

- not be dependent on the continued operation of insurance companies in the market;
- allow government to ensure consumers are protected in line with intended policy outcomes; and
- allow government to have greater control over the costs and risks it is exposed to than under the current model, in which private insurance is underwritten by government.

The main weaknesses of this option are that it:

- would require substantial funding from government or industry to initially establish a pool of funds and maintain viability in the early years of the fund's existence;
- may require larger ongoing contributions from industry (through levies) to maintain the fund, than under current insurance premiums;
- would need to establish who would contribute to the fund (for example, home owner or builder, noting builder participation in the market is not static).
- would be costly to establish and maintain the various administrative functions required to manage the fund and deal with claims. Administrative costs might include undertaking due diligence as a prerequisite to allowing a builder to be covered by the fund;
- is at risk of being decimated by a few large claims; and
- is at risk of being used for other purposes, exposing government to unfunded liabilities.

If the building industry remains stable (that is, with few insolvencies), a fidelity fund would continue to grow beyond any reasonable prudential requirement unless the contribution rate was reduced.

## **National housing indemnity insurance scheme**

One option proposed by the ERA was for the establishment of a national housing indemnity insurance scheme.

The most significant strengths of this model are the effect economies of scale could have on the viability of private insurers remaining in the home indemnity insurance market and potential downward pressure on insurance premiums.

A number of complicating factors in establishing a national scheme include the current inconsistency in building regulation across jurisdictions, and the differences in the makeup of the industry when compared across jurisdictions. A number of recent or proposed Council of Australian Governments' reforms to building industry regulation may address some of these issues, including the national construction code and national licensing of builders.

However, pursuing national reform is a costly and time-consuming exercise, and to pursue national reform in this area would require evidence that there is significant benefit to consumers, industry and governments from doing so.

## **Separation of the insurance product**

This option would have home indemnity insurance divided into two separate products, covering two separate risks:

- that a builder dies, becomes insolvent, or disappears after commencement, but prior to completion of relevant building work; or
- that a builder dies, becomes insolvent or disappears and that the work of that particular builder is found to be faulty during a period covering six years from completion of the building work.

The argument put forward by the ERA is that this might improve clarity for consumers on what they are covered for.

There may be benefit in separating these products if there were some choice offered to consumers on whether to purchase one or both of these coverage schemes. However, as long as both are mandatory, the benefit of separating these insurance types appears to be very small.

## **In-house provision of insurance**

This option would have government provide home indemnity insurance to builders without (or with limited) private sector involvement. It would be:

- underwritten and capitalised by government (thereby government would bear all of the risk);

## Department of Treasury's Submission to the

- funded by insurance premiums; and
- managed by a government body.

To manage the costs to government of this approach, one sub option could be for certain 'front desk' services (such as the issue of project certificates, collection of premiums and claims handling) to be administered by the private sector following a competitive tender process. This is the approach taken in New South Wales and Victoria.

Potential strengths of this option include:

- existing consumer benefits provided by the current home indemnity insurance scheme would be maintained;
- it would allow government to directly manage its costs and risk exposure; and
- it would not be dependent on the continued operation of insurance companies in the market.

Potential weaknesses of this model include the:

- capitalisation required to establish and operate the scheme is likely to be significant;
- administrative costs in establishing appropriate systems and staff expertise to manage the scheme could also be significant (though this could be managed by outsourcing particular functions to insurers); and
- it could expose government to a greater share of the risk from claims.

There would be significant administrative issues to be addressed in this option regardless of whether it was directly administered by government or whether certain functions were outsourced to a private insurer. If government were to administer it directly, there is the risk that without sufficient expertise, experience and resources it may not be able to adequately assess and manage the risks appropriately. However, there are also risks under an outsourced model that without appropriate governance and accountability mechanisms insurers acting as agents for government in administering the scheme may not conduct appropriate due diligence and other administrative functions.

