Draft Report - Inquiry into Western Australia's Home Indemnity Insurance Arrangements

4 April 2013

Economic Regulation Authority
WESTERN AUSTRALIA

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A full copy of this document is available from the Economic Regulation Authority website at www.erawa.com.au.

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Executive Summary

On 5 June 2012, the Treasurer of Western Australia gave written notice to the Economic Regulation Authority (**the Authority**) to undertake an inquiry into the effectiveness of Western Australia's home indemnity insurance arrangements. Among other things, the Terms of Reference require the Authority to give consideration to:

- the existing legislation regarding home indemnity insurance;
- whether there is an ongoing need for the mandatory provision of home indemnity insurance;
- alternative regulatory models that could be applied in Western Australia to replace or improve current arrangements, including the establishment of a fidelity fund; and
- whether there is scope, within home indemnity insurance arrangements, to address the costs to homeowners of damage caused by ground subsidence due to underlying geological causes rather than builder or developer default.

This Draft Report addresses these Terms of Reference. Its release follows the release of an Issues Paper on 5 July 2012. Ten public submissions were received in response to the Issues Paper. In addition, the Authority has consulted with numerous organisations in the building, insurance, government and consumer sectors in the preparation of this Draft Report.

To assist in the production of this Draft Report, the Authority engaged PWC to provide supporting technical and actuarial advice on the nature of markets for home indemnity insurance both in Western Australian and other Australian jurisdictions. This advice underpins some of the analysis contained in the report, though all key findings and conclusions are those of the Authority.

The Authority welcomes submissions on matters raised in this Draft Report. Section 1.3 of this Draft Report contains information on the process for making a submission.

Existing Home Indemnity Insurance Arrangements

In Western Australia, the provisions of the *Home Building Contracts Act 1991* (**the Act**) and its associated regulations make it mandatory for all home builders who build for another person to hold home indemnity insurance when the value of the project is above $20,000.

The insurance provides financial protection to consumers who incur losses due to the death, disappearance or insolvency of their builder, either during the period in which the construction is being undertaken or in the six years following completion of construction. Specifically, consumers are able to make a claim on the insurance for the following costs if they have been brought on by the death, disappearance or insolvency of their builder:

- loss of deposit – for which insurers will currently pay up to $20,000;
- incomplete construction – for which insurers will currently pay up to $100,000; and

- defects incurred within six years of completion of the house – for which insurers will currently pay up to $100,000.

Home indemnity insurance in Western Australia is currently offered by two private sector insurers, QBE and Calliden. In recent years, QBE has issued approximately 90 per cent of the total number of home indemnity insurance contracts written in Western Australia. Both companies are signatories to Heads of Agreements with the State Government. These agreements provide a broad framework for the provision of home indemnity insurance.

The terms contained in QBE's Heads of Agreement oblige the Government to accept QBE's cumulative liabilities that are between $10 million and $90 million if these liabilities arise from a single builder failure. In return for accepting this risk, the Government receives 10 per cent of the value of premiums written by QBE. Calliden has no risk-sharing arrangement with Government as it chooses to limit its potential liabilities arising from the failure of a single builder to less than $10 million.

The cost of construction of an average house in Western Australia is approximately $250,000. Based on current pricing structures of the insurers (as at March 2013), a premium for such a house is in the order of $1,000, which is equivalent to 0.4 per cent of the total cost of construction.

Over the period between July 2010 and January 2013, QBE and Calliden paid approximately 150 claims at an average value of approximately $40,000 per claim. Over 50 per cent of the claims paid have been triggered by builders failing to complete construction. Approximately 30 per cent of claims have been paid in instances of defective work and the remainder have been triggered by loss of deposit.

There have been no instances, over this same period, where the Government has been required to accept liabilities incurred by QBE. This is because QBE has not incurred liabilities in excess of $10 million arising from the collapse of a single builder.

Characteristics of the Housing Industry in Western Australia

In total, there are around 6,600 builders in the Western Australian residential building industry. However, of these, only 1,500 or so are considered to be active builders. The three largest builders in Western Australia account for 35 per cent of the market and the State's 20 largest builders account for 64 per cent of the market. By way of comparison, the market share of the 20 largest builders in other jurisdictions is:

- 24 per cent in New South Wales;
- 34 per cent in Victoria;
- 23 per cent in Queensland; and
- 34 per cent in South Australia.[1]

Compared to other industries, the building industry is highly cyclical both in terms of the number of houses constructed (approximately 17,000 per annum on average in Western Australia but with relatively large annual fluctuations) and in terms of builders entering and exiting the industry (referred to as turnover). The Authority estimates that the rate of

[1] Housing Industry Association, 2012, *HIA Housing 100 2011/12*.

turnover in the Western Australian building industry has ranged between 2.5 and 5.0 per cent between 2006/07 and 2010/11. This equates to an average of around 240 builders leaving the industry per annum.

The Case for Mandatory Home Indemnity Insurance

The existing mandatory requirement for builders to hold home indemnity insurance is a consumer protection measure that was introduced by the Government in 1997.

Generally, the Authority advocates against Government intervention in markets unless there is good reason. This is because Government intervention in any market inevitably involves costs and distorts the free and flexible functioning of markets. However, Government intervention in private markets may sometimes be justified in the case of market failures. Market failures can result in situations where private sector markets do not deliver outcomes that are efficient or optimal when considered from a whole of society perspective.

On consideration of the merits of Government intervention so as to make home indemnity insurance mandatory, the Authority found that there was sufficient evidence to justify a policy response. This conclusion is based on the findings below:

- *The large size of potential losses that may be incurred by consumers in the absence of insurance* – costs incurred due to loss of deposit, incomplete construction or defective work may typically be in the tens of thousands of dollars and very conceivably in excess of $100,000. Potential losses to consumers are most pronounced in cases where a builder fails to complete a house.

- *The limited ability of consumers to make reasonably informed decisions about the risks when entering into a building transaction* – due to a host of information asymmetries and complexities peculiar to the construction of houses, the Authority considers it can be very difficult for consumers to make informed decisions about both (i) the quality of construction of new houses and (ii) the likelihood of a builder dying, disappearing or becoming insolvent during the time between the receipt of a deposit and the completion of a house (and for a warranty period beyond completion).

- *The lack of availability of a market-based solution that consumers could reasonably access to protect themselves against the relevant risks* – there exists both empirical and theoretical evidence that indicates that, in the absence of Government intervention, the private sector would be unlikely to provide consumers with a reasonably accessible product that could provide protection against loss due to the risks of death, disappearance or insolvency of a builder with whom they have entered into a contract.[2]

The Authority considers that there is a case for some form of Government intervention to protect consumers against potential losses arising from the death, disappearance or insolvency of their builder. This intervention may be best provided through the regulated requirement for mandatory insurance. The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because

[2] This is primarily because of the small size of the market for insurers and the difficulties in estimating the relevant risks.

the losses incurred due to non-completion are potentially much greater than they are for defective work.

Evaluation of Existing Model of Home Indemnity Insurance

After reviewing the existing model of home indemnity insurance arrangements in Western Australia, the Authority concluded that it was not sufficiently capable of providing a long term and stable consumer protection mechanism. The model seeks to (and does) engage private sector insurers to provide insurance for consumers for losses incurred due to loss of deposit, incomplete work and defects. However, the model has not elicited a suitably competitive supply response from private insurers.

QBE currently accounts for about 90 per cent of the market and Calliden the remaining 10 per cent. Calliden has neither the financial capacity nor the risk appetite to fill the market gap that would arise were QBE to exit the market. The possibility of QBE exiting the market is a realistic one. Throughout the course of this inquiry, QBE has indicated to the Authority the difficulties that it faces in the provision of this product and provided data as to its lack of profitability.[3]

It would be inevitable that the State Government would be placed in an undesirable position if QBE were to exit the market for home indemnity insurance. New arrangements would need to be established rapidly to ensure that residential home construction could continue unimpeded. Past cases of insurers exiting the market demonstrate this point. In its report to the Authority, PWC comments on the "covered contract" arrangements that the Government implemented following the exit of Vero from the market:

> Covered contracts are home indemnity insurance contracts which were underwritten by a third party insurer but 100% underwritten by the State Government ie there is a full risk transfer to the State Government.
>
> Covered contracts were used to incentivise Calliden and QBE to quickly enter the market following the exit by Vero. Under the arrangement the State Government retained 55% of the premium.

While the existing model is not considered to be satisfactory to be able to provide a long term consumer protection mechanism, the Authority acknowledges that it may be inevitable for there to be a continuation of the current model in the short term during the transition to new arrangements. Given the timing of this review and the upcoming expiry (on 30 June 2013) of the existing Heads of Agreements, the Authority is not opposed to such a course of action as a short term measure though it does contend that some adjustments should be made to make the scheme more transparent and to enable the Government to receive a premium income that is commensurate with the risks that it bears.[4]

[3] South Australia is the only other jurisdiction in Australia that operates a similar model to Western Australia. The South Australian Government recently announced that QBE was withdrawing from the State's home indemnity insurance market as of 1 July 2013. Beyond this date, it is conceivable that the only market in which QBE will be providing and underwriting home indemnity insurance will be the Western Australian market.

[4] The Authority supports the PWC statement that: "if the scheme were to continue the distribution of premium should be altered to more accurately reflect the cost to the Government, its exposure and the capital required to be held to support the reinsurance exposure. This will result in an increased premium but limit the downside risk to the Government in the event of a major builder collapse. Currently the Government holds 39% of the total risk...but retains only 10% of the premium." See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 24.

The Nature of the Insurable Risks

In the course of undertaking this review, the Authority formed a view (guided by stakeholder insights, actuarial analysis and the analysis of principles of insurance) that home indemnity insurance as it is currently offered to consumers essentially comprises two distinct products.

The first product covers consumers for losses incurred prior to completion of construction of a house (that is, construction period insurance). The second product covers consumers for losses incurred in the six years following completion of a house (that is, warranty period insurance).

The two products are distinct when considered both from the perspective of the consumer and the perspective of insurers.

From a consumer perspective, the potential costs (both financial and emotional) incurred during the construction period due to the non-completion of a house tend to be significantly greater than the cost of defects incurred over the warranty period. Accordingly, the argument for the need for some type of mandatory consumer protection mechanism is stronger in the case of the construction period than it is for the warranty period.

From the perspective of insurers, there are a number of points to note. First, the estimation of risks requires a different methodological approach across the two different classes of product. Relative to the provision of construction period insurance, warranty period insurance is characterised by a more regular claims profile with (i) lower claims costs; (ii) more regular claim frequencies; and (iii) lower claims variability.

Second (and related to the first point), the nature of the risks for the two different products are different. In particular, potential losses that may arise in the provision of construction period insurance are greater than those for warranty period insurance. This has implications for the capital required by an insurer – a significantly greater value of capital reserves is required for construction period insurance than it is for warranty period insurance.

Third, the provision of warranty period insurance can be problematic for private sector insurers due to the “long tail” nature of the insurance. Under current arrangements, warranty period insurance stands for a period of six years following completion of a house. The “long tail” can make the estimation of appropriate premiums difficult but more so it limits the ability of insurers to determine the profitability of their product offering because the policies that they write stand for such a long period of time.

Two key conclusions are drawn from the above assessment:

- the appetite among private sector insurers for the provision of construction period insurance is likely to be greater than the provision of warranty period insurance (and indeed provision of both forms of insurance combined as is the case under present home indemnity insurance arrangements); and

- the provision of construction period insurance, with the potential for large losses and the corresponding need for high capital reserves, is better suited to private sector insurers with expert knowledge and access to capital reserves while the provision of warranty period insurance, with lower potential losses and a more stable claims profile, could be undertaken by parties other than private sector insurers.

The Authority's Recommended Model

The Authority recommends that the existing model be replaced by one which separates construction period coverage from warranty period coverage. Under this model, referred to as the *private with industry supplement model*, the Authority recommends that:

- private sector insurers provide insurance (with government reinsurance) to cover non-completion risks and that this portion of the insurance be mandatory such that builders are required to hold the appropriate insurance before commencing work; and

- the building industry (through the building industry associations) becomes the provider of warranty period insurance.

In this report the Authority identifies this model as being superior to eight other models that were considered using criteria such as stability, consumer choice, consumer protection, affordability, compliance costs and the extent of Government involvement (as a proxy for the costs and risks to Government). The Authority considers that the implementation of this model would deliver net benefits to the community.

Implementation Issues

Construction Period Insurance

The intent of the *private with industry supplement* model is to engage the private sector so as to access private sector efficiencies and expertise where sufficient private sector interest is considered to exist (that is, in the provision of coverage for non-completion risks).

The Authority expects there to be a reasonable level of interest by private sector insurers in the provision of insurance for the construction period alone. However, the Authority considers it unlikely that there will be scope for the Government to cease its current role as a provider of reinsurance. The prime reason for this is that the capital reserves required to be held by the insurers are large (given the potential for large losses arising from the collapse of one or more major builders) relative to the relatively small size of the market and the premium pool that it generates. The provision of Government reinsurance helps reduce the capital requirements and hence the opportunity costs incurred by the insurers in providing this product.[5]

The Authority is not opposed to a continuation of some form of Government reinsurance program as has existed in recent years provided that the Government is able to recoup an amount of premium revenue that is commensurate with the risks it bears. On this the Authority notes that it is estimated that, under existing arrangements, the Government currently retains approximately 39 per cent of the estimated maximum loss yet recoups only about 10 per cent of premium revenue.[6]

The Authority accepts that there would likely be an increase in total premiums paid by consumers if the Government were to recoup a share of the premium revenue that was reflective of the risks borne. However, the Authority considers it necessary that (i) the full

[5] Also noting that the Authority has been advised that there is no appetite among private reinsurers to provide a similar service.

[6] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.24.

costs of the insurance are passed to the consumers who stand to benefit from the insurance; and (ii) that the Government earn a revenue stream reflective of the potential losses that it may, at some point, incur.

Warranty Period Insurance

The design of warranty period component of the model is based on the premise that there is merit in the pursuit of industry self regulation where possible. On this, the Authority concurs with a finding put forward by a Commonwealth Self Regulation Taskforce (consisting of representatives from a range of industry and consumer groups):

> Industry self-regulation is increasingly being seen as an alternative means of promoting fair-trading, ethical conduct and streamlining compliance with agreed product and service standards in an industry. While industry self-regulation can advance consumer confidence in products and individual companies, it can also promote good business practice.
>
> [A self-regulation mechanism] is often more flexible and less costly for both business and consumers than direct government regulation. [7]

The Authority considers that the flexibility of a self regulation approach would deliver benefits to builders and consumers that could not be achieved through the implementation of alternative models. These benefits include:

- *Knowledge benefits* – by nature, building industry associations hold significant knowledge and understanding of the building industry and the practitioners that work within it. The Authority considers it advantageous to access this knowledge because it means that the warranty protection can be provided by the industry itself with the knowledge that is necessary to ensure disruptions and costs on builders (and hence ultimately consumers) are minimised.

- *Incentive benefits* – in a model where the building industry associations are the providers of warranty insurance (through the use of a fidelity fund for example) there is an inherent incentive to keep builder contributions as low as possible. This can be done by ensuring builders adhere to appropriate building standards and maintain appropriate business practices so that warranty claims are minimised. Building industry associations are well-placed to influence the behaviour of builders in these regards because of the close relationship and existing communication channels that exists between building industry associations and builders.

It is the view of the Authority that the warranty component of the insurance could be voluntary if it was demonstrated that there was sufficient interest from industry in providing a readily accessible form of insurance.

Under such a model, the building associations would impose a levy on their members such that they become parties to a fidelity fund. Consumers would then be free to choose their builders (in the absence of mandatory warranty provisions) with knowledge that builders who are registered members of an association would hold insurance while those builders who are not registered members would not.

On matters of implementation, the Authority holds the view that warranty insurance should only provide consumers with protection in the event that structural defects[8] (rather than

[7] Taskforce on Industry Self-Regulation, 2000, *Draft Report*, p. 15.

[8] The provision of insurance for structural defects only could be achieved by specifically defining the word structural as has been done in New South Wales in its Building Regulations: “a structural element, in

any defects) are encountered. Such an approach would minimise claims made (thus lowering costs for all) and would limit claims only to those instances where there is a strong case for the existence of a consumer protection mechanism. The Authority does not view warranty period protection as being a vehicle by which consumers should be able to claim for relatively minor and cosmetic defects, or defects brought on by "wear and tear".

Conclusions

If the existing home indemnity insurance arrangements were to continue such that both the main insurer and the Government were to recoup premium revenue in accordance with the distribution of risks, then aggregate premiums (for the construction and warranty period) would be likely to increase above current levels. The extent of the required premium increase is not clear at this point in time. However, the Authority considers that full Government compensation would not render home indemnity insurance unaffordable, noting that at present, premiums only account for about 0.4 per cent of the cost of constructing a new house.

Modelling by PWC indicates that actuarially fair premiums charged under a model such as that recommended by the Authority are broadly consistent with premiums charged under the existing model with full Government compensation. Ultimate premium outcomes under the Authority's recommended model cannot be known with certainty due to the following variables:

- the degree to which other private insurers enter the market under the proposed model or the degree to which existing insurers reallocate capital given the changes;
- the response by insurers to potential negotiations on the risks and premium sharing arrangement; and
- the approach taken by industry in providing warranty protection (including the length of the warranty period, the maximum payout limits, and the degree to which a profit is pursued).

Ground Subsidence

The Authority does not recommend a broadening of the State's home indemnity insurance arrangements to include coverage for costs incurred by consumers due to instances of no fault ground subsidence.

The Authority undertook extensive research and stakeholder consultation to identify known cases of subsidence damage to houses in Western Australia. Through research and stakeholder consultation undertaken as part of this inquiry, the Authority was made aware of only five cases (each occurring within the past five years) in which no fault subsidence has caused significant damage to houses in Western Australia.

There are no formal mechanisms for protecting or compensating consumers affected by 'no fault' ground subsidence in Western Australia. However, there have been instances of the Western Australian Government providing ex gratia payments to home owners affected by subsidence on an ad hoc basis.

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relation to a building, means a component or part of an assembly which provides necessary supporting structure to the whole or any part of the building." See, *NSW Home Building Regulation 2004*.

Based on available information, the Authority considers that it is unlikely that the inclusion of subsidence damage cover in home indemnity insurance arrangements would deliver net benefits to the community. The reasons behind this conclusion include the following:

- The nature of the risks relevant to home indemnity insurance (being builder collapse and the occurrence of defects) are completely different to those that would be relevant to some form of no fault subsidence scheme (being poorly understood geological factors). Given this disparity of risks, the Authority can see no reason to bundle the two products together.

- Related to the above is that private insurers are unwilling to provide no fault subsidence insurance. Attempting to include subsidence coverage would limit the ability to engage the private sector in a privately run home indemnity insurance scheme.

- The ability to protect consumers from the costs of no fault subsidence damage via a home indemnity insurance mechanism is highly limited as home indemnity insurance is only relevant to new dwellings whereas all dwellings are susceptible to damage from subsidence. In 2011, new homes constructed accounted for only 2.5 per cent of the State's stock of separate houses.

- Given the limited number of cases of no fault subsidence resulting in significant damage costs, it is unlikely that the benefits associated with including subsidence cover in home indemnity insurance arrangements would exceed the costs.[9] These costs would include administration costs associated with drafting the appropriate legislation; compliance costs on builders and consumers in adhering to the regulations; and transition costs incurred by insurers in coming to terms with the new regulations and gaining an ability to ascertain subsidence risks. These latter costs would inevitably be passed on to consumers.

The Authority considered a range of alternative consumer protection mechanisms including a requirement for builders to provide warranty protection, a fidelity fund, and a mandatory government levy but determined that each of these mechanisms would be costly to implement and would only be able to deliver very limited benefits to the community.

Due to the potential for large individual losses and the inability of consumers to protect themselves the Authority is not averse to a continuation of the current approach of informal ex gratia payments by the Government to consumers.

[9] Noting that the benefits of such an approach are even more limited if it is considered that they would only be attributable to owners of newly constructed houses that incurred significant subsidence damage as it would only be newly constructed houses that are covered under a model where subsidence cover is provided through home indemnity insurance.

1 Introduction

The Treasurer of Western Australia has given written notice to the Economic Regulation Authority (**the Authority**) to undertake an inquiry into Western Australia's home indemnity insurance arrangements.

The inquiry has been referred to the Authority under section 38(1)(a) of the *Economic Regulation Authority Act 2003*, which provides for the Treasurer to refer to the Authority inquiries on any matter relating to an industry that is not a regulated industry.

1.1 Terms of Reference

The Terms of Reference for the inquiry, which are presented in **Appendix 1**, require the Authority to have regard to the following:

- how Part 3A of the *Home Building Contracts Act 1991* operates, including measures taken by the State Government to underwrite the private provision of home indemnity insurance since the Act was amended in 2002;
- whether there is an ongoing need for the mandatory provisions of home indemnity insurance;
- alternative models that could be applied in Western Australia to replace or improve current arrangements, including the establishment of a fidelity fund; and
- whether the scope of the State's home indemnity insurance arrangements, or whichever model is recommended, should also address the costs to homeowners of damage caused by ground subsidence due to underlying geological causes rather than builder or developer default.

The Terms of Reference also require the Authority to consider:

- red tape burdens on the insurance and building industries;
- possible implications for home affordability; and
- costs and financial risks to the Government.

1.2 Review Process

In addition to the Authority's own internal research and analysis, the findings of this inquiry have been informed by a public consultation process and the receipt of technical advice from actuarial consultants engaged by the Authority.[10]

On the review and consultation process, the Authority notes that:

- An Issues Paper was published on 5 July 2012 on which submissions were sought from stakeholder groups, industry, Government and the general community. The due date for submissions was 16 August 2012.

[10] The Authority engaged PWC to provide supporting technical and actuarial advice on the nature of markets for home indemnity insurance both in Western Australian and other Australian jurisdictions. This advice underpins some of the analysis contained in the report, though all key findings and conclusions are those of the Authority. The PWC report is available on the Authority's website.

- Ten public submissions were received in response to the Issues Paper, which are published on the Authority's website.
- Following consideration of submissions, the Authority has developed this Draft Report. Public submissions on the Draft Report are invited on 13 May 2013 (see section 1.3 below on how to make a submission).
- The Final Report for the inquiry is to be delivered to the Treasurer by 28 June 2013 and the Treasurer will, in accordance with the *Economic Regulation Authority Act 2003*, have 28 days to table the report in Parliament.

1.3 How to Make a Submission

Submissions on any matter raised in this Draft Report or in response to any matters in the Terms of Reference should be in both written and electronic form (where possible) and addressed to:

Inquiry into Western Australia's Home Indemnity Insurance Arrangements
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Email: publicsubmissions@erawa.com.au
Fax: (08) 6557 7999

Submissions must be received by 4:00pm (WST) on 13 May 2013.

Submissions made to the Authority will be treated as in the public domain and placed on the Authority's website unless confidentiality is claimed. The submission or parts of the submission in relation to which confidentiality is claimed should be clearly marked. Any claim of confidentiality will be dealt with in the same way as is provided for in section 55 of the *Economic Regulation Authority Act 2003*.

The receipt and publication of a submission shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, where the submission in whole or part contains information of a confidential nature and no duty of confidence will arise for the Authority in these circumstances.

Further information regarding this inquiry can be obtained from:

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2 Home Indemnity Insurance in Western Australia

This chapter contains a discussion of the history of home insurance regulations in Western Australia and concludes with a summary of the existing arrangements and a brief comparison of the existing arrangements with home indemnity insurance arrangements in other jurisdictions.

2.1 Overview

In Western Australia, the provisions of the *Home Building Contracts Act 1991* (**the Act**) and the associated regulations[11] make it mandatory for all home builders who build for another person (the consumer) to hold home indemnity insurance if the value of the project is above $20,000.[12] This mandatory obligation is given effect through Part 3A Section 25C of the Act, which dictates that:

> *(1) A builder must not perform residential building work to which this Division applies unless –*
>
> *(a) a policy of insurance that complies with this Division is in force in relation to the residential building work; or*
>
> *(b) corresponding cover is provided by an approved fund in relation to the residential building work.*[13]

The Act goes on in Section 25D to specify the type of insurance required. Specifically, the insurance must provide the new home purchaser with insurance against:

> *(i) the risk of losing an amount paid by way of deposit under the residential building work contract, up to a limit of $13,000 or such other limit as is prescribed;*[14] *and*
>
> *(ii) the risk of loss, other than indirect, incidental or consequential loss, resulting from non-completion of the residential building work,*
>
> *by reason of the insolvency or death of the builder or by reason of the fact that, after due search and enquiry, the builder cannot be found.*

The insurance is also required to cover new home purchasers against loss resulting from faulty workmanship in instances where the builder is unavailable due to death, disappearance or insolvency. This element of the insurance cover is required to stand for a period of six years from the day of practical completion of a new home.[15]

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[11] The *Home Building Contracts (Home Indemnity Insurance Exemptions) Regulations 2002.*

[12] Provisions of the Act relating to insurance are not applicable to owner builders or to multi-storey, multi-unit developments.

[13] The Authority is not aware of an approved fund being used to provide home indemnity insurance in Western Australia.

[14] The actual limit to the amount paid in the event of a lost deposit is $20,000 rather than $13,000. While the Act states that the limit is $13,000, Schedule 1 of the *Home Building Contracts Regulations 1992* states that a limit of up to $20,000 may be paid to a consumer for loss of deposit.

[15] "*Practical completion"* means brought to the stage where the home building work is completed except for any omissions or defects which do not prevent the home building work from being reasonably capable of being used for its intended purpose." *(See: Home Building Contracts Act 1991.)*

The home indemnity insurance provisions of the Act offer consumers with 'last resort' cover.[16] This means that if a builder is still trading, statutory protection is afforded under provisions of the building contract that is held between the consumer and the home builder. In the event of a dispute, consumers must first pursue claims with their builder if their builder is available.[17] Home indemnity insurance can only be triggered in the joint events of death, disappearance or insolvency of a builder; and incomplete or defective building work.

The insurance held by builders must provide for cover for the lesser of –

(i) at least $100,000 or such other amount as is prescribed; or

(ii) the cost of the building work.

In summary, the home indemnity insurance provisions of the Act provide consumers with protection against the risk of loss in the event of insolvency, death, or disappearance of their home builder. The risks that are covered by the home indemnity insurance provisions of the Act and its associated regulations include:

- the risk of losing a deposit (up to $20,000) paid under a building contract;
- the risk of loss resulting from non-completion of residential building work; and
- the risk of incurring building remedy costs during a six year period following completion of the house.

The Act is currently administered by the Building Commission[18] and prior to that it was administered by the Department of Consumer and Employment Protection. Enforcement of the Act is provided by relevant local government authorities as they have the responsibility of approving building applications, and in the process, ensuring that builders hold appropriate insurance.

The sections of the current form of the Act stipulating the mandatory requirements for home indemnity insurance came into effect in 1997 after the *Home Building Contracts Amendment Act 1996* was enacted. Prior to this a voluntary home indemnity insurance scheme operated in Western Australia. The voluntary scheme had been established by private sector insurers after encouragement from some parts of the home building industry.[19]

The Second Reading in Parliament of the *Home Building Contracts Amendment Bill* provides the objectives for the introduction of mandatory home indemnity insurance:

> This Bill will protect the customers of builders, and the purchasers of homes – including owner built homes – sold within the six year statutory warranty period. Protection will be provided against financial loss as a result of death, disappearance

[16] In contrast, 'first resort' insurance does not depend on the triggers of death, disappearance or insolvency. Under a first resort scheme consumers are provided cover for building defects irrespective of whether the builder is available or not.

[17] As is discussed later in this report, there is a host of regulation that relates to dispute resolution procedures that are activated in situations where a builder is still available.

[18] The Building Commission forms part of the Department of Commerce and its roles include licensing building service providers, investigating and prosecuting for offences against building laws, providing a dispute resolution services and setting standards for building.

[19] Department of Consumer and Employment Protection, 2004, *Report on the Statutory Review of the Home Indemnity Insurance Scheme in Western Australia*, p. 2.

or insolvency of the builder or owner-builder during the construction period or the statutory warranty period.[20]

2.2 Exemptions

The Act and its associated regulations[21] dictate that there are a number of situations for which home indemnity insurance is not required:

- owner builders are not required to have home indemnity insurance unless an owner-built property is sold within seven years of the date of issue of the relevant building licence;[22]
- in cases where work is undertaken that is not in connection with an existing structure or building (for example, stand alone swimming pools, garages, sheds and driveways);
- if the value of work is less than $20,000;
- for the construction of multi-storey, multi-unit developments with three or more stories; and
- in the construction of leased retirement villages.

2.3 Home Indemnity Insurance in Practice

2.3.1 The Builder and Consumer

To obtain home indemnity insurance cover, a builder will contact an insurance company (often via a broker).[23] The insurance company will review the credentials of the builder and determine if they are eligible for insurance. Eligible builders are granted a 'pre-qualified' status from their insurer. Typically 'pre-qualified' status will apply to a builder for one year. Essentially this means that if a builder secures a contract to build during that year then he or she will be able to obtain insurance in relation to that particular building after forwarding the relevant details to the insurer. As part of the pre-qualification process, the insurer will make a judgement about the riskiness of the builder and then determine premiums accordingly. The higher the perceived risk of the builder the higher will be the rate of premium charged.

Under the existing home indemnity insurance arrangements in Western Australia, the builder is responsible for ensuring that an insurance policy is in place, yet it is the consumer who is protected by the cover afforded by the insurance policy. It follows that it is almost inevitably the case that the insurance costs are passed to the consumer.

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[20] Department of Consumer and Employment Protection, 2004, *Report on the Statutory Review of the Home Indemnity Insurance Scheme in Western Australia*, p. 4.

[21] *Home Building Contracts (Home Indemnity Insurance Exemptions) Regulations 2002*.

[22] Under existing regulations, an owner builder is not required to hold home indemnity insurance to construct a house. However, if that house is sold within seven years of the date of issue of the building licence then the owner builder will be required to purchase home indemnity insurance prior to the sale of the house. In this way the purchased insurance will provide protection to the new owner of the house should the owner builder die, disappear or become insolvent. See, QBE, 2008, *Domestic Construction Insurance Policy, Owner Builders Western Australia*.

[23] Insurance brokers assist clients to compare, review and get prices for insurance products and are common in most insurance markets.

Premiums (inclusive of GST and charges) in Western Australia range from about $250 to $3,850 per contract. Premiums are dependent on the perceived "riskiness" of the relevant builder and the relevant contract value.

The intent of the home indemnity insurance provisions of the Act is to protect the consumer for financial loss incurred as a result of:

- a house being left incomplete due to the death, disappearance or insolvency of builder; and
- a defect being incurred within a period spanning six years from completion of construction and the builder being unavailable due to death, disappearance or insolvency.[24]

In the event of an incomplete house, it is important to note that a consumer should, under the requirements of the *Home Building Contracts Act 1991*, have only paid the builder for work completed; and therefore not be immediately out of pocket following the death, disappearance or insolvency of a builder. However, there will typically be additional costs involved in securing a second builder to complete the house. These costs will typically relate to the second builder checking the existing work for quality, redoing existing work where necessary and taking on the liability risks that come with the decision to complete the house. The insurance cover afforded to the consumer under the existing home indemnity insurance arrangements is intended to compensate consumers for the additional costs incurred as a result of having a second builder complete construction rather than for the total costs of constructing a new home.[25]

2.3.2 The Insurer

Providers of home indemnity insurance must determine appropriate premiums to cover themselves for the events that they are insuring against. Broadly, there are two events that home indemnity insurance provides cover for:

(i) the event where a builder dies, becomes insolvent or disappears after commencement but prior to completion of relevant building work; and

(ii) the event where 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 pricing of premiums to cover these events requires insurers to consider, for event (i) the financial position of builders (to account for the likelihood of insolvency) and the likelihood of death or disappearance during the construction period. For event (ii) the financial position of builders and the likelihood of death or disappearance must also be considered but over a much longer timeframe (six years) and these events must be considered in conjunction with the likelihood of poor quality workmanship eventuating over that period.

In offering home indemnity insurance, providers must account for risks that are specific to individual builders and risks that are related to the building market as a whole. Risks that are specific to individual builders include:

[24] The six year defect period for home indemnity insurance matches the six year statutory warranty period for which builders are liable provided that they are still available. Under the provisions of the *Home Building Contracts Act 1991*.

[25] Under the Act, the insurance cover held by the builder must provide the consumer with at least $100,000 worth of cover. In practice, no insurer in Western Australia offers cover of more than $100,000.

- *the financial position (current and historic) of the builder* – all else being equal, a builder with a precarious financial position has a greater chance of becoming insolvent than one that is in sound financial position;

- *the type of project* – some types of projects may be assessed as being riskier than others, for example non-structural work is not normally as risky as structural work;

- *the quality of work of a builder* – a builder with a greater degree of technical competency is likely to generate fewer claims than one with a lesser degree of competency; and

- *the risks of death or disappearance of the builder*.

Market-based risks are those risks that apply to the building industry as a whole. These include:

- *the domestic building market* – a downturn in domestic building activity could lead to a rise in builder insolvencies;

- *the availability of credit* – builders often use credit to manage cash flows so a tightening of creditor requirements could push some builders towards insolvencies; and

- *the cost of materials* – an increase in the cost of materials can affect both costs to the builder and costs to insurers in paying out claims.[26]

Providers of home indemnity insurance must consider the risks over the six year statutory warranty period that commences following the completion of construction. This risk must be assessed and priced prior to the commencement of construction.

2.4 Triggering a Claim

In a case of incomplete or defective work a consumer is able to trigger a claim under existing home indemnity insurance arrangements by establishing either the occurrence of death, disappearance or insolvency of their builder. It is the responsibility of the consumer to establish the occurrence of either of these events.

Relevant proof of death is required to be provided to the insurer in the event of a builder death. In an event of disappearance the consumer is required by the Act to conduct “due search and inquiry”. The Act does not stipulate exactly what “due search and inquiry” entails but from past cases it can be ascertained that meaningful attempts to contact the builder by phone and mail are required in the first instance. An insurer will usually undertake its own search for a builder after having received notification of a claim being made due to disappearance.[27]

For an insolvency claim to be triggered, a builder must be listed as ‘under external administration’ or ‘controller appointed’ on the website of the Australian Securities and Investment Commission. Such an outcome can eventuate as the result of voluntary action taken by a builder or as a result of a court order. The Authority is aware that in some

[26] The Essential Services Commission, 2012, *Performance of Victoria’s Domestic Building Insurance Scheme 2010-2011*, p. 9.

[27] The Economic Regulation Authority, November 2012, Consultation with the Building Commission, Department of Commerce.

situations it can be costly for a consumer to pursue a builder in court in an attempt to establish insolvency.[28]

On receipt of a claim an insurance company is likely to send an assessor to the relevant site so as to determine relevant costs. Consumers are usually charged an excess of $500 for each claim made.[29]

2.5 Other Consumer Protection and Dispute Resolution Mechanisms

The *Building Services (Complaint Resolution and Administration) Act 2011* and the *Home Buildings Contracts Act 1991* provide a framework for consumers to pursue disputes with their builder if that builder is still trading and available (that is, has not died, disappeared or become insolvent). The dispute resolution procedures contained in the two Acts are administered by the Building Commission.

The provisions of the two Acts enable consumers to lodge a complaint against a builder if they have encountered either a breach of contract (for which protection is provided in the *Home Buildings Contracts Act 1991*) or defective building work (for which protection is provided in the *Building Services (Complaint Resolution and Administration) Act 2011*).[30] Complaints are able to be made at any point from the signing of a contract to six years after the completion of a house.

On the matter of breaches of contract, Part 3, Section 17 of the *Home Building Contract Act 1991* states:

> *If an owner or builder under a contract claims that -*
>
> *(a) there has been a breach of -*
>
> *(i) the contract, not being a breach in respect of which a building remedy order may be made under the Building Services (Complaint Resolution and Administration) Act 2011; or*
>
> *(ii) a provision in Part 2;*[31] *or*
>
> *(b) the owner or builder is entitled to compensation under Schedule 1;*[32]
>
> *then, subject to the Building Services (Complaint Resolution and Administration) Act 2011, the owner or builder may make a complaint* [to the Building Commissioner] *under section 5(2) of that Act.*

On the matter of defective work, Part 2, Section 5(1) of the *Building Services (Complaint Resolution and Administration) Act 2011* states that:

[28] This issue is considered in more detail later in the report. As home indemnity insurance is a consumer protection measure it is important to ensure that consumers stand to incur net benefits in instances where valid claims are made.

[29] The Economic Regulation Authority, November 2012, Consultation with the Building Commission, Department of Commerce.

[30] Similarly, builders are able to lodge complaints against consumers.

[31] Part 2 outlines the legal requirements of home building works contracts.

[32] Schedule 1 outlines the consequences for non fulfilment of conditions.

> *a person may make a complaint to the Building Commissioner about a regulated building service not being carried out in a proper and proficient manner or being faulty or unsatisfactory.*

Part 2, Section 6(1) provides consumers with an ability to make a complaint within six years of completion of a house:

> *A building service complaint is made out of time if the complaint is made more than 6 years after the completion of the regulated building service to which the complaint relates.*

Complaints that have been lodged with the Building Commission may trigger one of the following courses of action:

- the parties to the complaint can be ordered to engage in conciliation with a third party;
- an interim disciplinary order can be invoked having the effect of immediately rescinding the licence (and hence ability to work) of the builder against whom the complaint is made;
- a building remedy order can be granted requiring the builder to fix the problem;
- an order to pay can be granted requiring appropriate payment to the consumer (up to $100,000) so that the problem can be fixed;
- complex and intractable disputes can be referred to the State Administrative Tribunal for final judgement; or
- the complaint can be dismissed on grounds that it is factitious or somehow incorrect.

In 2010/11, the Building Commission received 545 complaints against registered builders, the majority of which were to do with issues surrounding workmanship.[33] As a result of these complaints, builders were ordered to pay about $2 million to consumers. In approximate terms there was one complaint made against a registered builder for every 38 dwelling units approved in 2010/11.[34]

2.6 A Brief History of Home Indemnity Insurance in Western Australia

The voluntary home indemnity insurance scheme that existed in Western Australia prior to 1997 informally commenced sometime during the 1980s.[35] The motivation to shift to a legislated and mandatory scheme can be traced back to consumer groups who, at the

[33] Some complaints made are based on contractual matters.

[34] Building Commission (Builders' Registration Board), 2011, *2010/11 Annual Report*, pp. 24-27.

[35] Mamutil, J, 2004, *Home Warranty Insurance – Building a Stable Regulatory Regime*, Australian and New Zealand Institute of Insurance and Finance Journal, Vol. 27, No.2, p. 19.

time, argued for an increase in consumer protection.[36] Initially, two insurers, HIH and FAI, provided insurance under the newly mandated scheme.[37]

The State Government proposed amendments to home building legislation to make it compulsory for builders to have indemnity insurance before building new homes or undertaking major renovations or extensions.[38] This decision was made following advice from the Ministry of Fair Trading that existing voluntary indemnity schemes covered only 44 per cent of new homes and extensions. The Ministry of Fair Trading said the proposal for compulsory indemnity insurance had the support of major industry bodies and consumer groups. This initiative was also a pre-election commitment and followed trends around Australia towards compulsory cover prescribed in legislation and provided by the private sector.[39]

In November 1999, the Ministry of Fair Trading commenced a public statutory review of the home indemnity insurance scheme.[40] This review was undertaken because of a condition contained within section 25H of the Act that the Minister should carry out a review of the operation and effectiveness of the home indemnity insurance provisions as soon as practicable after the expiration of two years from their commencement. At that time, there were four insurance brokers who were approved to issue home indemnity policies under the Act. The brokers represented eight underwriting insurers.

In March 2001, prior to completion of the review, both HIH and FAI were placed into liquidation. Given these events, the review explored the need for change to the home indemnity insurance arrangements so that the building industry could continue to operate effectively. On completion of the review, the Western Australian Minister for Fair Trading affirmed the Western Australian Government's commitment to a compulsory home indemnity insurance scheme whereby the insurance was provided by private sector insurers. The Minister announced an intention to:

- consider legislative changes to enable discretionary mutual schemes to be developed on the basis of providing genuine competition to the private insurers but without any Government subsidisation;
- provide for temporary suspension of the requirement for warranty insurance if cover should become unavailable in the market in the future; and
- work to attract new insurers into the market.[41]

The collapse of HIH and FAI, who together accounted for about 40 per cent of the market, created difficulties for builders in obtaining insurance. Delays in the processing of home indemnity insurance applications brought on by the rapid shift of builders to the remaining insurance providers resulted in delays in the issue of building licences. It soon became clear that the demand for home indemnity insurance exceeded the capacity of the industry

[36] Ministerial Media Statement, 2004, *Minister Welcomes New Competition in Home Indemnity Insurance*, October.

[37] At the time FAI operated as a subsidiary company of HIH.

[38] Ministerial Media Statement, 1995, *Proposed Amendments to Home Building Legislation*, June.

[39] Ministerial Media Statement, 1996, *Legislation Dealing with Builders' Indemnity Insurance*, February.

[40] Ministry of Fair Trading, 1999, *Review of the Home Indemnity Insurance Provisions of the Home Buildings Contract Act 1991*.

[41] National Policy Congress, 2001, *Submission on Home Warranty,* Submission to the Canadian Home Builders' Association.

to supply it and this would cause problems for the building industry given that it was mandatory for a builder to hold insurance prior to the commencement of construction.[42]

Immediately following the collapse of HIH and FAI, there was only one company offering home indemnity insurance in Western Australia. This company was Home Owners Warranty who acted as an agent for Royal and Sun Alliance.

Dexta Corporation (an agent of Allianz Australia) entered the market in late March 2001 and Australian Home Warranty (an agent for Reward Insurance) entered the home indemnity insurance market in May 2001.[43]

At this point in time the market was served by three insurers. However, none of these insurers were particularly large and problems were encountered in processing the volume of applications received in the wake of the collapse of HIH and FAI. Difficulties and delays continued to be experienced by builders in obtaining home indemnity insurance due to the limited capacity of the market to provide it.

In July 2001, the State Government intervened in an effort to avoid a slowdown in building activity brought on by difficulties in the insurance market. The intervention was in the form of a 'rescue package'. The package allowed for the provision of Government-provided cover for homeowners who had previously been covered by HIH or FAI. In effect, this enabled builders who had held insurance certificates with HIH or FAI but who could not obtain alternative cover to build under insurance that was provided by the Government.

Still the market suffered from the lack of capacity left by the absence of HIH and FAI. This lack of capacity was compounded by Dexta's withdrawal from the market in April 2002.[44] Further Government action was initiated in April 2002 in an effort to build the capacity of the market. Through the signing of Heads of Agreement with the insurance providers the Government agreed to underwrite any costs from the loss of a single builder that exceeded $10 million (up to a limit of $90 million).[45]

Private sector interest in the market increased following the Government's underwriting commitment. Major insurance players such as CGU, Lumley and Vero entered the market and at one point prior to 2009 there were six insurers offering home indemnity insurance in Western Australia. However, competitive conditions in the provision of home indemnity insurance did not last long.

Both CGU and Lumley withdrew from the market in 2009, each citing a lack of capacity to provide the product and in 2010 Vero also ceased to offer home indemnity insurance in Western Australia.[46] Other smaller insurers also exited the market around this time.

QBE entered the market in 2007 and Calliden entered the market in 2010. These are the only two insurers currently offering home indemnity insurance in Western Australia. Both

[42] Ministerial Media Statement, 2002, *Legislation to Help Building Industry Introduced*.

[43] Ministry of Fair Trading, *Annual Report*, 2000-2001.

[44] Since its commencement in the market, Dexta experienced difficulties processing the volume of claims received and in obtaining adequate reinsurance cover. See, Department of Consumer and Employment Protection 2004, *Report on the Statutory Review of the Home Indemnity Insurance scheme in Western Australia*.

[45] Ministerial Media Statement, 2010, *Insurers Sign up to Secure Home Building Indemnity Cover*, May.

[46] Vero's decision to exit the market was based in part on bad publicity that had been encountered in the eastern states of Australia and a perception that such publicity was tarnishing the company's brand. See" Insurance News Net, *Vero's withdrawal from home indemnity Market raises concerns in Australia*, February 2010.

companies have signed Heads of Agreement with the State Government to secure their continuation in the market until 30 June 2013.

For QBE, the Heads of Agreement maintains that the Government will underwrite costs incurred in excess of $10 million arising from the failure of a single builder. In return, the Government receives a share of the premium income earned by QBE. The Deed also contains a provision that restricts the Government's ability to enter the market as an insurer.[47]

Summary of the Heads of Agreement

On 30 June 2010, the State Government entered into Heads of Agreement arrangements with QBE and Calliden.

The Heads of Agreement establish the risk sharing arrangements between the State Government and the insurers and effectively transfer a proportion of the reinsurance risk held (in the first instance) by private insurers to the State Government.

Under the Heads of Agreement, QBE and Calliden have agreed to:

- provide covered contracts[48] to Vero customers with existing home indemnity insurance contracts for an administration fee of 45 per cent of the premiums; and
- continue to provide home indemnity insurance to builders in a similar manner and service standard as had existed prior to 30 June 2010.

In return for the insurers accepting these obligations, the State Government agreed to accept 100 per cent of the liabilities of QBE and Calliden in regards to losses arising from covered contracts.

QBE agreed that it would provide insurance to Vero's clients, if the State Government agreed to provide the same reinsurance to QBE that was offered to Vero at the time. As such, the State Government agreed to accept QBE's cumulative liabilities that exceed $10 million and up to $90 million if they arise from a single builder failure. In return for reinsuring, the State Government receives a fee equal to 10 per cent of the premiums. Calliden does not have a risk sharing agreement as their cumulative liabilities do not exceed $10 million.[49]

Both Heads of Agreement expire at midnight on 30 June 2013. At the time of writing this report, the State Government had commenced discussions with both insurers about extending existing arrangements beyond 30 June 2013.

[47] Western Australia State Government, 2010, *WA Heads of Agreement* .

[48] A covered contract is an insurance policy issued to a builder that has the effect of transferring that builder's home indemnity insurance eligibility from a previous insurer (usually either insolvent or no longer operating in the market) to a new insurer that is actively operating in the home indemnity insurance market.

[49] Calliden does not have a risk-sharing arrangement with the Government because the company only provides insurance to relatively small builders and hence it does not carry the risk of incurring claims costs in excess of $10 million arising from the failure of a single builder.

2.7 Home Indemnity Insurance in Other Australian Jurisdictions

Western Australia's home indemnity insurance arrangements are broadly similar to those in New South Wales, Victoria and South Australia. In these States, home indemnity insurance is mandatory, 'last resort' and characterised by some level of support from Government. The Queensland scheme is unique in Australia in that it is a 'first resort' scheme.[50] The Tasmanian approach is also unique in that home indemnity insurance is no longer mandatory.

Table 2.1 provides a summary of other key elements of home indemnity insurance arrangements in Australia, including the minimum value of work for which insurance is required; the maximum valuable payable; and the coverage period.

[50] In a first resort scheme, consumers can make claims for financial cover from the scheme even when the builder is still trading.

Table 2.1 Home Indemnity Insurance Arrangements in Australian Jurisdictions

Jurisdiction	Western Australia	New South Wales	Queensland	Victoria	Australian Capital Territory	South Australia	Tasmania	Northern Territory
Type of scheme	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Voluntary	Mandatory
Provider of insurance	Private sector with State Government providing reinsurance	Government with private insurers acting as agents	Government	Government and private insurer	Private insurers and Master Builder Association through a fidelity fund	Private sector with State Government providing reinsurance	No insurance is offered	Master Builder Association through a fidelity fund
Type of insurance	Last resort	Last resort	First resort	Last resort	Last resort	Last resort	None	Last Resort
Threshold for insurance	$20,000	$20,000	$3,300	$12,000	$12,000	$12,000	-	$12,000
Maximum value payable	$100,000	$340,000 or 20% of the contract value	$200,000 for non completion and $200,000 for the warranty period	$200,000 or 20% of the contract value	$85,000	$80,000	-	20% of contract up to $200,000 for non completion and $200,000 for the warranty period less any non completion payment
Excess payable	$500	$250	Nil	$500	$500	$400	-	N/A
Period of cover	6 years from completion	6 years 6 months from completion	6 years 6 months from contract or payment of premium or commencement	6 years from completion	5 years from certificate of occupancy	5 years from completion	-	6 years structural warranty and 2 years non structural warranty

3 Statistical Overview

The purpose of this chapter is to highlight the key trends in home indemnity insurance premiums and claims data. The main areas examined are the size of the home indemnity insurance market, the cost of premiums, claims paid and the net loss ratio of home indemnity insurance in Western Australia. The majority of information contained in this chapter is based on data provided to the Authority by QBE covering the period between July 2010 and January 2013.[51]

3.1 Insurance Providers

QBE and Calliden are currently the only providers of home indemnity insurance in Western Australia. The Authority estimates that QBE services about 90 per cent of the market for home indemnity insurance (based on the number of premiums issued) with Calliden accounting for the remaining 10 per cent of the market.[52]

During the two years between 1 July 2010 and 30 June 2012, QBE issued approximately [redacted] home indemnity insurance contracts, with a total aggregate written premium of approximately $[redacted] million. Over the same period Calliden issued [redacted] home indemnity insurance contracts, with a total aggregate written premium of approximately $[redacted] million.

QBE also offers home indemnity insurance to owner builders.[53] Between 1 July 2010 and 30 June 2012, QBE issued [redacted] contracts, which generated total premium revenue of about $[redacted].

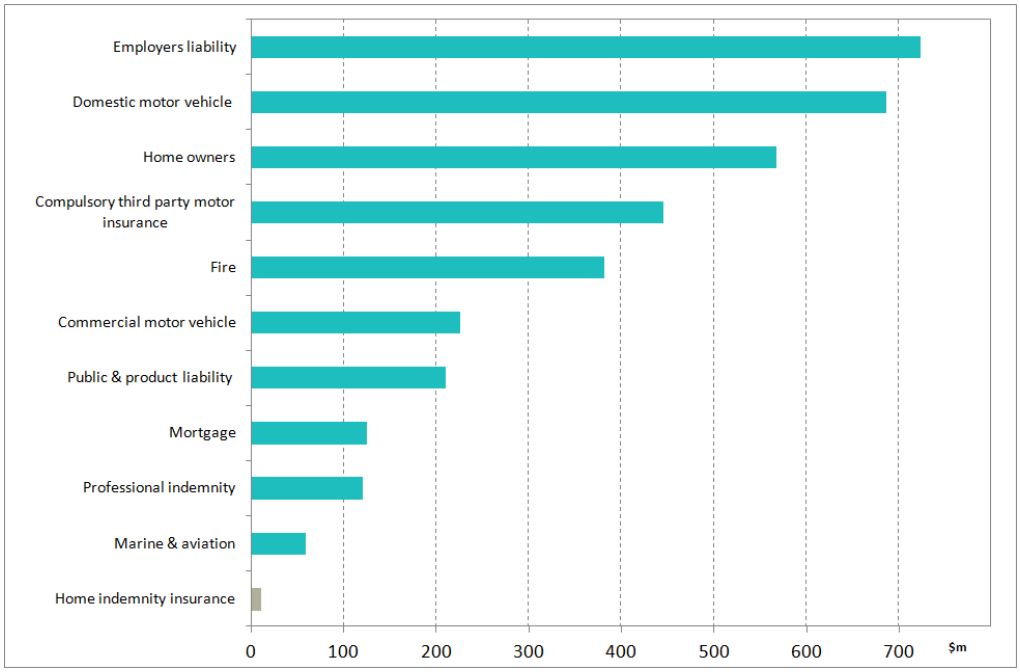
Considering the above information in the context of the most recent financial year for which data are available (2011/12), total written premium was $[redacted] million. The home indemnity insurance market accounts for a minor share of total premium revenue for insurers in Western Australia (Figure 3.1).

[51] Calliden had not provided sufficient data to enable meaningful analysis at the time the Draft Report was written. Given Calliden's small share of the home indemnity insurance market, it is unlikely that the main findings of this chapter would differ if Calliden data were included.

[52] The Authority estimated the insurers' market shares by comparing the number of contracts written by QBE and Calliden.

[53] Owner builders are only required to purchase home indemnity insurance if they sell an owner-built house within six years of completion.

Figure 3.1 Premium Revenue Earned by Insurers in Western Australia, 2011/12.



Source: General Insurance Supplementary Statistical Tables June 2012 APRA, Insurance Commission of Western Australia Annual Report 2012 and data provided by QBE and Calliden for 1 July 2011 to 30 June 2012.

3.2 Cost of Premiums

Home indemnity insurance premiums are set to reflect the level of risk that the insurers accept by insuring a building project and to recover a share of administrative costs associated with underwriting these projects.

Higher premiums are applied to 'riskier' builders and builds with higher contract values.[54] [redacted].[55] QBE classifies a builder's risk rating by assessing their general business and licence information, previous work performed and the builder's personal assets and liabilities.[56]

Figure 3.2 shows the different premiums charged to builders according to their risk rating and contract size.

[54] Contract value is the price agreed between the builder and the consumer.

[55] [redacted]

[56] QBE, *Residential Builders' Warranty Insurance Eligibility Review Application*, 2013.

Figure 3.2 QBE Home Indemnity Insurance Premium Rates by Builder Risk Category and Contract Value from 18 March 2013

Home indemnity insurance premiums as a percentage of contract values decline as the contract values increase for all categories of builders. The Authority believes that this downward trend is likely to be the result of the $100,000 maximum cap on payouts and the presence of fixed costs:

- As contract values increase, the $100,000 maximum payout cap declines as a share of the contract value such that premiums decline as a percentage of the contract value. However, the cost of the premiums in absolute dollars continues to increase with the contract value because the risk that the insurer will have to pay the full $100,000 cap increases with the contract value.[57]

- It is likely that some fixed costs are incurred in writing contracts. For low contract values, these fixed costs account for a relatively large share of total costs and hence the premium as a percentage of contract value is higher for low value contracts and declines as the contract values increase.

The cost of construction of an average house in Western Australia is approximately $250,000.[58] Based on current pricing structures of the insurers (as at March 2013)[59], a premium for such a house is in the order of $1,000, which is equivalent to 0.4 per cent of the total cost of construction.

[57] The marginal increase in risk is caused by the larger amount of work and proportionately larger probability of defect.

[58] Australian Bureau of Statistics, *Housing Finance, Australia, cat. no. 5609.0*.

[59] Including recent increases in QBE and Calliden's pricing structure, effective March 2013.

[redacted]

Although premiums have risen in Western Australia by 40 per cent in 2013, premiums are still in line with premiums charged in Victoria and lower than premiums charged in Queensland and New South Wales. Any comparison of premiums, including that contained in Figure 3.3, is indicative only. This is because there are marked differences between the home indemnity insurance arrangements in different jurisdictions and corresponding differences in the level of cover afforded to consumers (as can be seen from the analysis contained in Table 2.1 in Chapter 2).

Western Australia and Victoria have similar rating mechanisms, with premiums reflecting contract value and the builder's risk rating.[60] [61] The New South Wales Self Insurance Corporation applies a flat rate premium of 0.6 per cent of the contract price for metropolitan locations and 0.48 per cent for country locations.[62] Queensland's high premiums are due to the extent of coverage associated with a first resort scheme, as well the additional cover for subsidence insurance.[63]

Figure 3.3 Comparison of Premium Rates by State

[redacted]

[60] The premium data presented in Figure 3.3 for Western Australia and Victoria is that of medium risk builders.

[61] QBE is a participant in home indemnity insurance in both Western Australia and Victoria. However, QBE acts as an administrator of the Victorian Government scheme rather than as a private insurer.

[62] The premium data presented in Figure 3.3 for News South Wales is that of metropolitan builders. Source: New South Wales Government, Home Warranty Insurance Fund, *Fact Sheet 7- Premiums,* 2012.

[63] Queensland Building Services Authority, *Premium Table*, 2013.

3.3 Claims Paid

Between 1 July 2010 and 13 January 2013, QBE paid a total of [redacted] claims to consumers.[64] [65] Claims are allocated to three different categories according to the stage of building development at which the builder became insolvent, died or disappeared. The categories are:

- failure to commence, which occurs when a builder has accepted a job and receives a deposit but fails to begin the build;
- failure to complete, which may occur any time between when the builder started building and practical completion; and
- defective work which occurs when there is a defect in the building within six years of practical completion.

Table 3.1 shows claims paid according to the claim categories listed above. The majority of claims arose during the construction phase of building (that is, failure to complete). This is likely due to the high level of insolvencies in the first two years of the insurance.[66] There were also a notably large proportion of claims for defective work.

Failure to complete claims also resulted in the highest average cost per claim at $[redacted]. Costs associated with failure to complete claims include the cost of surveying the work already completed and the cost of paying a new builder to complete the build. Defective work claims can range from non-structural (e.g. incorrect door handles fitted) to structural (e.g. defective stairwell). The average value of defective work claim is lower than failure to complete claims because of the inclusion of non-structural claims. The claim costs associated with failure to commence are relatively low because the maximum deposit is capped at $20,000.[67]

Table 3.1 Number and Value of Claims by Trigger

[redacted]

Figure 3.4 further illustrates the difference in the size of claims paid for failure to complete and defective work. Claims caused by defective work tend to be clustered in the lowest value ranges.[68] Claims for failure to complete tend to be more evenly distributed across

[64] [redacted]

[65] [redacted]

[66] Information about the timing of claims is contained in the discussion surrounding Figure 3.5

[67] The Home Building Contracts Act Regulations 1992 Schedule 1 stipulates that home indemnity insurance covers loss of deposit, up to a maximum of $20,000.

[68] [redacted]

value ranges below $100,000. However, there is also a large number of failure to complete claims valued at over $100,000. Anecdotal evidence provided to the Authority indicates that this is because some builders at risk of insolvency try to bring forward payments by taking short cuts in order to increase cash flows.

Figure 3.4 Size and Number of Failure to Complete and Defective Work

[redacted]

Home indemnity insurance claims are triggered by incomplete or defective work that cannot be rectified by the builder due to death, disappearance or insolvency. The majority of claims paid by QBE ([redacted]) were caused by builder insolvencies, (refer to Table 3.2). Death and disappearance account for the remaining [redacted] of all home indemnity insurance claims.

Insolvency claims result in a higher average value of claims compared to death and disappearance. As previously explained, the Authority believes this is due to builders who know that they are becoming insolvent and try to bring forward payments by taking short cuts.

Table 3.2 Claims by Cause of Builder Failure

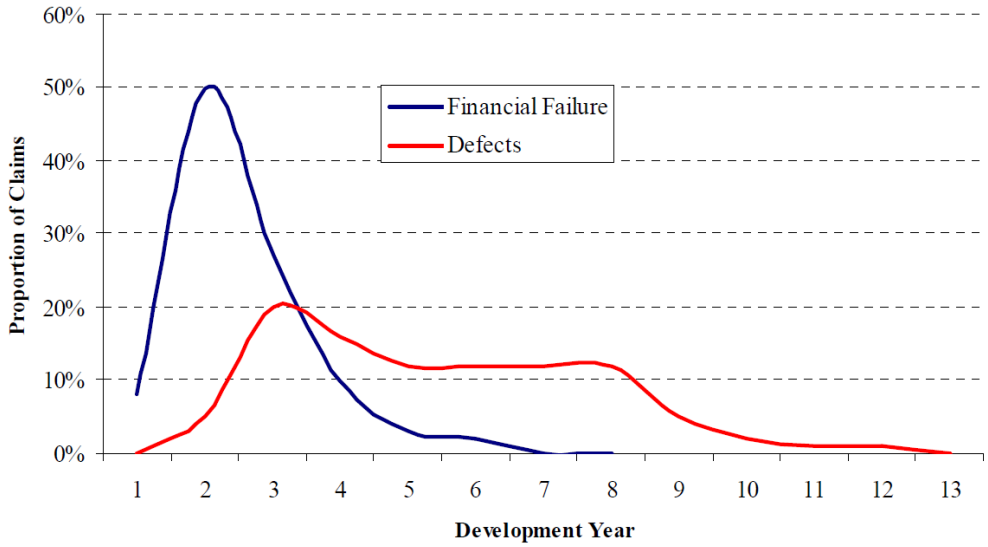
[redacted]

The Authority has insufficient data to illustrate the profile of claims by year as QBE has only operated in the Western Australian home indemnity insurance market for two years. Instead, Figure 3.5 shows the profile of claims paid by the former Housing Guarantee Fund in Victoria. Although the insurance provided by the Housing Guarantee Fund was

first resort, the Authority considers that the timing of the claims should be comparable to a last resort scheme.

As seen in Figure 3.5, 50 per cent of insolvency claims occurred in the second year. Defect claims peaked in year three at approximately 20 per cent and were steady for the following five years at approximately 12 per cent per annum. The claim period of 13 years is longer than the defect period of six years for several reasons[69] including; delays in the building commencement date after the contract is signed and a longer time taken to complete construction than expected resulting in an extended period of claim finalisation.[70]

Figure 3.5 Profile of Claim Timing by Year



Source: Daniel Smith 2005, First or Last Resort or does it really matter? p.7.

The Authority has used data provided by QBE to report on the average time taken for a claim to be paid by the insurer. This is important in assessing the efficiency of the private insurer. In order to calculate this, the Authority only analysed claims that have been fully paid. On average it takes QBE [redacted] days to complete a claim from the date of receiving the claim to the date of final payment.

[redacted]

[69] The development years starts from the time the contract was signed.

[70] Building Services Authority, *Part A - Overview of home warranty*, p. 2.

Table 3.3 Number of Claims Over $100,000 by Builder ($)

[redacted]

3.4 Net Loss Ratios

A net loss ratio is the total value of claims for a period (generally one year) divided by the total premiums collected over that period. This measure estimates the proportion of the total premiums paid back to consumers in the form of claim pay outs. A net loss ratio greater than 100 per cent means that over 100 per cent of the premium income has been paid out in claims. A typical target loss ratio for insurers is 75 per cent.[71]

Figure 3.6 shows QBE's annual net loss ratios since 2007 as calculated by QBE. The blue bars represent the actual annual loss ratios to date that have been experienced by QBE (incorporating data up until 13 January 2013). The grey bars represent QBE's projected final loss ratio for a given year. The predicted final loss ratios are greater than the actual annual loss ratios to date reflecting the fact that claims may still need to be paid in future years.[72] The gap between the two bars is greater in later years as there is a longer time remaining in the defect period during which claims can be made.[73]

[redacted]

[71] Australian Competition and Consumer Commission, 2002, *Second insurance industry market pricing review*, pp. 12.

[72] The Authority notes that available data includes claims paid over a period of two to three years. Conclusions that can be drawn from these data are not definitive because policies that have been written by QBE are still active at the time of writing. It is likely that more claims will be made and paid on existing policies over coming years. As such, actual net loss ratios will change over time.

[73] The defect period is six years from practical completion.

Figure 3.6 QBE Net Loss Ratios

4 An Overview of the Building Industry in Western Australia

The purpose of this chapter is to describe the nature and key characteristics of the Western Australian building industry. An understanding of the building industry is critical to developing an understanding of the market for home indemnity insurance as it has a direct influence on the types of risks assumed by insurers and hence their willingness to offer insurance.

In this chapter the key features of the building industry that have implications for the provision of home indemnity insurance are discussed, including the highly cyclical, and competitive nature of the building industry and rates of builder turnover. Housing affordability in Western Australia is also discussed.

4.1 Overview of the Building Industry

The building industry makes a significant contribution to the Western Australian economy. In 2011/12, the construction of dwellings contributed $9.9 billion (or 4.2 per cent) to Western Australia's Gross State Product.[74] The construction industry more broadly accounts for about 12 per cent of employment in Western Australia.[75]

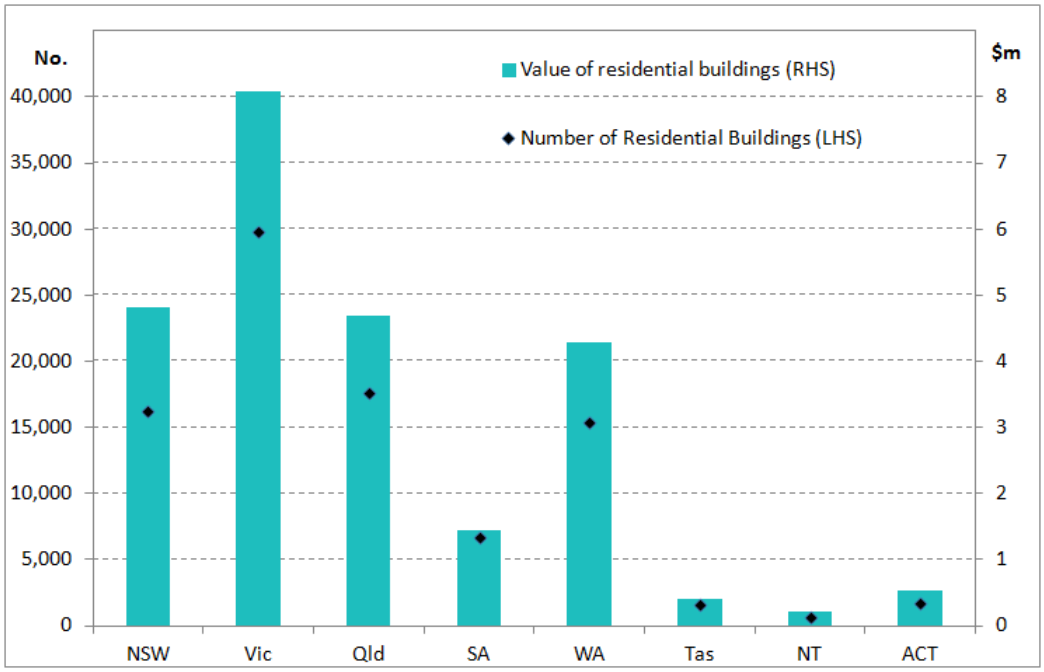
Figure 4.1 shows the number and dollar value of residential building approvals for 2011/12. In this period, Western Australia accounted for 17 per cent of the number of building approvals for new houses, which is significant given that Western Australia accounts for approximately 11 per cent of Australia's population.[76]

[74] Australian Bureau of Statistics, 2012, Cat. No. 5220.0 *Australian National Accounts – State Accounts 2011/12*, p.24.

[75] Australian Bureau of Statistics, 2013, Cat. No. 6291.0.55.003 *Labour Force, Australia, Detailed, Quarterly, February 2013*.

[76] Australian Bureau of Statistics, 2012, Cat. No. 3101.0 *Australian Demographic Statistics, June 2012*.

Figure 4.1 Number and Value of Building Approvals for New Houses (2011/12)



Source: Australian Bureau of Statistics, January 2013, Cat No. 8731.0 - Building Approvals, Australia, November 2012.

4.2 Key Features of the Building Industry

4.2.1 Cyclical Nature of Residential Construction

Compared to other industries, the building industry is highly cyclical. The Australian Bureau of Statistics notes:

> While many industries experience steady growth over time, each component of the building lifecycle[77] exhibits periods of expansion followed by periods of contraction. The movements in the dwelling lifecycle are typically greater than most other components in the economy. As a result its impact would be more significant to the movements to GDP rather than its levels.
>
> The movements in the building lifecycle are related to movements in the wider economy. The linkages between the two are complex and it is not always clear what is driving what. For example, a stronger economy might lead to increased building, or increased building might lead to a stronger economy.[78]

The cyclical nature of the residential building industry is apparent in data on the number of dwellings commenced, under construction or completed per annum in Western Australia. In the 10 years since 2001/02, the average number of new private dwelling commencements in Western Australia has been around 17,000 per annum.[79] However, there is considerable annual variation in building commencements around this average.

[77] The building industry lifecycle, as defined by the Australian Bureau of Statistics, is comprised of the following stages: finance; approval; commencement and completion.

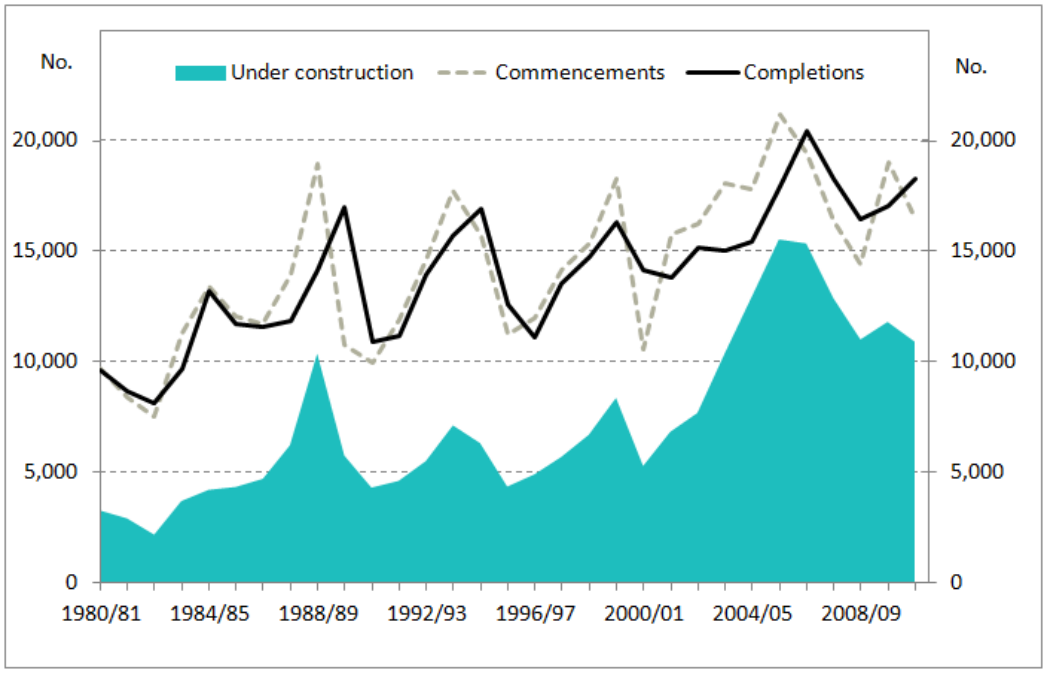
[78] Australian Bureau of Statistics, December 2003, Understanding the building lifecycle by its cyclical nature.

[79] Australian Bureau of Statistics, January 2013, Cat No. 8752.0 *Building Activity*, Australia, September 2012.

Most recently, housing activity peaked in 2005/06 with around 21,000 dwellings commenced. Housing activity has subsequently deteriorated, with a trough in activity in 2007/08 when only around 14,000 dwellings were commenced.[80] Housing activity has not returned to its previous levels, as is apparent from data on the number of houses under construction (refer to Figure 4.2).

The Housing Industry Forecasting Group anticipates that dwelling commencements will increase by 20 per cent in 2012/13 compared to 2011/12.[81]

Figure 4.2 Private Residential Building Activity in Western Australia, 1980/81 to 2010/11



Source: Australian Bureau of Statistics, January 2013, Cat No. 8752.0 Building Activity, Australia, September 2012. Note: Annual data has been used for dwelling commencements and completions and an annual average has been used for dwellings under construction.

The residential building market in Western Australia cannot be considered to be a 'single' market. There can be significant variations in activity between the geographic regions reflecting different economic and social conditions. According to the Housing Industry Forecasting Group, residential building activity is strong in the North West region of Western Australia (particularly in the Pilbara), with resource projects being a major influence.[82] The value of residential building approvals in the Pilbara increased by 39.5 per cent between 2010/11 and 2011/12.[83]

4.2.2 Concentration of the Building Industry

The housing industry in Western Australia is characterised by a small number of very large builders and a very large number of small builders.

[80] Australian Bureau of Statistics, January 2013, Cat No. 8752.0 *Building Activity*, Australia, September 2012.

[81] Housing Industry Forecasting Group, 2012, *Forecast Dwelling Commencements in Western Australia,* October.

[82] Housing Industry Forecasting Group, 2012, Forecast Dwelling Commencements in Western Australia, April, p. 5.

[83] Pilbara Development Commission, 2012, Economic Profile-Building Approvals.

The three largest builders (BGC, Alcock/Brown-Neaves Group[84] and Pindan Pty Ltd) account for 35 per cent of the market (Table 4.1).[85] Other large builders operating in Western Australia include JWH Group, Summit Homes Group, Gemmill Homes, Content Living, Ross North Group, Hickory Group and Danmar Homes.[86]

Table 4.1 Top 5 Builders in Western Australia 2011/12

Largest builders in Western Australia	No. of houses built (2011/12)	Market share (percentage)
BGC	2,692	15.3
Alcock/Brown-Neaves Group	2,371	13.5
Pindan	1,122	6.4
JWH Group	1,096	6.2
Summit Homes Group	857	4.9
Remaining builders	9,410	53.6
Total	**17,548**	**100**

Source: Housing Industry Association, 2012, HIA Housing 100 2011/12.

Western Australia's 20 largest builders increased their market share from 59 per cent in 2010/11 to 64 per cent in 2011/12.[87] The dominance of larger builders in Western Australia is apparent when the Western Australian industry is compared to industries in other Australian jurisdictions.[88] By way of comparison, the market share of the 20 largest builders in other jurisdictions in 2011/12 was:

- 24 per cent in New South Wales;
- 34 per cent in Victoria;
- 23 per cent in Queensland; and
- 34 per cent in South Australia.[89]

4.2.3 Competition in the Building Industry

Notwithstanding the relatively high level of concentration in the residential building industry in Western Australia, the market is considered to be highly competitive.

[84] The Alcock/Brown-Neaves group has nine home builder companies under it, each specialising in different markets in Western Australia. Source: Alcock/Brown-Neaves, 2012, *Our WA building and construction companies*.

[85] Housing Industry Association, 2012, *HIA Housing 100 2011/12*, p. 9.

[86] Housing Industry Association, 2012, *HIA Housing 100 2011/12*, p. 9.

[87] Oneperth.com.au, 2012, *Five WA builders in Aust Top 20*.

[88] Anecdotal evidence suggests that the degree of concentration in the Western Australian building market is a result of greater construction activity on "greenfield" development sites in this State relative to other jurisdictions. The large-scale development of new housing estates - "greenfield sites" - offers builders with potentially large gains from economies of scale due to the construction of a large number of similar dwellings in similar locations. Such gains from economies of scale are not as pronounced in other jurisdictions due to the greater degree of "brownfields" development, which necessitates single structure (and often unique) dwellings on individual sites spread across large geographical areas.

[89] Housing Industry Association, 2012, *HIA Housing 100 2011/12*.

In total, there are around 6,600 builders in the Western Australian residential building industry (Table 4.2). However, of these, only 1,500 or so are active.[90] [91]

Table 4.2 Builder Registrations in Western Australia

Builder Type	2008/09	2009/10	2010/11	Percentage Change 2008/09 to 2010/11
Individual Builders	4,329	4,433	4,603	6.3
Companies	1,147	1,565	1,673	45.9
Partnerships	316	309	299	-5.4
Total registered builders	**6,092**	**6,307**	**6,575**	**7.9**

Source: Builders Registration Board, Annual Reports 2008/09, 2009/10, 2010/11.

A contributing factor to the large number of small businesses is that the building industry has low barriers to entry and exit due to low start up margins and minimal licensing requirements.[92] In addition, the value of a builder's business is low during economic downturns and as such tradesmen can either purchase an existing business or establish a new business at minimal cost.[93]

4.2.4 Turnover in the Building Industry

Builders may enter and exit the industry for a number of reasons (with the rate at which they enter and exit the industry referred to as the rate of builder turnover). In the context of home indemnity insurance, it is exits from the building industry that are caused by a builder dying, disappearing or becoming insolvent that are relevant. These reasons are a pre-condition for a consumer making a claim against a home indemnity insurance if there is defective or incomplete work.[94]

The Authority estimates that the rate of turnover in the Western Australian building industry has ranged between 2.5 and 5.0 per cent between 2006/07 and 2010/11 (refer to Figure 4.3). This equates to an average of around 240 builders leaving the industry per annum.[95]

[90] The Economic Regulation Authority, November 2012 Consultation with the Building Commission, Department of Commerce and the Master Builders Association of Western Australia.

[91] An active builder is one that holds a valid building permit and is at present building houses. In contrast, a non-active builder is one that holds a valid building permit but is working in another occupation due to various reasons (for example, a downturn in the building industry or the builder may have a supervisory role in the building company thus does not use the building permit).

[92] Building Valuer Network, 2013, *Building Industry*.

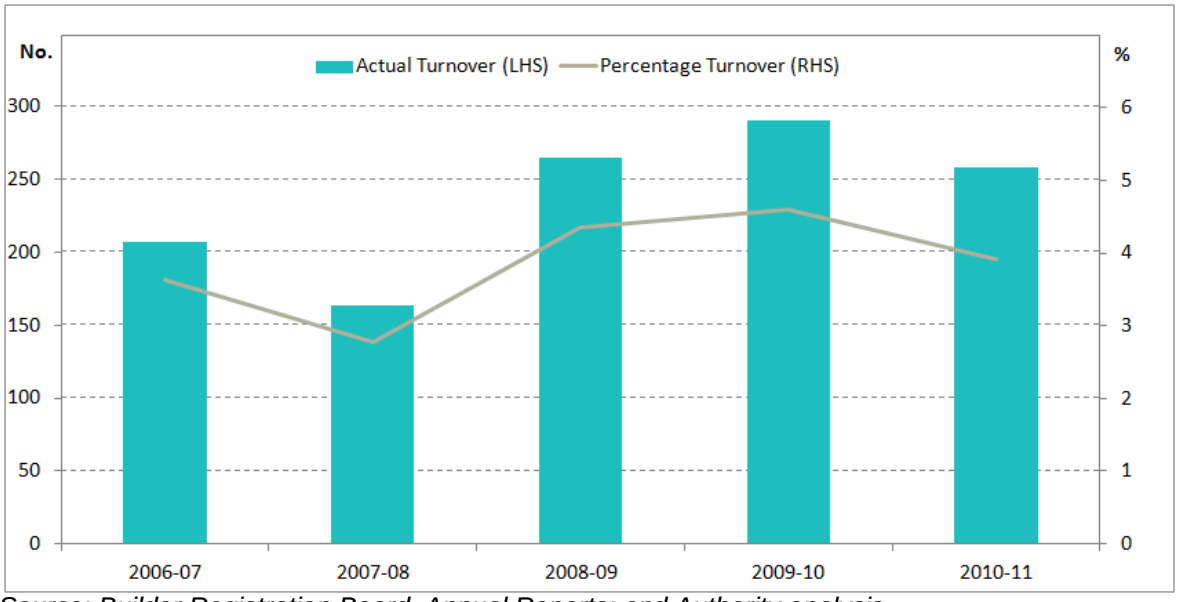
[93] Building Valuer Network, 2013, *Building Industry*.

[94] If a builder leaves the industry for reasons such as retirement or to pursue another career then that builder is still liable to rectify defects if they occur within six years of completion and hence home indemnity insurance provisions do not apply in these instances.

[95] These estimates are based upon data from the Building Commission, which is responsible for registering builders in Western Australia. The Building Commission does not record statistics on the rate of builder turnover, but it does record the total number of builders registered, the number of new licences approved and the number of licences approved through mutual recognition. The rate of builder turnover has been calculated as: the previous year's number of registered builders, plus the number of new licences approved, plus mutual recognitions approved, less the present year's number of registered builders.

The rate of builder turnover estimated by the Authority will include departures from the industry that do not have implications for home indemnity insurance claims (for example, retirements and departures to seek other career opportunities).

Figure 4.3 Turnover of Registered Builders



Source: Builder Registration Board, Annual Reports; and Authority analysis.

Businesses in the construction industry[96] (which includes the residential building industry) appear to experience a high rate of insolvencies in comparison to other industries. Australian Securities and Investments Commission (ASIC) data indicate that, at 22.1 per cent, the construction industry accounted for the largest share of insolvencies by industry in Australia in 2011/12.[97]

The main causes of insolvency in the construction industry (as nominated in reports to ASIC by external administrators) were: poor strategic management of business; inadequate cash flow or high cash use; poor economic conditions; poor financial control (including lack of records); and trading losses.[98]

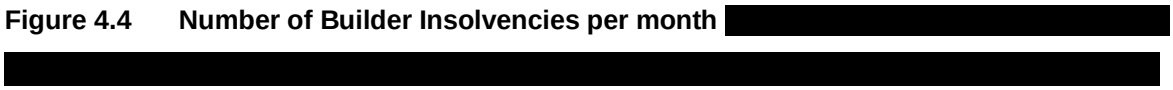
As discussed in Chapter 3, builder insolvency is the major cause of claims for home indemnity insurance in Western Australia. The Authority has not been able to obtain accurate data on the number of residential builders that become insolvent in Western Australia per annum. The Authority has instead relied upon data from QBE on the causes of builder failure that have led to claims (Figure 4.4). [redacted]

[96] The Australian Securities and Investments Commission maintain data on insolvencies by Australian and New Zealand Standard Industrial Classification (ANZSIC) industries. The Construction Division includes units mainly engaged in the construction of buildings and other structures, additions, alterations, reconstruction, installation, and maintenance and repairs of buildings and other structures. Units engaged in demolition or wrecking of buildings and other structures, and clearing of building sites are included in Division E Construction. It also includes units engaged in blasting, test drilling, landfill, levelling, earthmoving, excavating, land drainage and other land preparation. Source: Australian Bureau of Statistics and Statistics, Australian and New Zealand Standards Industrial Classification, 2006, *Cat. No. 1292.0 Australian and New Zealand Standard Industrial Classification*.

[97] ASIC, 2012, *Insolvency statistics: External administrators' reports 1 July 2011–30 June 2012*.

[98] ASIC, 2012, *Insolvency statistics: External administrators' reports 1 July 2011–30 June 2012*, p. 20.

Figure 4.4 Number of Builder Insolvencies per month



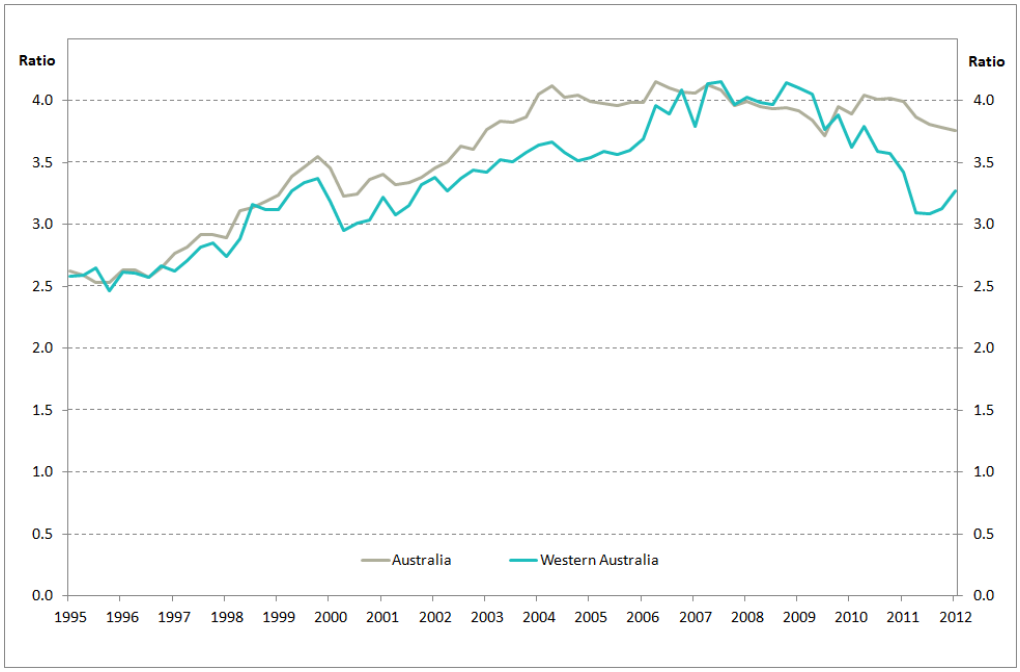
4.2.5 Housing Affordability

As part of the terms of reference for this inquiry, the Authority has been asked to consider the possible implications of home indemnity insurance for housing affordability. Housing affordability relates to a person's ability to pay for their housing.[99]

As home indemnity insurance only applies to the construction of new dwellings, the Authority has derived a measure of new house affordability by calculating a ratio of house construction costs to average annual full time earnings. By this measure the cost of constructing a new dwelling became less affordable in both Western Australia and Australia between 1995 and 2008 (refer to Figure 4.5). However, construction costs as a multiple of full time earnings have trended downwards (that is, construction costs have become more affordable) in recent years. In Western Australia, average construction costs are currently about 3.3 times annual average earnings.

[99] Australian Housing and Urban Research Institute, 2013, *Housing Affordability*.

Figure 4.5 Dwelling Construction Costs as a Multiple of Adult Full-Time Earnings



Source: Australian Bureau of Statistics, January 2013, Cat No. 5609.0 Housing Finance, Australia November 2012. Australian Bureau of Statistics, August 2012, Cat No. 6302.0 Average Weekly Earnings, May 2012.

Housing affordability is affected by demand-side and supply-side factors. On the demand-side, the major factors currently affecting housing affordability are strong population growth and financial and economic influences (such as increasing income levels, high levels of employment and access to affordable credit).[100] On the supply-side, the housing supply level has been constrained by low investment in public housing and planning, regulatory and financial barriers.[101]

Deteriorating levels of housing affordability have been a significant concern for Australian Governments for a number of years with Australia's five largest capital cities being considered to be 'severely unaffordable' based on a method of calculating housing affordability known as the median multiplier.[102] Of the five major Australian capital cities, Perth is the second most affordable (with a median multiple of 5.9) behind Brisbane (with a median multiple of 5.8). Sydney (8.3), Melbourne (7.5) and Adelaide (6.5) are considered to be less affordable than Perth.[103]

[100] Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[101] Australian Housing and Urban Research Institute, 2013, *Housing Affordability.*

[102] The median multiplier is calculated by dividing the median house price by the gross before tax annual median household income. The median multiplier can be calculated for different geographic regions (e.g. cities) to provide an indication how affordable a region is (that is, whether it is affordable, moderately unaffordable, seriously unaffordable or severely unaffordable). A median multiple of 3.0 or less is considered to be affordable, while a multiple of 5.1 or more is considered to be severely unaffordable. Source: Performance Urban Planning, 2013, *9th Annual Demographia International Housing Affordability Survey: 2013, p. 12.*

[103] Performance Urban Planning, 2013, *9th Annual Demographia International Housing Affordability Survey: 2013, p. 13.*

The consequence of deteriorating levels of affordability is that only a small proportion of homes sold are affordable by low and moderate income households.[104]

- Only 4.4 per cent of homes in Western Australia were affordable for low income households in 2010/11,[105] placing Western Australia as the third least affordable state or territory in Australia on this measure.[106]

- Only 25 per cent of homes sold were affordable for moderate income earners,[107] placing Western Australia as the second least affordable state or territory in Australia on this measure.[108]

The proportion of low income earners with mortgage stress[109] in Western Australia was in line with the national average of 37 per cent.[110]

Home indemnity insurance premiums have potential to directly affect the affordability of constructing a new dwelling by adding to the overall cost. Premiums may also indirectly affect the cost of established dwellings (reflecting that established dwellings are a substitute for new dwellings).

Home indemnity insurance premiums, while certainly adding to the overall cost of a new dwelling, are a comparatively small component of the cost of constructing a new dwelling. The main costs of constructing a new dwelling are the building material and labour costs involved in construction. On average, home indemnity insurance premiums are estimated to increase the cost of construction of a new dwelling by 0.19 per cent in Western Australia.[111]

[104] This is a measure of housing affordability used by the Council of Australian Governments (COAG) in its Affordable Housing 2010-11 report. This measure refers to low to moderate income earners looking to purchase a home. It includes the affordability of a mortgage at current interest rates. This is compared to the house sales price over the relevant period. (COAG, Affordable Housing Report 2010-11)

[105] Low income households are defined as those with a gross weekly household income of $1,164 or less per week. Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[106] Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[107] Moderate income households are defined as those with a gross weekly household income of $1,868 or less per week. Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[108] Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[109] This refers to those people who have purchased through debt. The indicator shows whether they can afford to buy homes and if they experience ongoing financial difficulty because of the repayments. This indicator includes mortgage stress for low income earners, which occurs when mortgage repayments exceed 30 per cent of their gross income. (COAG, Affordable Housing Report 2010-11)

[110] Council of Australian Governments, 2012, *Affordable Housing 2010-11: Comparing performance across Australia.*

[111] Based on an average construction price of $248,000 (derived from Australian Bureau of Statistics, *Housing Finance, Australia, cat. no. 5609.0*) and an average premium value of $475.

5 Objectives of Home Indemnity Insurance

The purpose of this chapter is (i) to examine the Government's principal objectives in introducing the existing mandatory home indemnity insurance arrangements in Western Australia; and (ii) to assess whether there is adequate justification for this Government intervention. The analysis contained in this chapter will inform the Authority's view on the second point in its Terms of Reference, this being to consider whether there is an ongoing need for the mandatory provisions of home indemnity insurance.

5.1 Consumer Protection

The current mandatory home indemnity insurance arrangements in Western Australia were introduced in 1997 through amendments made to the *Home Building Contracts Act 1991* via the *Home Building Contracts Amendment Bill* (the Bill). (Western Australia had voluntary insurance arrangements for builders prior to these amendments.)

Parliamentary debate at the time of the introduction of mandatory home indemnity insurance provides a clear indication that the objective of the introduction of mandatory insurance was to protect consumers. The second reading speech to Parliament of the then Minister for Fair Trading indicates that the Government's stated objective was for introducing mandatory insurance was to:

> increase protection against financial loss for consumers who build or buy new homes or renovate their existing home.[112]

The Minister noted that the Bill would address 'a significant gap in consumer protection' under the then voluntary home indemnity insurance arrangements.

> Currently home owners without home indemnity insurance stand to suffer significant financial loss when builders fail. Often they are unaware of the fact that their builder has no insurance and find out only when their builder fails. [113]

It was further noted in the second reading speech for this Bill that:

> Under current voluntary insurance arrangements, less than half of all new dwellings and substantial renovations are covered by home indemnity insurance and potentially a significant number of consumers are at risk.[114]

So in summary, the then Government's key objective in introducing the Bill was to prevent consumers from experiencing significant losses in the event that their builder has not taken out adequate insurance. In other words, the existing mandatory requirement for builders to hold home indemnity insurance is a consumer protection measure that has been introduced by the Government.

5.2 Is the Consumer Protection Objective Warranted?

Rather than assess the specific merits of the existing *form of* Government intervention (this is done later in this report), the Authority first considered the question of whether any

[112] Western Australia, Parliamentary Debates, Legislative Assembly, 27 June 1996, pp. 3474 (Mrs Cheryl Edwardes).

[113] Western Australia, Parliamentary Debates, Legislative Assembly, 27 June 1996, pp. 3475 (Mrs Cheryl Edwardes).

[114] Western Australia, Parliamentary Debates, Legislative Assembly, 27 June 1996, pp. 3474 (Mrs Cheryl Edwardes).

form of Government intervention is justified to protect consumers from potential costs incurred due to the death, disappearance or insolvency of a builder.[115]

The Authority advocates against Government intervention in private markets unless there is good reason for some form of Government intervention.[116] This is because Government intervention in any market inevitably involves costs and distorts the free and flexible functioning of markets.[117] However, Government intervention in private markets may sometimes be justified in the case of market failures, in which private sector markets do not deliver outcomes that are efficient or optimal when considered from a whole of society perspective.

The approach taken by the Authority is to assume the default position of Government intervention not being justified unless:

- there is strong evidence of one or more market failures having the potential to result in significant but avoidable sub-optimal outcomes; and
- the benefits of Government intervention exceed the costs.

The framework used by the Authority to determine whether there is a case for Government intervention is as follows:

- Consider the size of potential losses that consumers may face as a result of death, disappearance or insolvency of a builder. For a consumer protection measure to be warranted it must be demonstrated that the measure protects consumers (either individually or in aggregate) against potential large losses.[118]
- Consider the ability of consumers, when engaging in a building transaction, to be able to make informed decisions about the builder that they engage in the context of the quality of workmanship of the builder and the risks of death, disappearance or insolvency of the builder. For there to be a case for some form of Government intervention to protect consumers it needs to be established that consumers are unable to make fully informed decisions about the risks that they face when engaging in building transactions.
- Consider the availability of a market-based solution (for example, insurance services provided by the private sector) that consumers could reasonably access to protect themselves from the risks that arise due to death, disappearance or insolvency of a builder. For there to be a case for some form of Government intervention to protect consumers it needs to be established that there is an absence of market-based solutions that can achieve the desired outcome.

[115] The Authority has taken the approach of considering the case for Government intervention in a broad sense in an effort to avoid confining its analysis to the merits or otherwise of the existing mandatory insurance arrangements. If it is the case that some form of Government intervention is justified, then this approach allows the merits of different options to be considered in an unbiased manner.

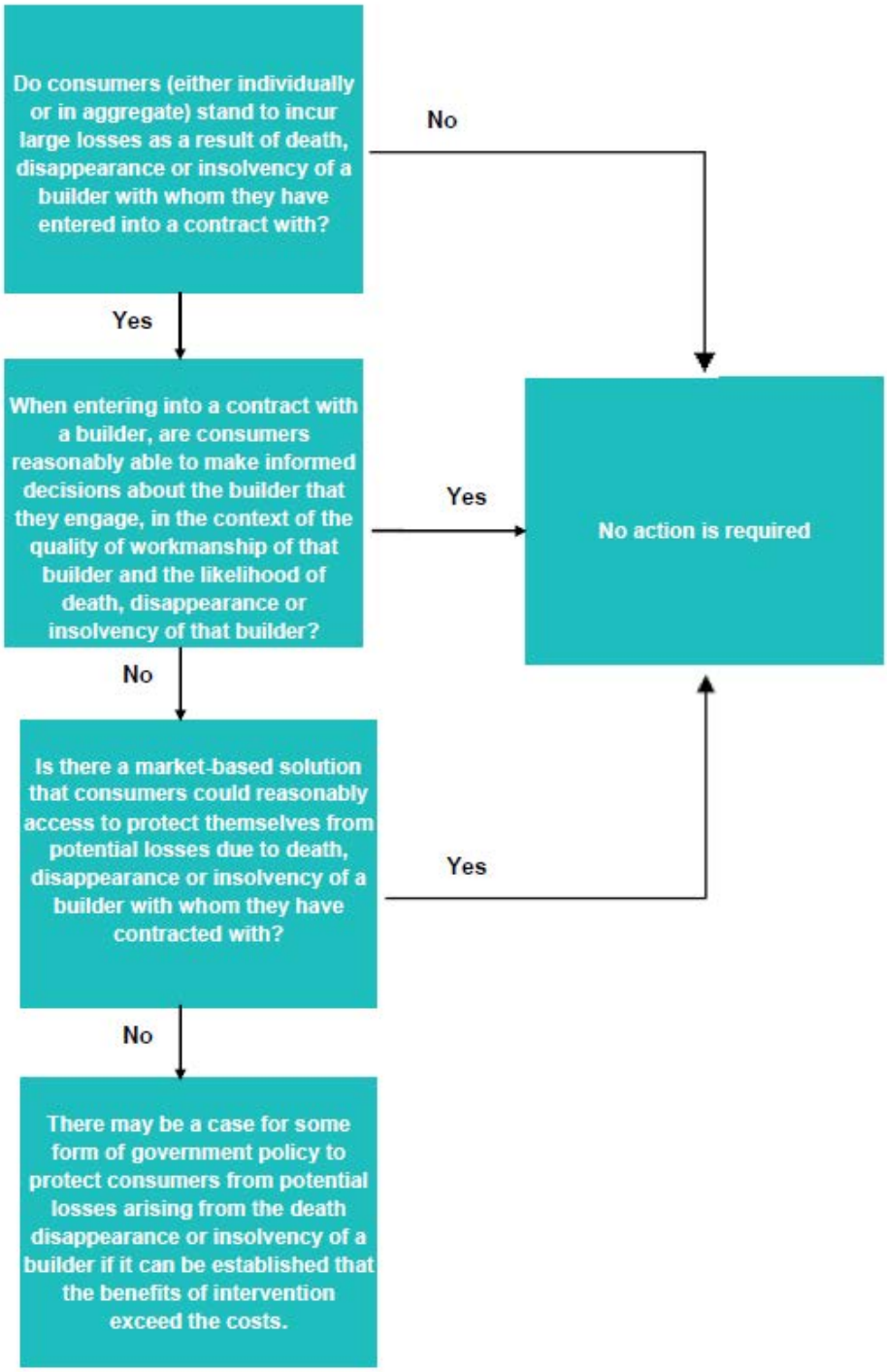
[116] Ultimately this view is informed by the First Welfare Theorem that states that competitive markets generally provide commodities in efficient quantities. See, Rosen, H.S., 2002, *Public Finance*, McGraw-Hill Irwin, Sydney, p. 179.

[117] For example, the existence of mandatory requirements to have home indemnity insurance imposes costs on consumers and builders by limiting choice, imposing a financial cost on consumers and imposing "red-tape" burdens on builders.

[118] There may be a case for a consumer protection measure to be implemented if: (i) a large number of consumers stand to incur relatively small individual losses or (ii) a small number of consumers stand to incur relatively large individual losses or (iii) a large number of consumers stand to incur large individual losses. The case for a consumer protection measure to be implemented is not so strong if there is only a small number of consumers that stand to incur relatively small individual losses.

If all of the above three criteria are satisfied, then it is the Authority's view that some form of Government intervention may be required to protect consumers against potential losses that may arise due to the death, disappearance or insolvency of a builder. The framework is depicted diagrammatically in Figure 5.1 below.

Figure 5.1 Framework to Determine the Need for Government Intervention



5.3 Size of Potential Losses

Broadly, there are three potential areas of loss that consumers may incur as a result of death, disappearance or insolvency of a builder. These potential losses are:

- the loss of deposit that has been paid by a consumer to a builder after which time the builder dies, disappears or becomes insolvent;
- losses arising from the incomplete construction of a new house due to a builder dying, disappearing or becoming insolvent during the construction period; and
- losses arising from structural and non-structural defects becoming apparent after completion only after the builder has died, disappeared or become insolvent.

Each of these losses is considered below.

5.3.1 Loss of Deposit

When engaging a builder to construct a new home, it is typical for a consumer to pay a deposit to the builder prior to the commencement of construction. Section 10 of the Act stipulates that this deposit must not exceed 6.5 per cent of the 'total amount payable under the contract for the home building work'.[119]

As stated earlier in this report, the average value of construction of a new home in Western Australia is approximately $248,000.[120] Consumers are therefore liable to pay, on average, approximately $16,000 deposit to a builder prior to the commencement of construction.

Should a builder die, disappear or become insolvent after receiving a deposit and prior to commencing construction then a consumer would stand to lose, on average, $16,000. For many consumers such a loss could be considered to be significant.

5.3.1.1 Claims Evidence

Data on claims paid does not exactly demonstrate the size of potential losses faced by consumers because existing regulations dictate that the maximum amount payable by an insurer for a loss of deposit is $20,000. Still, the data are indicative of the size and frequency of potential losses. Between July 2010 and January 2013 (30 months), QBE - the main provider of home indemnity insurance in Western Australia - paid [redacted] claims for loss of deposit at an average value of $[redacted] per claim.

5.3.2 Losses due to Incomplete Construction

Once construction has commenced, it is typical for a consumer to pay progress payments to a builder as work is completed. Section 10 of the Act requires that such progress payments can only be charged for work that has been performed or materials or services supplied.[121]

In the event where a builder dies, disappears or becomes insolvent the consumer should have only paid for the value of work completed and therefore on first consideration would

[119] *Home Building Contracts Act 1991*, Section 10(1)(a)(i).

[120] Australian Bureau of Statistics, *Housing Finance, Australia,* cat. no. 5609.0.

[121] *Home Building Contracts Act 1991*, Section 10(1)(b)(i).

not be out of pocket. However, it is when the consumer seeks to engage a second builder to complete the house that additional costs are commonly incurred. In agreeing to complete already existing work a second builder will typically charge a premium relative to the original contract. The second builder needs to be convinced that the structural integrity of the existing work is up to standard because in agreeing to complete a house the second builder may become liable for any existing poor workmanship even though such workmanship was not undertaken by the second builder. This can be achieved through a combination of:

- rigorous investigation of existing work which takes time; and
- the demolition of any areas of suspect work and the rebuilding of these areas by the second builder.

It is common also for a second builder to charge an additional premium simply for the additional risks involved in taking on an existing project.

The Authority understands that a consumer that is forced to find a second builder will generally pay costs that are 10 to 20 per cent higher than the total original contract costs with more evidence that costs will be closer to 20 per cent than 10 per cent.[122] Given the average value of construction of $248,000 such costs would amount to between $28,000 and $56,000.

Anecdotal evidence provided to the Authority suggests that some builders have continued to construct houses knowing that the financial position of their business is precarious. In these cases, it is common for a builder to engage in as many contracts as possible with the intention of "front-loading" the contracts by seeking payment as early as possible in the building schedule so as to generate cash flow. Such builders also tend to have incentives to take short cuts in construction so as to save costs. In situations where these builders eventually end up insolvent or having disappeared, it is commonly the case that it costs more than $100,000 to finish an incomplete home because typically the existing structures, having been built to a poor quality, need to be removed and rebuilt.[123]

5.3.2.1 Claims Evidence

Data on claims paid does not exactly demonstrate the size of potential losses faced by consumers because the maximum amount that is currently paid out by insurers for incomplete construction is $100,000. Still, the data are indicative of the size and frequency of potential losses. Between July 2010 and January 2013 (30 months), QBE paid [redacted] claims for incomplete construction at an average value of $[redacted] per claim.

5.3.3 Losses due to Defects

Under provisions of the *Building Services (Complaint Resolution and Administration) Act 2011*, consumers are protected from costs incurred due to defects that become apparent following the completion of a house. Provided that a builder is still available, the Act

[122] Hansard, Debate in the Legislative Council, 26 October 1994, p. 6033; and Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance*, p. 7.

[123] [redacted]

dictates that a builder must rectify, for no additional costs to the consumer, any defects that become apparent within 6 years of completion of a house.

In the absence of any other protective mechanisms, a consumer would be liable to incur the costs of rectifying defects in the event that defects are identified within six years and the builder has died, disappeared or become insolvent.

It is difficult to ascertain an average cost of defects incurred. Parliamentary debate in 1994 suggested that at the time it was not unusual for repairs to be valued at $20,000 or more.[124] This estimate when inflated to today's dollars amounts to approximately $34,000.

Given this information, it may be reasonable to assume that on average, a consumer would stand to lose in the order of $34,000 in the event that a defect is incurred over the period of six years following completion of a house.

5.3.3.1 Claims Evidence

Data on claims paid may not exactly demonstrate the size of potential losses faced by consumers because the maximum amount that is currently paid out by insurers for defective work is $100,000. Still, the data are indicative of the size and frequency of potential losses. Between July 2010 and January 2013 (30 months), QBE - the main provider of home indemnity insurance in Western Australia - paid [redacted] claims for defective work at an average value of $[redacted] per claim.

5.3.4 Conclusions on the Size of Potential Losses

Approximations on the size of potential losses faced by consumers in the event of death, disappearance or insolvency of a builder range from, on average, $18,000 to $56,000. Data on claims paid by QBE provide support for these approximations in that in the 30 months between July 2010 and January 2013:

- [redacted] claims have been paid for loss of deposit at an average value of $[redacted] per claim;
- [redacted] claims have been paid for incomplete construction at an average value of $[redacted] per claim; and
- [redacted] claims have been paid for defective work at an average value of $[redacted] per claim.

The Authority considers these financial losses to be large and that they are incurred on a relatively frequent basis. On average, considering only the above types of claim,[125] about [redacted] claims have been paid per month. It is especially the case that potential losses arising from the non-completion of a house are the largest both in terms of size of loss and frequency of occurrence.

The above sections have focussed solely on financial costs. The Authority is also aware of the potential social costs involved as a result of defaulting builders.

> For most Australians the purchase of a home is not only the biggest financial transaction of their lives, but also is central to their sense of wellbeing. There are

[124] Hansard, Debate in the Legislative Council, 26 October 1994, p. 6033.

[125] QBE also has a category of claims called other, which has not been especially considered here. Details of "other" claims paid were presented in Chapter 3.

> enormous personal costs associated with delays in completing construction of a home and obtaining repairs to faulty building work.[126]

In conclusion, the Authority believes that potential losses arising from the death, disappearance or insolvency of a builder are of large enough magnitude to warrant further investigation as part of a consumer protection framework. The financial and social costs borne by consumers are likely to be higher in instances where houses are left incomplete due to the death, disappearance or insolvency of a builder rather than in instances where completed houses are found to be defective.

5.4 The New Home Building Market

Having established that there is the potential for consumers to incur large losses when they enter into transactions with builders, the next task is to consider whether consumers are able to make fully informed decisions about the risks that they face when engaging in building transactions. If consumers are able to make fully informed decision about the risks that they face then the case for Government intervention is weakened.

There exists a range of existing consumer protection mechanisms in the new home building market. These mechanisms include:

- the licensing of builders – the intent of the implementation of a mandatory licensing system is to prevent (financially, technically or ethically) unsuitable builders from operating in the market;
- the implementation of dispute resolution procedures – the intent of existing dispute resolution mechanisms is to provide consumers with a means to resolve disputes with a builder in situations where a builder is still trading and available;
- the implementation of building standards – the intent of the implementation of building standards is to ensure that builders build to a suitable standard; and
- the implementation of regulations on the timing of payment instalments – existing regulations require that consumer payment instalments are aligned to the value of work completed so as to avoid situations whereby a consumer has paid for work prior to that work being completed.

The above mechanisms have been implemented primarily to account for information asymmetries that exist between a consumer and a builder. Due to various characteristics of the building industry it is difficult for a consumer to make informed choices.

Specific factors include:

- the existence of information asymmetries between consumers and builders relating to financial security and future intentions of the builder such that a consumer cannot reasonably be expected to be able to make an accurate assessment of the likelihood of a builder disappearing or becoming insolvent part way through a project;[127]

[126] Hansard, Debate in the Legislative Council, 26 October 1994, p. 6034.

[127] The existence of information asymmetries are a differentiating feature of the risks involved in constructing a home in contrast to the risks involved for example in the protection from damage due to climatic events of an existing and complete home. When considering whether to purchase home insurance for an existing home the relative lack of information asymmetries enables consumers to make better-informed choices about the risks that they face.

- further information asymmetries exist that can make it difficult for a consumer to assess the level of quality that a builder will adhere to in the construction of a home. Such asymmetries are particularly acute because of the complexity of house construction and because consumers are infrequent purchasers of new homes;

- a host of other characteristics apply to housing that ultimately make it difficult for consumers to make informed choices about the quality of workmanship that goes into a new home:[128]

    - individuality – some new houses are not standard in their design or build. This makes consumer comparisons of price and build quality difficult and for builders, quality management is not as easy as it would be in an industry characterised by standard outputs;[129]

    - long period of production – it is quite possible that economic conditions or the preferences or financial position of parties change during the time that it takes to complete a house;

    - long period of use – relates to the difficulty consumers have in assessing the quality of workmanship and the costs that are borne (potentially over a long time period) as a result of faulty workmanship;

- the potential for there to be non-aligning incentives between a consumer and a builder: for example, a builder may (for one reason or another) have an incentive to risk their reputation in an effort to construct a house with poor quality and as quickly as possible so as to generate cash flow.[130]

5.4.1 Conclusions on the Building Market

The Authority believes that the factors above when considered together constitute a case that it can be very difficult for consumers to make informed decisions in the new housing market. Some of these difficulties are addressed through existing regulations. However, on balance there is a case that, primarily due to information asymmetries, it is not possible for consumers to make informed decisions about the likelihood of a builder dying, disappearing or becoming insolvent during the time between the receipt of a deposit and the completion of a house, much less to be able to make the same judgement for the six year warranty period following completion of a house. Consumers can also have difficulty assessing the quality of a builder's workmanship due to the nature of houses, the infrequency with which they are purchased and the lack of technical understanding about housing construction techniques.

5.5 The Insurance Market

Having satisfied the first conditions of a case for Government intervention, the final condition is an examination of the availability of a market-based solution that consumers

[128] Organization for Housing Warranty Japan, 2005, *Housing and Home Warranty Programs World Research,* pp. 23-26.

[129] Quality management is exacerbated by unstable factors of production. Houses are not constructed in the stable environment of a factory setting but rather are constructed outdoors in unstable and variable environments.

[130] Numerous stakeholders with whom the Authority has consulted have indicated that such situations do arise in the Western Australian home building market from time to time.

could reasonably access to protect themselves from the risks that arise due to death, disappearance or insolvency of a builder. If a reasonably accessible market-based solution exists that enables consumers to protect themselves then there may be no need for Government intervention.

For this stage of the assessment framework, the Authority has considered the availability of insurance as a means for consumers to protect themselves. The existence of information asymmetries is not uncommon but does not justify Government intervention on its own if consumers are able to access insurance to protect themselves when entering into transactions involving information asymmetries. For example, it is often the case that motor vehicle manufacturers or dealerships offer consumers the option to purchase extended warranties for periods beyond the standard statutory or manufacturer's warranty.[131] In these instances, the existence of extended warranties has not come about due to Government regulation but simply as a result of market forces.

For reasons set out below, the Authority considers that in the absence of Government intervention, it is unlikely that a readily available insurance product that provides protection due to loss brought about by the death, disappearance or insolvency of a builder would be available to consumers.

5.5.1 The Supply of Insurance

Experience in the Western Australian market and in interstate home indemnity insurance markets shows that there has been volatility in insurers entering and exiting the home indemnity insurance market. Such volatility has occurred despite the fact that in recent history in most Australian jurisdictions it is has been a mandatory requirement of Government for builders to hold home indemnity insurance prior to commencement of construction of a new home.

Recent examples of the instability in supply of home indemnity insurance include:

- In Western Australia there has been up to six insurers offering home indemnity insurance under mandatory arrangements but presently there are only two providers in the market. Both providers have expressed some reluctance to continue to operate in the market. This is despite both the existing mandatory requirements on builders and also despite some significant portion of the risk (in the case of QBE) being underwritten by the State Government.

- In 2010, the New South Wales Government became the sole provider of home indemnity insurance in that State following the rapid withdrawal of Lumley, CGU and Vero from the market even though it was mandatory under legislation for builders to hold home indemnity insurance.[132]

- Also in 2010, the Victorian Government announced that it would replace the State's mandatory privately-run insurance scheme with a Government scheme. Just prior to this announcement, four of the five insurers operating in the market had either left or announced plans to leave the market.[133]

[131] Extended warranty policies may be offered by the manufacturer, the dealer or a third party insurer. See, Fair Trading New South Wales website for more details.

[132] Finity, 2012, *Observations on Scheme Progress to 30 June 2011*, *Supplement to Quarterly Reports*, p. 2; and Department of Commerce (WA), 2010, *Review of Home Indemnity Insurance in Western Australia*, p. 1.

[133] Legislative Council Standing Committee on Finance and Public Administration, *Inquiry into Builders Warranty Insurance*, 13th Report to the Legislative Council, p. 11.

- In 2008, the Tasmanian Government removed the mandatory requirement for builders to hold home indemnity insurance. Today, there are no insurers offering home indemnity insurance in Tasmania and it is not possible for consumers to purchase the insurance.[134] A similar experience was encountered in the Northern Territory where, until recently[135], the Northern Territory Government acted as the insurer under a voluntary scheme because a lack of private sector interest.[136]

- Following the withdrawal of several large insurers from the home indemnity insurance market in the Australian Capital Territory in 2002, the Master Builders Association commenced the operation of a fidelity fund thus enabling builders to purchase home indemnity insurance as required by law.[137]

- The South Australian Government recently announced that QBE was withdrawing from the State's home indemnity insurance market as of 1 July 2013. [138]

There is a range of reasons as to why private sector insurers find the home indemnity insurance market unattractive. These reasons relate to the type of risks that are being insured (some risks are more readily insurable than others) and also a number of economic considerations relating to the supply of insurance.

The basic business model of an insurance company is detailed in the box below and following this is an examination of relevant factors relating to the supply of insurance.

[134] The Economic Regulation Authority, October 2012 Consultation with the Department of Justice, Tasmania.

[135] Northern Territory has recently shifted to a fidelity fund arrangement operated by the Master Builder Association.

[136] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 16.

[137] The Economic Regulation Authority, October 2012 Consultation with Master Builders Association, Australian Capital Territory.

[138] Deputy Premier John Rau, 2013, *QBE to Exit Building Indemnity Insurance Market,* Government of South Australia News Release, 14 March.

The Business Model of Insurance Companies

Like any private business, the primary objective of insurance companies is to maximise profit (that is, the difference between total revenue and total costs). On the revenue side of the equation, insurance companies earn income in two main ways:

- insurance premiums earned by selling insurance policies; and
- returns that the insurance company generates by investing those premiums.

Offsetting these sources of revenue are costs incurred by insurance companies. Costs that are specific to insurance companies include:

- losses from claims made against insurance policies;
- costs associated with underwriting; and
- reinsurance costs.

Insurance companies will aim to set premiums such that the revenue earned will exceed costs and the expected value of claims against policies, yet not be set so high as to deter people from taking out insurance policies or choosing to purchase insurance through a competitor.

Insurance companies set premiums using statistics, probabilities and historical data to estimate future claims. More specifically, setting premiums involves the insurance company making assumptions about the likelihood and severity of risks covered by a particular insurance policy and the expected average amount that the insurance company would need to pay out across the relevant class of insurance policy (in the event of insured events occurring).

Insurance companies will vary premiums according to the different perceived risk levels of those seeking insurance. Insurance companies may also manage their risks (and hence potential losses) by declining to insure some applicants.

5.5.1.1 Principles of Insurable Risk

Some classes of risk are better suited to being insured than others. The Authority has considered the insurability of the risks arising from the death, disappearance or insolvency of a builder using a framework of the characteristics of insurable risk.[139] These characteristics are:

[139] As developed by Mehr and Camack "Principles of Insurance", 6th edition, 1976, pp 34 – 37 and also utilised by Smith, 2005, *Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 26.

- *a large number of similar clients* - insuring large groups of similar and similarly-exposed clients facilitates the estimation of risks and likely losses and hence makes pricing the insurance easier;[140]

- *definite loss* - the event that results in an insurance claim being made should have a relatively unambiguous time, location and cause;

- *accidental loss* – the most easily insurable form of risks are accidental risks that are beyond the control of parties to the insurance policy;

- *large loss* - the potential magnitude of the loss should be reasonably significant for the beneficiary of the insurance otherwise there is little incentive to purchase insurance;

- *affordable premiums* - the likelihood of the insured event should not be so high that it results in the premium being too expensive so as to make the insurance policy unattractive for consumers;

- *calculable loss* - an insurable risk is one for which the likelihood of an insured event occurring and the resulting cost can be reliably estimated; and

- *limited risk of catastrophically large loss* - insured events should be unrelated to each other and should not be so severe as to have the potential to bankrupt an insurer.

The Authority has considered these principles as they apply to two categories of risk that consumers bear arising from death, disappearance or insolvency of a builder in the absence of protection. These two categories of risk are:

i. Non-completion risk - associated with a builder dying, disappearing or becoming insolvent during the period following receipt of a deposit but prior to completion of a house.

ii. Structural defect risk - associated with a builder dying, disappearing or becoming insolvent within six years of completion of a house and that house incurring a defect within that time.

The Authority considers that neither of the two risk categories completely satisfies the seven principles of insurable risk. The first category of risk (non-completion risk) is deemed to exhibit more 'insurable' characteristics than the second category of risk (defect risk) (Table 5.1). The failure to satisfy the principles of insurable risk is likely to be a significant factor in the apparent unwillingness of insurance companies to offer home indemnity insurance, even in markets where home indemnity insurance is a mandatory requirement imposed on builders.

[140] This principle has two elements. First, the requirement for a large number of exposed clients is a result of the law of large numbers: as the size of a sample increases, the average result of the sample is likely to approach the average of the whole population hence making the estimation of risks easier. Second, the requirement for clients to be similarly exposed refers to the requirement for each of the insurable clients to be similar and hence exposed to a similar level of risk. The more homogenous is a group of clients the more insurable will be their risks.

Table 5.1 Summary Assessment of Builder Failure against the Principles of Insurable Risk

Principle	First Category of Risk (Non-Completion Risk)	Second Category of Risk (Defect Risk)
Large number of similar exposure units	*Not satisfied* - The market of new home buyers in Western Australia is relatively small (on average about 18,000 new homes are built per year in Western Australia) and the heterogeneity of building companies means that the criterion for similarly exposed units is also not satisfied.	*Not satisfied* - The market of new home buyers in Western Australia is relatively small (on average about 18,000 new homes are built per year in Western Australia) and the heterogeneity of building companies means that the criterion for similarly exposed units is also not satisfied.
Definite loss	*Satisfied* – It should be relatively straight forward to establish that a builder has died, disappeared or become insolvent prior to the completion of a house furthermore the period over which such an event can occur is constrained to the construction period of the house (approximately 12 months).	*Not satisfied* - the existence and cause of a genuine defect needs to be established before a claim can be finalised and it must also be established that the defect is a result of the actions of a builder. The timeframe for a genuine claim of defect can be incurred over a period of six years following construction of a house.
Accidental loss	*Partly satisfied* – Death of a builder is accidental. Insolvency may or may not be accidental. Disappearance is not accidental.	*Partly satisfied* – Death of a builder is accidental. Insolvency may or may not be accidental. Disappearance is not accidental. Defective work may or may not be accidental.
Large loss	*Satisfied* – As established earlier in this section, consumers stand to incur large losses in absence of insurance.	*Satisfied* – In some cases consumers may stand to incur relatively large losses but they are unlikely to be as large as the losses faced due to non-completion.
Affordable premium	*Satisfied* – Evidence from existing home indemnity insurance markets indicates that premiums charged are unlikely to be unaffordable particularly when considered in the context of the costs involved in a purchasing a new home.	*Satisfied* – Evidence from existing home indemnity insurance markets indicates that premiums charged are unlikely to be unaffordable particularly when considered in the context of the costs involved in a purchasing a new home.
Calculable loss	*Partly satisfied* – It is generally the case that the additional costs associated with securing a secondary builder to complete an unfinished house are approximately 20 per cent of the initial contract value. Though if there is unethical conduct on behalf of a builder, the additional costs could be much higher.	*Partly satisfied* – The costs of rectification vary significantly depending on the type of defect incurred.
Limited risk of catastrophically large loss	*Not satisfied* – The risk of catastrophically large loss is high due to the existence of very large builders in Western Australia and the cyclical nature of the industry which may cause a correlation of risks and hence the collapse of numerous builders at around the same point in time.	*Partly satisfied* – The risk of catastrophically large loss is somewhat limited by the fact that the events for the insurance to be triggered include (i) the death, disappearance or insolvency of a builder and (ii) the occurrence of structural defects. The two triggers are likely to dull the potential for a catastrophically large loss.

5.5.1.2 Evaluation of the Insurability of Non-Completion Risk

The main factors that limit the insurability of non-completion risk include the small size of the market which is limited to the volume of new homes constructed and the relatively high risks of catastrophic loss. The small size of the market limits the ability of insurers to rely on the law of large numbers[141] and this makes the estimation of the probability of losses difficult.[142] All insurers prefer to offer insurance to large markets.[143]

Not only is the new home building market relatively small from an insurance perspective but it is also comprised of a highly heterogeneous set of builders. This is particularly the case in Western Australia. Some builders are single person enterprises operating relatively simple business models while others are large-scale builders that build multiple thousands of homes per year and run sophisticated business operations. For insurers, this heterogeneity of builders makes the task of identifying and quantifying risks potentially difficult and costly. In a small market it is even less likely that there will be an ability (or an appetite) for insurers to invest extensive resources in distinguishing the different risks of individual operations and this again can limit the insurability of the risks in question.[144] In the provision of actuarial advice to the Authority, PWC noted:

> Insurance schemes are most efficient when there is a large pool of highly uniform risks which are independent of each other. Despite home indemnity insurance policies being issued on a per housing start basis, they are ultimately insuring against builder failure, which is highly concentrated towards a small number of large risks in Western Australia.[145]

The high risks of catastrophically large loss arise because the Western Australian home building industry is concentrated and also because economic factors that may cause one builder to become insolvent may drive other builders to insolvency. This means that occurrence of different insurance events may not be independent from each other and hence the "insurability" of the risks of insolvency is relatively low.

The relatively high potential for catastrophic loss has a twofold effect on the supply of insurance. The first relates to the obvious risks that an insurer takes on if such a product is offered. The second relates to the need for the insurer to hold capital to protect against the potential for a large loss to be incurred. The higher the potential loss incurred, the higher will be the capital requirement that an insurer is required to hold. Thus even if a large loss is never incurred, an insurer offering a product characterised by the potential for

[141] The law of large numbers, also known as the law of averages, states that the observed frequency of an event more nearly approaches the underlying probability of the population as the number of trials approaches infinity. In the context of insurance, the more cars insured, the more accurately can be predicted the percentage of cars likely to be stolen. See, *Economic Basics of Insurance: Law of Large Numbers*, http://www.hmrc.gov.uk/manuals/gimanual/gim1130.htm.

[142] Consider as an example a comparison between the home indemnity insurance market and the car insurance market. In Western Australia, it is estimated that there are approximately 2.0 million registered vehicles (Australian Bureau of Statistics, Cat. No. 9309.0). In 2011/12, there were approximately 17,500 new houses constructed in Western Australia. The car insurance market is therefore approximately 114 times as large as the home indemnity insurance market.

[143] It is interesting to consider the case of public liability insurance as it has similar characteristics to forms of home indemnity insurance (long tail, uncertain risks, relatively small market). However, unlike home indemnity insurance most Australian insurers offer public liability insurance. To quote the ACCC, the fact that most insurers offer public liability "is primarily as a consequence of it being a component of home and contents policies. This spreads the fixed costs such as acquisition, issue and administration over a considerably larger base premium." See, ACCC, 2002, *Second Insurance Industry Pricing Review*, p.43.

[144] Australian Competition and Consumer Commission, 2002, *Second Insurance Industry Market Pricing Review*, p. 72.

[145] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 8.

large loss will incur high opportunity costs as a result of having to have a large value of capital held in reserve.[146]

In summary, the main limiting factors on the insurability of non-completion risks are:

- the small size of the market and the heterogeneity of builders; and
- the potential for catastrophic losses.

As demonstrated in Table 5.1, other limiting factors include:

- the absence of pure accidental losses; and
- the absence of easily calculable losses.

5.5.1.3 Evaluation of the Insurability of Defect Risk

Similar factors exist in the consideration of structural defect risk though catastrophic risks are unlikely to be as pronounced in cases of defects as they are in cases of non-completion.[147]

However, the insurability of defect risk suffers from a lack of clarity around what constitutes a definite loss. That is, there can be much uncertainty about what constitutes a genuine defect risk. If an insurer were to provide insurance against this type of risk it is likely that they would incur high administrative costs in identifying genuine claims and then estimating the relevant costs of claims.

In considering other factors, defect risk also performs relatively poorly in terms of insurability when it comes to matters such accidental loss. There are some elements of defect risks that may be accidental, for example death or insolvency. However, disappearance of a builder is not accidental and neither may be insolvency in some circumstances.

Further, the quality of workmanship affected by a builder is not the result of accident and sometimes is the result of a conscious decision on behalf of builders to “cut corners” so as to save costs. A submission by Vero to an earlier inquiry into home indemnity insurance demonstrates the issue of accidental loss from the perspective of insurers:

> One of the basic criteria required to create an insurable event is, such event is accidental and beyond control of the insured or any other party with a financial interest.[148]

The long tail associated with defect risk (six years) also makes the provision of insurance difficult and relates to the criterion of definite loss in Table 5.1. In offering a typical long tail

[146] The Australian Prudential and Regulation Authority imposes an Insurance Risk Charge on Australian insurers. This charge is the minimum amount of capital required to be held against insurance risks. In simple terms, the higher the assessed risks that are being insured, the higher will be the minimum capital requirement.

[147] This is because the costs of rectifying defects are typically lower than the costs of completing incomplete works. It is also because there are effectively two triggers for a defect claim to be actioned: death, disappearance or insolvency *and* the occurrence of a defect; whereas there is only one trigger for a non-completion claim to be actioned: this is the death, disappearance or insolvency of a builder following the acceptance of a deposit.

[148] Vero Insurance, 2008, *Submission 71 to VCEC Inquiry into Housing Regulation*, quoted in Standing Committee on Economics, 2008, Australia’s Mandatory Last Resort Home Warranty Insurance Scheme, p. 61.

line of insurance, insurers must strike a premium that reflects risks carried for a long period of time. This premium cannot then be changed should the likelihood of a claim being triggered change over that long period of time, which it almost inevitably will.

> One of the main consequences of long tail lines of business is that deteriorations in claims experience can take some years to materialise and, if not properly monitored, can have a sizeable impact on the feasibility of the scheme.[149]

Both QBE and Calliden have expressed to the Authority the difficulties surrounding the estimation of premiums and the uncertainties that arise as result of the six year warranty insurance period. For QBE at least, the existence of the six year warranty period is perhaps the most concerning aspect of the company's home indemnity insurance service offering.[150] Similar views have been expressed to the Authority by Calliden.

In summary, the main limiting factors on the insurability of defect risks are:

- the small size of the market and the heterogeneity of builders; and
- the absence of definite losses (incorporating issues surrounding the six year tail).

As demonstrated in Table 5.1, other limiting factors include:

- the absence of pure accidental losses;
- the absence of easily calculable losses; and
- the potential for catastrophic losses.

5.5.2 Conclusions on the Insurance Market

There exists both empirical and theoretical evidence that indicates that, in the absence of Government intervention, the private sector would be unlikely to provide consumers with a reasonably accessible product that could provide protection against loss due to the risks of death, disappearance or insolvency of a builder with whom they have entered into a contract. The absence of private sector supply of insurance is something that has been observed in other insurance markets (see box below).

[149] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 6.

[150] The Economic Regulation Authority, October 2012, Consultation with Calliden and QBE.

The Supply of Insurance

It is not unusual for there to be a lack of supply for insurance services even though there might be demand for it. For example, flood insurance for crops and livestock is not available in Australia and neither is multi-peril crop insurance. Similarly, in the early 2000s there was a large scale withdrawal of insurers offering public liability and professional indemnity insurance in Australia. More recently, some insurers have ceased to provide flood insurance to home owners living in certain regions of Queensland.

When considered as lines of insurance, professional indemnity insurance and public liability insurance have many similarities with insurance for the type of risks relevant to this inquiry. In particular, these are uncertain claims costs and the long tail nature of the insurance. Insurance product lines that have these types of characteristics have a tendency to be viewed by insurers as marginal when compared with other product lines.

Lines of insurance that carry a greater level of uncertainty are the first lines of insurance that will cease to be offered particularly in times when capacity is constrained. In such times, insurers will opt to use their limited financial capacity to offer safer lines of insurance. Thus, even if a particular line of insurance is deemed to be profitable it may not be supplied by insurance companies, particularly in times when financial capacity is constrained.

Source: Australian Competition and Consumer Commission, 2002, Second Insurance Industry Market Pricing Review*, pp. 63-80; S. Elsworth, 2012, Suncorp Will Not Offer New Policies to Queensland Towns, Courier Mail, 7 May.*

The Authority assessed the relative insurability of (i) non-completion risk and (ii) defect risk and found both risks to contain certain elements that limited their insurability. These limiting factors are summarised in Table 5.2.

Table 5.2 Factors Limiting the Insurability of Non-Completion and Defect Risks

Non-Completion Risk	Defect Risk
Small market and heterogeneity of builders	Small market and heterogeneity of builders
Absence of pure accidental losses	Absence of definite losses (incorporates issues surrounding the six year tail)
Absence of easily calculable losses	Absence of pure accidental losses
Potential for catastrophic losses	Absence of easily calculable losses
	Potential for catastrophic losses

Source: Authority analysis.

On consideration of the above factors, the Authority considers that the insurability of both non-completion risk and defect risk is limited and that the limitations are more pronounced for defect risk than they are for non-completion risk.

5.6 Conclusions on the Need for Government Intervention

The Authority has adopted a rigorous framework to determine whether there is a need for some form of Government intervention to protect consumers from the risks of death, disappearance or insolvency of a builder with whom they are contracted. This framework requires that three hurdles be cleared before a case for intervention can be made. The Authority has found that:

- First, consumers stand to suffer large financial (and possibly emotional) losses in the event that their builder dies, disappears or becomes insolvent. Such losses are particularly large if the death, disappearance or insolvency occurs prior to completion of a house but may also be relatively large if it occurs during a period spanning six years from completion of a house (if that house is found to have defects).

- Second, consumers cannot reasonably be expected to make informed decisions about the likelihood of their builder dying, disappearing or becoming insolvent over the period for which the builder is engaged or for the subsequent six year warranty period that follows completion of a house. This is primarily because of information asymmetries that exist between a consumer and a builder but also simply because of the length of time involved and the likelihood of change that can take place over such a period of time.[151]

- Third, in the absence of some form of Government intervention it would be highly unlikely that some market-based solution would be available that consumers could reasonably access to protect themselves from the risks that arise due to death, disappearance or insolvency of a builder.

The Authority considers that there is a case for some form of Government intervention to protect consumers against potential losses arising from the death, disappearance or insolvency of their builder. The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because the losses incurred due to non-completion are potentially much greater than they are for defective work.

It is important to note that the analysis does not find that the current form of Government intervention (being the mandatory requirement for builders to hold home indemnity insurance) is necessarily the optimal form of intervention.

A range of potential consumer protection options - including the existing measures - are presented in the next chapter. Following this, each potential option is assessed for its suitability and ability to deliver the desired consumer protection outcomes at minimum cost to consumers, builders and the Government.

[151] The fact that most consumers are very infrequent purchasers of new houses also limits their ability to make informed decisions as this hampers the ability to learn from past decisions and experiences.

6 Options for Government Response

This chapter contains a selection of models that could be implemented with the intent of providing protection to consumers against losses incurred as a result of death, disappearance or insolvency of their builder.

6.1 Overview

The following sections present the broad frameworks of the models that the Authority considers to be options that could provide financial protection to consumers who incur costs as a result of death, disappearance or insolvency of their builder.

It is not a necessary condition of an effective model that it be based on the traditional concept of insurance[152] but given the nature of the problem at hand, the Authority has determined that models that are based on the concept of insurance are likely to present the most effective options. This is because the nature of the problem requires a large pool of funds, that can be accessed to pay claims as they arise.

6.2 A Comment on First Resort or Last Resort Insurance

A common point of discussion on matters relating to home indemnity insurance is the merits of 'first resort' insurance versus 'last resort' insurance. Insurance offered as part of a last resort scheme (as is the model currently used in Western Australia[153]) can only be activated in the event of death, disappearance or insolvency of a builder. It is, as the name suggests, a form of last resort protection that can be triggered when a consumer has no viable avenue to resolve a dispute with a builder because that builder is unavailable.

First resort insurance does not require the death, disappearance or insolvency of a builder as a necessary condition for a claim to be triggered. Under a first resort scheme, a consumer is able to trigger a claim in instances where work is incomplete or defective irrespective of whether the builder is available and trading or has died, disappeared or become insolvent.

Proponents of first resort schemes argue that a key difference between first and last resort schemes is the greater burden of responsibility on consumers that arises under a last resort scheme. This is because under a last resort scheme the task of establishing that a builder has died, disappeared or become insolvent will often fall to the consumer. Whereas, in theory, under a first resort scheme, consumers have no need to be concerned about whether or not their builder has died, disappeared or become insolvent.[154] Rather, consumers need only be concerned about whether they have encountered a genuine defect or whether work that a builder has contracted to complete

[152] Being that a premium is paid upfront in exchange for a commitment by an insurer to pay a claim if and when a certain event takes place in the future.

[153] Last resort insurance schemes are used in every Australian jurisdiction except Queensland and Tasmania. Queensland implemented a first resort model in 1973 whereas in Tasmania neither first nor last resort insurance is available.

[154] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October.

has been left incomplete. In either case the consumer is able to make a claim. The responsibility for paying claims or rectifying the situation then falls to the insurer.

The insurer can either seek to force the builder to complete unfinished work or rectify defective work if the builder is available, or pay the claim itself if the builder has died, disappeared or become insolvent.

In first instance, it appears that first resort schemes provide effective and immediate cover for consumers. However, in practice, the Authority has found that first resort insurance processes can be as equally as onerous and disruptive to consumers as traditional building dispute resolution processes (refer box below).

The First Resort Dispute Resolution Process in Queensland

The Authority has reviewed some of the processes surrounding the making of a claim under the Queensland first resort insurance scheme. In short, the scheme requires that consumers seeking to make a claim must:

- *first*, check that the provider of the insurance can assist with the complaint and that the complaint can be made within the given timeframes;
- *second*, clearly identify all defects or incomplete items and try to resolve these with the builder (in events where the builder is available);
- *third*, if step two is unsuccessful provide written notification and explanation of concerns to the builder and provide sufficient time for the builder to rectify;
- *fourth*, if the required work has not been undertaken, the consumer must complete a complaints form and provide it to the insurer;
- *fifth*, the merits of the complaint is assessed by an Assessment Officer employed by the insurer and the Assessment Officer may bring the builder and consumer together to commence a mediation process;
- *sixth*, if mediation is unsuccessful a Building Inspector (also employed by the insurer) is assigned to undertake a site inspection. If the builder is found to be at fault then an order to rectify will be issued, otherwise the case is dismissed;
- *seventh*, if the builder fails to adhere to the order to rectify, the insurer may commence disciplinary action in the State Administration Tribunal.

The real world ramifications of this process on consumers was outlined in a number of submissions made to the *2012 Inquiry into the Operation and Performance of the Queensland Building Service Authority*. Consumers identified lack of feedback from insurers in relation to decisions made; excessive time delays; and high costs associated with securing legal and engineering advice as problems encountered under the first resort scheme. Consumers also complained of poor quality rectification works being performed under order by the original builder.

Sources: Building Services Authority website, http://www.bsa.qld.gov.au; and submissions to the Inquiry into the Operation and Performance of the Queensland Building Services Authority 2012, available at: http://www.parliament.qld.gov.au.

Although a first resort scheme appears to provide a more efficient and effective scheme for consumers, in actual fact the process is similar to that of a last resort scheme. Given this, the Authority considers that a first resort home indemnity insurance scheme in Western Australia is not feasible for a number of reasons. These reasons are discussed below.

6.2.1 Perverse Incentives and Nuisance Claims

The Authority holds concerns that a first resort insurance scheme may bring about perverse incentives and an excessive amount of non-genuine claims (commonly referred to as nuisance claims). The potential for these results arise from the incentives that are created by a first resort insurance scheme, where in theory, the first action step for a consumer who is dissatisfied with a builder or building process is to make a claim. For example, under a first resort scheme there may be a tendency for the following suboptimal outcomes to arise:

- *moral hazard affecting builders* – with the knowledge that consumers are covered for defective or incomplete works, there may be a tendency for the standards of builders to not be as high as they otherwise would be;

- *moral hazard affecting consumers* – similarly, knowing that they are protected by a first resort scheme, consumers may not invest the same amount of resources into the selection of an appropriate builder and the monitoring of the building process. The Authority considers that this would be a suboptimal outcome because free markets work to produce optimal results for consumers through the mechanism of consumers choosing preferred suppliers based on their assessments of the price and quality of the service offering. A first resort scheme may blunt this mechanism; and

- *nuisance claims* – there may be a tendency for consumers to resort to making claims without investing sufficient time in following up on the issue with the builder. Such claims need to be assessed and therefore first resort schemes can be very costly to run. High costs are ultimately paid by all consumers of the insurance irrespective of whether they have a need to trigger a genuine claim.

6.2.2 High Costs but Few Tangible Benefits

First resort insurance schemes are designed to provide consumers with protection in instances where a builder is still trading and available *and* in instances where the builder is unavailable due to death, disappearance or insolvency.

In Western Australia, and most other jurisdictions, the existing last resort insurance scheme operates in conjunction with other pieces of legislation that exist to provide consumers with protection in the event of a dispute incurred while a builder is trading and available. These arrangements, implemented principally through the *Building Service (Complaint Resolution and Administration) Act 2011*, were discussed in Chapter 2.

The Authority considers that the existing dispute resolution mechanisms contained in the *Building Service (Complaint Resolution and Administration) Act 2011* are broadly effective in providing an effective avenue for consumers to pursue in the event of a dispute

involving an active builder. Further, the existing mechanisms are able to be amended to bring about improvement in areas where they may be considered to be deficient.[155]

The implementation of a first resort scheme would require that the existing dispute resolution mechanisms created through legislation be rescinded. The administrative infrastructure, Government processes and knowledge about how the existing dispute resolution scheme works would all be replaced by new processes brought about by a first resort scheme. In theory, the first resort scheme would provide similar levels of consumer protection as that which exist at present. That is, the combination of the existing last resort mechanisms (triggered when the builder is unavailable) combined with dispute resolution mechanisms (triggered when the builder is available) provides the same level of consumers protection as would a first resort scheme.

This point was well made by Smith in his review of the merits of first versus last resort insurance:

> If the various support systems are appropriately provided then either a first or last resort scheme can be sustainable and can provide adequate consumer protection.[156]

Shifting to a first resort scheme would entail very high administration and transition costs yet as evidenced above would deliver few (if any) tangible benefits to consumers. The Authority considers that the "various support systems" referred to by Smith are "appropriately provided" and hence there would be no net benefits created by a shift to a first resort insurance scheme. It is likely that such a shift would impose significant net costs on the community.[157]

6.2.3 Lack of Private Sector Interest

Prior to the collapse of HIH in 2001, most jurisdictions in Australia operated first resort home indemnity insurance schemes. At the time of writing this report, Queensland was the only jurisdiction operating a first resort scheme. In Queensland, the State Government acts as the sole insurer.

Other jurisdictions have shifted from first to last resort schemes primarily as a result of a lack of private sector interest in the provision of first resort home indemnity insurance services.[158] For example:

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[155] Through discussions with the Building Commission, the Authority has been made aware of certain aspects of the existing dispute resolution mechanisms that could be improved. It is considered beyond the scope of this inquiry to delve into these areas and assess the scope for improvement.

[156] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 34.

[157] Smith (p. 34) also found that an effective first resort system "requires a monopoly insurance provider with strong controls over builder licensing". In this way, the insurer can have a greater understanding of the risks for which it faces when providing first resort insurance services for different builders. In short, first resort insurance is far more affected by the competence of builders than is last resort insurance. Such an approach has been adopted in Queensland where the Building Services Authority acts as a licenser, regulator and insurance provider. The Queensland model has recently come under criticism for the potential for conflicts of interest that arise due to the multiple roles being undertaken by a single organisation. Accordingly, recommendations have been made to separate the insurance function from the other functions of the BSA as a means to improve the effectiveness of the model and also to restore consumer and builder faith in the model. See, Transport, Housing and Local Government Committee, 2012, *Inquiry into the Operation and Performance of the Queensland Building Services Authority 2012*, p. 52.

[158] In conjunction with the shift to last resort these jurisdictions have sought to strengthen the consumer protection mechanisms where circumstances exist where the builder is still trading and available. See for example *Standing Committee on Finance and Public Administration, Inquiry into Builders Warranty Insurance, 2010, pg.15.*

- Victoria and New South Wales both shifted to a last resort scheme shortly after the collapse of HIH in 2001 and the withdrawal of other insurers from the market;[159]

- Tasmania shifted to a last resort scheme in 2003[160] and subsequently to a voluntary scheme in 2008;[161] and

- South Australia, the Northern Territory and the Australian Capital Territory all operate last resort insurance schemes.

The lack of private sector interest in a first resort insurance scheme was a point noted by the Productivity Commission in its 2008 *Review of Australia's Consumer Policy Framework*.[162] Also in 2008, Vero submitted to a Senate inquiry into Australia's home warranty arrangements and specifically commented on the problems in the provision of first resort insurance:

> One of the basic criteria required to create an insurable event is, such event is accidental and beyond the control of the insured or any other party with a financial interest. First resort builders warranty insurance does not and cannot work because it fails to meet the two primary tests of insurance, i.e. those of insurable/financial interest and insurable event. A builder may gain a potential financial advantage by triggering an event which is not accidental and over which he has control.[163]

Similar comments to the Senate inquiry were put forward by the Housing Industry Association in relation to the workings of a first resort insurance scheme that put the onus on insurers to force available builders to rectify or complete existing work:

> The risk of obtaining and enforcing a court order [against a builder] is not one the insurer can realistically insure.[164]

In addition to issues surrounding the insurability of risks under a first resort scheme is the issue of the large volume of claims that are typically generated by such schemes. Under a last resort scheme, disputes do not reach the insurer unless the builder has died, disappeared or become insolvent whereas under a first resort scheme, the insurer must deal with all disputes and seek recovery from builders.

Such an outcome has clear cost implications for insurers. First resort schemes also tend to generate an increased number of 'nuisance claims' where consumers have not adequately followed up with their builder.[165] Most insurers are not willing to handle the large volume of general inquiries that are typically generated by first resort insurance.[166]

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[159] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, pp. 14-15.

[160] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 15.

[161] The Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, p. 8.

[162] Productivity Commission, 2008, *Review of Australia's Consumer Policy Framework*, Volume 2, pp. 124-127.

[163] The Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, p. 61.

[164] The Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance Scheme*, p. 61.

[165] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs*, Report to the Economic Regulation Authority [Draft Report], p. 12.

[166] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 26.

The Authority has a preference for schemes that are able to engage private sector insurers where possible and appropriate. To opt for a first resort insurance scheme would, in the current environment, remove the possibility of private sector involvement and this is considered undesirable for the facts that:

- private sector insurers are likely to be more efficient and have more expertise than the Government in the provision of home indemnity insurance services;[167] and
- a model whereby Government acts as the sole insurer has no ability to deliver competitive outcomes to consumers because the Government would act as a monopoly provider of services.

Furthermore, the difficulty in insuring first resort risks as discussed above would equally apply to a Government provider of insurance as it does to private sector insurers. The Authority considers it sub optimal to constrain its model to one where the Government is forced to be the sole insurer,[168] and where the "insurability" of the risks that would be taken on by Government is low.

6.2.4 Conclusions on First Resort Insurance

For the reasons stated above, the Authority does not consider a first resort insurance scheme to be appropriate for Western Australia given the existing legislation and policy frameworks that are intended to protect consumers in instances where their builders are still trading and available. It is for this reason that the models presented in this chapter are all last resort schemes. These models are classified as either private sector models; Government models; industry models; or hybrid models.

6.3 Overview of Model Options

Key features of the different models discussed in this chapter include the:

- *provider(s) of insurance* – providers could include parties such as private sector insurers, the Government or the building industry;
- *vehicle(s) by which insurance is provided* – models may be based on the typical model of insurance; a fidelity fund model; or some other form of contractual arrangement;
- *period for which consumers are protected* – the period for which consumers are covered (currently the construction period plus a six year warranty period) can be altered; and
- *degree of choice surrounding participation* – the current scheme is mandatory but consideration of voluntary alternatives is warranted provided that consumers are appropriately informed about the choices available to them and the risks that they face.

[167] Such has been the finding from experiences in New South Wales (and possibly Victoria) where the Government has chosen to act as the sole insurer under a last resort model but has had to engage the private sector insurers to perform risk rating and other administrative processes due to the expertise held by the private sector and the lack of expertise within the Government. Source: The Economic Regulation Authority, January 2013 Consultation with the New South Wales Home Warranty Insurance Fund.

[168] Last resort insurance schemes by contrast offer the flexibility to enable some (though perhaps limited) degree of private sector participation.

The Authority has considered nine models (including the status quo). These models are defined as private sector models, government models and hybrid models. The key features of each of the models are summarised in Table 6.1. Following the table is a discussion of the characteristics of each model.

Table 6.1 Overview of Model Options

Model Name	Provider(s) of Insurance	Vehicle(s) by which Insurance is Provided	Period for which Consumers are Protected	Degree of Consumer Choice
Private Sector Models*				
- Status quo	Private sector	Typical insurance model	Construction + 6 year warranty period	No choice
- Private limited coverage	Private sector	Typical insurance model	Construction + 2 year warranty period	No choice
- Fidelity fund	Industry	Fidelity fund	Assumed to be construction + 6 year warranty period but flexibility exists	Choice may be enabled
- Builder based	Industry	Member obligations / contractual agreements	Assumed to be construction + 6 year warranty period but flexibility exists	Choice may be enabled
Government Models				
- Government full coverage	Government	Typical insurance model	Construction + 6 year warranty period	No choice
- Government limited coverage	Government	Typical insurance model	Construction + 2 year warranty period	No choice
- Government opt-out	Government	Typical insurance model	Construction + 6 year warranty period if purchased	Informed choice
Hybrid Models				
- Private ancillary	Government and private sector	Typical insurance model	Construction period as mandatory with warranty period optional	No choice for basic cover but ancillary cover is optional
- Private with industry supplement	Private sector and industry	Combination of insurance model and fidelity fund	Construction + 6 year warranty period	Some choice may be enabled for defect cover

** Note: While these models (and some other models in the table) are referred to as private models it is almost inevitable that their implementation would require some form of government reinsurance, as exists under the status quo. This is because there is an absence of private sector reinsurers willing to offer reinsurance in this market and insurers would be unlikely to provide home indemnity insurance services in Western Australia without being able to access some form of reinsurance. This issue is discussed in more detail in Chapter 11. Source: Authority analysis.*

6.4 Private Sector Models

Private sector models are those where private sector insurers act as the primary providers of insurance. As noted in the table above, it is unlikely that these models could be pure private sector models because there will likely be a need for the Government to provide some form of reinsurance so as to attract private sector insurers into the market. This issue is discussed in more detail in Chapter 11 in the context of a discussion on the implementation of the recommended model.

6.4.1 Model 1: The Status Quo

The *status quo model* is characterised by the following features:

- a mandatory requirement for builders to hold the relevant insurance prior to the commencement of construction;

- the Government provides reinsurance for the main private insurer for any loss incurred between $10 million and $90 million resulting from the failure of a single builder;

- the private sector providers of insurance determine insurance premiums based on the risk rating of different builders and the premium revenue earned by the Government is calculated as a percentage of the total premium charged by the private sector insurer; and

- the model provides cover to consumers for loss of deposit (up to $20,000); and losses due to incomplete construction (up to $100,000); and for defects incurred within a six year period commencing at the completion of construction (also up to $100,000).

6.4.2 Model 2: Private Limited Coverage

Past history (in both Western Australia and other jurisdictions) has shown that private sector insurers are generally reluctant to provide insurance under the existing Western Australian model. There are currently two insurers operating in the Western Australian market and each insurer serves different segments of the market.[169] The Authority considers that this is demonstrative of the absence of a real competitive private sector supply response to the current model.

Consultation with private sector insurers and the Authority's own review of insurance principles has indicated that one of the key factors of the current model that deters insurers is the existence of the six year defect period. The six year defect period makes the pricing of premiums difficult and prevents insurers from being able to ascertain the true cost of any particular underwriting year until many years after that underwriting year.

> Delays in building and settling claims can mean that payments [by insurers] in relation to a particular year are still being made 10 years after the policy was issued. This in turn means that it takes several years before the ultimate costs of an underwriting or generation year can be known with any certainty.[170]

For these reasons, the Authority considers that a model similar to the existing model but with a shorter defect period (two years rather than six years)[171] is worth consideration because such a model may attract a greater degree of private sector participation.

In turn, a greater competitive response would likely bring benefits to consumers in terms of prices and service offering. Such benefits will be offset to some extent (from a consumer perspective) by the reduction in defect protection from six years to two years. An evaluation of this model will require consideration be given to the potential size of these gains and losses.

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[169] As a means of comparison, the Authority conducted a quick internet search for companies that offer car insurance in Western Australia. In the space of a few minutes, the Authority identified more than 15 different providers of car insurance in Western Australia.

[170] See, D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 6.

[171] A warranty period of two years is suggested because it is a balance between being long enough to provide consumers with some degree of protection for defects while also being short enough to attract interest from private sector insurers. It is also based on discussions with the Housing Industry Association where it was indicated that a two year (rather than a six year) defect period is sufficient to protect consumers against major building defects. This is because it has been said that most defects will become apparent within two years of completion of a house (specifically two summers and two winters).

The key features of this model are similar to the status quo in that the insurance is predominantly provided by private sector insurers and that the scheme is mandatory. The distinguishing feature of this model compared to the status quo is the shortened warranty period.

6.4.3 Model 3: Fidelity Fund

The Terms of Reference of this inquiry specifically require the Authority to consider a *fidelity fund model* as a possible alternative to current arrangements. The Authority has taken the term fidelity fund to refer to a financial instrument to which members of the fund contribute money. The money collected in the fund can then be used to provide compensation to consumers that incur losses due to death, disappearance or insolvency of a builder.

Fidelity fund arrangements such as described above have been used to protect new home buyers in the Australian Capital Territory since 2001 (operated by the Master Builders Association) and have also recently been implemented in the Northern Territory (also operated by the Master Builders Association).[172]

Fidelity Funds in the ACT and NT

In 2002, the Master Builders Association, in response to private insurer withdrawals from the market, lobbied the State Government to enable it to operate a fidelity fund as an effective alternative to insurance purchased through private insurers.

In response to the establishment of a fidelity fund the ACT Government imposed a set of prudential standards and statutory warranties that apply to fidelity funds under the *Building Act 2004*. Provisions of the *Building Act 2004* enable the ACT Government to approve the use of a fidelity fund as a vehicle for builders warranty protection and also to establish prudential standards and penalties for non-compliance.

Related legislation requires trustees of an approved fund to maintain sufficient capital at all times and that ongoing valuation of an approved fund must be performed by an actuary. In valuing an approved fund, an actuary is required to calculate the appropriate value of contributions to the fund that is to be paid by its members. Approved funds are also required by regulation to have in place adequate contingency plans outlining response plans for disasters, unforseen events and system failures.

A similar system is being established in the Northern Territory which commenced on the first of January 2013. The Northern Territory fund will charge builders a flat rate of the contract price of work to be undertaken.

In Western Australia, Division 3A of the *Home Building Contracts Act 1991* enables the creation of an “approved fund” to provide cover as would be provided by an insurance

[172] In the Australian Capital Territory, a fidelity fund scheme operates in conjunction with QBE offering private insurance services to builders. In approximate terms, the MBA fidelity fund services 70 per cent of the market and QBE services 30 per cent of the market. Source: The Economic Regulation Authority, October 2012 Consultation with the Master Builders Association, Australian Capital Territory .

contract. The Authority is not aware of a fund ever being approved by the relevant Minister but is aware of one proposal being put forward by the private sector.

For the purposes of this inquiry the Authority has assumed the following:

- the fidelity fund would be the only means by which builders could obtain the appropriate cover that would enable them to build and contributions to the fund would be mandatory;
- the fidelity fund would not seek reinsurance and would not outsource its administrative functions;
- the fidelity fund would be operated by a party other than the Government, most likely an industry association such as the Housing Industry Association or the Master Builders Association;
- contributions to the fidelity fund would be calculated at a fixed rate per value of building work undertaken and this fixed rate would be payable by all builders;[173]
- (as a default option)[174] payments from the fund would be made on the same basis as exist at present, that is:
    - non-completion payments would be paid to consumers in the event of death, disappearance or insolvency of a builder; and
    - payments to rectify defects incurred within six years of completion would be made if a builder was unavailable due to death, disappearance or insolvency.
- the fidelity fund would require some form of statutory oversight by Government to ensure appropriate capital is maintained.

6.4.4 Model 4: Builder-Based Model

The Netherlands is one of a few countries that operates a voluntary home indemnity insurance scheme. However, in the Netherlands financial protection is provided to consumers through the country's main builder association, the Warranty Housing Institute.

Dutch builders are able to join the Warranty Housing Institute on a voluntary basis. Builders that join are automatically included in the Institute's consumer protection arrangements. These arrangements include the provision of guarantees to consumers that choose to build with members of the Institute. In the event that a member of the Institute becomes insolvent or defective work is encountered, the Institute will either:

- require one or more of its members to complete or rectify the work at no additional cost to that of the original contract price; or

[173] One of the key differences between an insurance scheme and a fidelity fund is that under an insurance scheme, the insurer assesses the relative risks of each policy that it writes and prices premium according to its assessment of these risks. Such a process requires a high degree of insurance expertise. Under a fidelity fund approach where the fidelity fund is provided by non-insurance experts, such as the building industry, the Authority has assumed that contributions are made to the fund on a fixed rate basis and that there is no individual risk rating of different builders.

[174] If the fidelity fund model is workable, it may be appropriate to consider altering the claims triggers to achieve desired outcomes. Consideration to this matter is given in later chapters.

- provide appropriate monetary compensation to the consumer.

It is estimated that up to 90 per cent of houses constructed in the Netherlands are subject to the guarantee provided by the Warranty Housing Institute.[175] Some commentators have indicated that builders in the Netherlands are able to use membership to the Institute as a point of differentiation or a means to enhance their reputation. Many local Government authorities will only provide approval for new houses to be constructed if they are constructed by members of the Institute.[176]

The Authority considers that consideration of some sort of model similar to that used in the Netherlands is warranted, particularly given that it would be associated with minimal (if any) need for Government involvement and may also avoid problems stemming from the lack of private sector appetite for the provision of home indemnity insurance in Western Australia.

6.5 Government Models

Government models are those where the State Government acts as the primary provider of insurance. Government models are considered because of the relatively low level of private sector interest in the provision of home indemnity insurance in Western Australia and because the State Government is considered as having the financial capacity to provide the necessary insurance services.

6.5.1 Model 5: Government Full Coverage

The *government full coverage model* is similar to the status quo except for the fact that it is the Government, rather than the private sector, that acts as the primary provider of insurance, and hence the primary collector of premium revenue.[177] Variations of this model have been implemented by the New South Wales Government (in 2010) and the Victorian Government (also in 2010) and in both states these schemes still operate.

The *government full coverage model* retains features of the existing model such as the mandatory nature of the insurance; the claim triggers (being death, disappearance or insolvency); and the level of protection afforded to consumers (loss of deposit, incomplete construction; and defects incurred within a six year period following completion of construction). Other key features of the *government full coverage model* are:

- the Government provides the insurance services and determines premiums based on the risk rating of different builders; and

- the premium revenue earned by the Government is pooled into a fund that is used for the payment of claims and, if deemed appropriate, for investment in activities deemed to reduce the likelihood of claims.[178]

[175] Sourced from translated version of the Warranty Housing Institute website.

[176] Organization for Housing Warranty Japan, 2005, *Housing and Home Warranty Programs World Research*, pp.91-94.

[177] Some administration revenue may be earned by private sector insurers if the private sector is engaged to undertake administrative tasks such as the risk rating of builders.

[178] It is not uncommon for private insurance companies to invest in activities that are perceived to be effective in reducing the incidence of claims. For example, some insurance companies provide customers with information on how to protect their home against climatic events or on how to reduce the chances of burglary.

6.5.1.1 Implementation and Administration Issues

The Authority considers that the Insurance Commission of Western Australia is most likely the organisation best-placed to administer a Government-run home indemnity insurance scheme. The Commission is already a provider of workers' compensation insurance and third party motor vehicle insurance and hence has knowledge and expertise in the functioning of insurance and reinsurance markets.[179] The Authority does recognise however that the Commission would require sufficient time and resources to build up the skills and capacity to be able to effectively provide home indemnity insurance services.[180]

The approach taken by Governments in New South Wales and Victoria has been to engage private sector insurers (QBE and Calliden) to assist with administrative tasks such as the risk rating of builders and the determination of premiums. The insurers receive an administration fee in return for the provision of such services. Both QBE and Calliden have expressed to the Authority a desire to participate as administrators in a Government scheme were such a scheme adopted in Western Australia.

Discussions with the New South Wales Home Warranty Insurance Fund have highlighted to the Authority that the use of insurers to perform administrative functions had been implemented initially as a temporary measure. Discussions with the New South Wales Home Warranty Insurance Fund have indicated that under such an arrangement it is difficult to appropriately incentivise the insurers to undertake risk assessments and premium determinations given that the insurers do not actually carry the risks for which they are required to assess.[181]

While it may be necessary, at least at first, to engage private sector insurers to perform administrative functions as part of a Government model, the Authority does not consider such an approach to be optimal over the longer term. Once Government has sufficient capacity to take full ownership of the scheme then it should do so such that there is an appropriate alignment of the tasks of risk rating and risk carrying.

6.5.2 Model 6: Government Limited Coverage

A government model that has a shortened warranty period (two years rather than six years)[182] is considered also as it is acknowledged that, as is the case with the private

[179] The Economic Regulation Authority, November 2012 Consultation with the Insurance Commission of Western Australia.

[180] Another option for the administration of a Government scheme would be the Building Commission. However, the Authority considers that there would be potential conflicts of interest in having the Building Commission act as both the licenser of builders and the administrator of an insurance scheme designed to protect consumers. Such conflicts have been noted in a recent review of the Queensland model where the Building Services Authority (BSA) acts as a licenser, regulator and insurance provider. The model has recently come under criticism for the potential for conflicts of interest that arise due to the multiple roles being undertaken by a single organisation. Accordingly, recommendations have been made to separate the insurance function from the other functions of the BSA as a means to improve the effectiveness of the model and also to restore consumer and builder faith in the model. See, Transport, Housing and Local Government Committee, 2012, *Inquiry into the Operation and Performance of the Queensland Building Services Authority 2012*, p. 52

[181] The Economic Regulation Authority, January 2013, Consultation with the New South Wales Home Warranty Insurance Fund.

[182] A warranty period of two years is suggested because it is a balance between being long enough to provide consumers with some degree of protection for defects while also being short enough to attract interest from private sector insurers. It is also based on discussions with the Housing Industry Association where it was indicated that a two year (rather than a six year) defect period is sufficient to protect consumers against major building defects. This is because it has been said that most defects will become apparent within two years of completion of a house (specifically two summers and two winters).

sector provision of insurance, a shorter warranty can be more easily managed (and hence may be less costly to the community) than a longer warranty period.

6.5.3 Model 7: Government Opt-Out

One of the limiting features of private sector models is that they are likely to prohibit the implementation of any form of voluntary or opt-out arrangements. This is because private sector insurers have stated, and have demonstrated, a reluctance to participate in home indemnity insurance schemes that are not mandatory.

For example, as noted earlier in the report, insurers in Tasmania exited the market following the removal of mandatory home indemnity insurance requirements in 2008.[183] Similar outcomes have been observed in the Northern Territory during the time that it operated a voluntary scheme.[184] In considering the matter of voluntary insurance, the Senate Standing Committee on Economics noted that:

> Insurance industry representatives argued that voluntary home warranty insurance is not practical because the market is too small and because of 'adverse selection' problems: the most likely takers would be builders who are at risk or consumers who think their builder is at risk. Vero advised that 'it would not be worth us writing voluntary insurance.'[185]

Further, in submitting to this inquiry, Calliden stated:

> Private insurers anticipate a low take up of a voluntary scheme and there would be little or no opportunity for accumulation of reserves and it is likely that Calliden would withdraw from this class of business.[186]

However, a government model could facilitate a shift toward granting consumers more choice about whether to purchase home indemnity insurance.

The Authority believes that a *government opt out model* is worth consideration. Such an arrangement would, by default, provide full protection to consumers (as per the *government full coverage model*) during the construction and warranty period. The opt out feature of the model would enable consumers to choose not to purchase the government-provided insurance and hence not be covered for any costs incurred as a result of the death, disappearance or insolvency of their builder. As a feature of this model, consumers would have to be provided with information on the risks that they would face were they to decide to opt out from the scheme so that they could make a reasonably informed decision.[187]

Such a scheme is not likely to bring any net benefits to the Government. In fact, it is likely to result in higher costs as a result of the need for the Government to provide the appropriate information to consumers and possibly because of higher administrative costs that would arise due to the added level of complexity. Further, the Government would likely incur the full costs of establishing and operating the necessary infrastructure for the

[183] The Economic Regulation Authority, October 2012 Consultation with the Department of Justice, Tasmania.

[184] D. Smith, 2005*, Builders' Warranty, First Resort or Last Resort or Does it Really Matter?*, Presentation to the Institute of Actuaries of Australia, XVth General Insurance Seminar, 16-19 October, p. 16.

[185] Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance*, p. 46.

[186] Calliden, 2012, *Submission to inquiry,* p.5.

[187] In the absence of the provision of such information, it would be likely that most consumers would elect to opt out. This is because of the presence of information asymmetries (discussed in chapter 5) that make it difficult for consumers to make informed decisions on the risks that they face when entering into a building contract.

scheme but the scheme will serve a smaller market such that the costs per customer (or per house built) are likely to be higher than under the *Government full coverage model*. The Government would also have to manage potential adverse selection problems.

However, the key benefit of an opt-out scheme is that it does provide consumers with the ability to choose whether to purchase insurance or not, thus delivering greater consumer sovereignty.

Opt Out Schemes

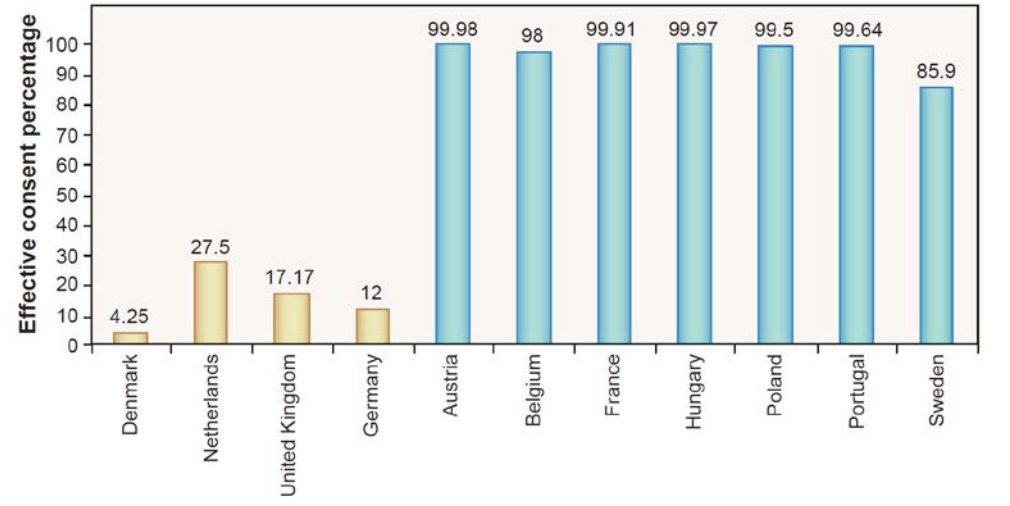
The effect that voluntary opt out schemes have on take up rates by consumers are best understood when contrasted with the alternative: voluntary opt in schemes.

Under a voluntary opt out scheme for home indemnity insurance, the default option is that a consumer will purchase insurance unless they make an informed and deliberate decision not to purchase insurance and accept the risks accompanying this decision. In contrast, under a voluntary opt in scheme, the default option is that a consumer will not purchase insurance unless they make an informed and deliberate decision to purchase insurance and actively seek it out.

Both types of schemes provide for consumer choice because consumers can elect not to purchase insurance under either scheme. However, opt out schemes tend to result in significantly higher take up rates than opt in schemes, as demonstrated by practical experience. For example, a survey of participation rates in retirement savings schemes in the United States found that employee participation rates increased from 49 per cent to 86 per cent after opt out arrangements were introduced.

As a further example, consent rates for organ donation schemes are significantly higher in European countries that have opt out policies (represented by the blue bars in Figure 6.1) than in the countries with opt in policies (represented by the gold bars).

Figure 6.1 Effectiveness of Organ Donation Opt Out Schemes



Source: Johnson and Goldstein, Do Defaults Save Lives? Policy Forum Medicine, Col 302, pg. 1338.

Opt out schemes may influence consumer take up rates in three ways. Firstly, consumers may believe that the default option is a suggestion by policy-makers, which implies that it is the recommended option. Secondly, making the decision often involves effort, whereas accepting the default option is effortless. The effort involved in decision making includes emotional effort (for example, the stress of making a decision) and physical effort (for example, filling out and lodging forms). Thirdly, individuals tend to have a status quo bias. Individuals will prefer to remain in the default category of a scheme unless they have strong bias that will motivate them to opt out of the scheme.

Opt out schemes are useful when consumers do not have sufficient information to

make an informed decision. Governments can use opt out scheme to protect consumers from making potentially harmful decisions (e.g. not purchasing appropriately priced insurance), without restricting the choices of well-informed consumers (e.g. those that have made a deliberate and informed decision not to purchase insurance).

The default option for an opt out scheme should be set to the best choice for the majority of consumers, so that consumers are automatically defaulted in to the 'most rational' position. This minimises the risk of individuals making irrational decisions.

By employing a default scheme the responsibility for making the correct choice shifts from individuals to the Government.[188] [189] The Government must decide which position is most beneficial to consumers and whether the benefits of cover outweigh the costs.

Assessment of an *opt out scheme* in the context of home indemnity insurance will require consideration to be given to the various costs and benefits of the scheme and particular consideration must be given to the possible ramifications of consumers choosing to opt out and then suffering large financial losses as a result.

6.6 Hybrid Models

Hybrid models are provided through some combination of private sector insurers, the Government and the housing industry itself (through its industry associations).

6.6.1 Model 8: Private Ancillary

If it is accepted that there is a role for government to play in the provision of insurance then it may be considered that this role should be minimised to provide a basic or minimum level of protection to consumers (rather than a full level of protection). For example, the maximum payout could be restricted to less than $100,000 and the defect period could be shortened with the maximum defect payment also capped.

Such a model may then foster the development of a competitive private sector insurance response thus providing consumers with the option to purchase extra protection.

Extra protection that may be offered by private sector insurers could include:

- additional financial payment in the event of genuine claims;
- a more timely processing and payment of claims;
- payment of costs incurred by the consumer in the event of claims such as legal costs, relocation and storage costs, living out of home costs (such costs are not currently paid to consumers under existing insurance arrangements);

[188] Assuming the Government is implementing the policy.

[189] Productivity Commission, *Review of Australia's Consumer Policy Framework,* Inquiry Report, 2008, pg. 386.

- payment of other subsidiary costs incurred as a result of an incomplete house such as damage due to weather and vandalism (such costs are commonly incurred particularly when houses remain incomplete for lengthy periods of time);

- extended defect protection perhaps through the lengthening of the defect period.[190]

This model is similar to the current model of health insurance in Australia where basic insurance is provided by the Federal Government (through Medicare) and consumers have the option to purchase additional or ancillary cover to obtain additional benefits:

> Ancillary cover pays for many services not covered by Medicare, such as optometrist services, physiotherapy, chiropractors, and most forms of dental care. Ancillary cover is commonly purchased as an adjunct to hospital cover, but many persons purchase it as a free-standing product.
>
> As in many other countries, private hospital insurance in Australia permits those who purchase it to jump the queues found in the public system, and receive care more conveniently and in more comfortable surroundings.[191]

This model may be most effective if it is consumers, rather than builders, who are responsible for purchasing insurance because it will depend on consumers generating a demand for insurance that can then be met through private sector supply.[192]

The underpinnings of such a model are:

- that if Government must become a provider of insurance then it should do so only to a very basic or necessary level so as to protect consumers;

- in providing insurance to consumers the Government would have the ability to indicate to consumers that they are only covered for a very basic level of protection and that they should not expect complete protection if their builder dies, disappears or becomes insolvent;

- the above mechanism would weaken some of the information asymmetries associated with this product as it could be argued that consumers then would understand the risks that they are exposed to in entering into a building contract. This may then create consumer demand for additional insurance protection;

- the market for additional protection may be small (as it will be dictated by the demand that comes from consumers) but this model removes any political or reputational pressures faced by insurers to keep premiums low because the decision to purchase additional insurance protection would be entirely optional;[193] and

[190] Under an optional service offering, insurers could elect to collect (and hence revise) premiums on an annual basis thus making the provision of defect insurance more attractive.

[191] T. Jost, 2001, "Private or Public Approaches to Insuring the Uninsured: Lessons from International Experience with Private Insurance*", New York University Law Review*, Vol. 76:419, pp. 456-457.

[192] Because insurance ultimately benefits consumers rather than builders there is unlikely to be sufficient voluntary demand generated from builders.

[193] The Authority understands that many of the concerns that insurers have about reputation issues essentially stem from the fact the home indemnity insurance is mandatory. Because of this consumers and builders often view any attempts by the insurers to raise prices as evidence of them unfairly profiting from a mandatory consumer protection measure. Source: The Economic Regulation Authority, October 2012 Consultation with QBE.

- the model allows insurers to design their own products free from regulatory interference.

Given the above points, it may be the case that there would be a competitive supply response from insurers (possibly boutique insurers) and consumers could then purchase additional insurance if desired at market rates.

The advantages of this model are that consumers are provided with a stable and minimal level of protection by the Government and that while the Government does act as an insurer, it is able to keep its role to a minimum. Beyond the basic level of protection, consumers are then free to choose whether to purchase additional insurance as provided by the private sector.

Key to the feasibility of such a model would however be the degree to which consumers would demand additional protection and the willingness of the private sector to provide additional protection if it were demanded in sufficient quantities by consumers.

6.6.2 Model 9: Private with Industry Supplement

This model is based on two key premises.

First, from a consumer protection perspective the largest losses that are likely be incurred by consumers relate to non-completion rather than defective works. Data provided by QBE indicate that the average payment for a claim of non-completion is approximately $[redacted] whereas the average payment for a claim of defect is approximately $[redacted].[194]

Second, private sector insurers are more interested in providing insurance against non-completion risk than they are in providing insurance against defect risks. The private sector appetite for the provision of the two different classes of risk relate to the insurability of the risks and the fact that, as discussed in Chapter 4, non-completion risks are more "insurable" than the long tail defect risks.

The design of the *private with industry supplement model* incorporates the above findings. Under this model, private sector insurers would be asked to provide mandatory insurance protection for consumers only against losses brought about by non-completion due to death, disappearance or insolvency of a builder. The product provided by the private sector would not be required to incorporate defect insurance for the six year period following completion.

Under this model there is then flexibility as to how the defect period is handled. For the purposes of evaluation of this model it will be assumed that the housing industry (through its industry associations) acts as the provider of insurance against defect risks and that it does so using some type of fidelity fund arrangement. Average claims payable due to defects are lower than those paid in instances of non-completion and claims are likely to be more stable hence are better suited to a fidelity fund model.[195]

[194] Such figures are indicative only of the costs incurred by consumers as a result of incompletion versus defective work. Paid claims do not necessarily equal total costs incurred by consumers. Moreover, claims paid for non-completion are capped at $100,000 irrespective of whether actual costs incurred by consumers are greater than $100,000.

[195] According to PWC, fidelity funds are best in situations where potential payouts are relatively small and consistent and risks are evenly distributed rather than concentrated. The Authority considers that of the two risks (non-completion risk and defect risk), fidelity funds are best suited to the provision of protection against defect risks because such risks exhibit these characteristics. See PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 34.

7 Evaluation Framework

The purpose of this chapter is to describe the framework used by the Authority for assessing and comparing the alternative models of Government response that were presented in Chapter 6. Selecting the most effective model(s) will inevitably involve some judgement on the trade-offs that are encountered when considering each model in the context of its alternatives.

7.1 Criteria for Assessing the Models

All models in Chapter 6 have been considered as being capable of providing consumers with some basic element of consumer protection. The process of identifying the most effective models requires that the models be assessed using a number of criteria. These criteria provide a useful framework for identifying the relative strengths and weaknesses of each model.

It is important to note at the outset of this chapter that the application of the criteria to the models may not clearly identify one single model as being superior to the others, but will deliver a narrower set of models that are deemed as being potentially effective options for implementation. Chapters subsequent to this one will contain discussion of the merits of the different models that fall from this analysis and the inevitable trade-offs that must be considered when trying to select a final model for recommendation. Subsequent chapters will also contain an assessment of the full benefits and costs of the recommended models.

The Authority considers that there are three hurdle criteria that any model must satisfy for it to be considered further. These are:

- *the ability of the model to be practically implemented* – for a model to be considered as legitimate option, it must be demonstrated that it can feasibly be implemented within the Western Australian context; and

- *the stability of the model* – to be considered as a feasible option, it must be demonstrated that a model is stable and capable of functioning over the long term and that it is able to withstand the peaks and troughs in the housing building cycle; and

- *that the implementation of the model delivers net benefits to the community* – for any government policy to be implemented, it should be established that the benefits of the policy exceed the costs.

In addition to the above hurdle criteria, the models will be assessed using a set of evaluation criteria as are outlined below (in no order of importance):

- *the level of consumer protection* – (all else equal) the greater the degree of protection afforded to consumers the better; and

- *the affordability to consumers* – (all else equal) the more affordable the model for consumers the better;

- *the extent of government involvement* – (all else equal) a model characterised by less government involvement is superior to one that necessitates more government involvement;

- *the degree of consumer choice* – (all else being equal) a model that enables some degree of consumer choice will be preferable to one that enables no choice;

- *compliance costs* – (all else being equal) the lower the indirect costs (such as time costs) incurred by parties such as builders and consumers, in complying with the requirements of the model the better;

- *the complexity of the model* – (all else being equal) the simpler the model, the better; and

- *efficiency* – (all else being equal) the greater the capacity of the model to achieve its objectives with fewer resources the better; and the greater the capacity of the model to achieve dynamic efficiency over time the better.

7.1.1 A Comment on the Evaluation Criteria

There is a degree of inter-dependence among some of the evaluation criteria presented above. For example, a model that offers a higher degree of consumer protection will almost inevitably be more costly for consumers (that is, less affordable). Ultimately, any decision about the optimal model(s) will require that some judgements to be made about what is an acceptable trade off between the different criteria. In other words, it is unlikely that any single model will perform well in *all* criteria.

Related to the above point is that it is unlikely that any single criterion (within the set of hurdle criteria) assessed in isolation will be sufficient to discredit a model and similarly, no single criterion will be capable of validating a model. It is also unlikely that any of the secondary criteria will be completely satisfied or completely dissatisfied; but rather the criteria will allow the performance of the different models to be assessed according to the degree to which each criterion is satisfied. This assessment will be done using a combination of both quantitative and qualitative information.

7.2 Hurdle Criteria

7.2.1 Practical Implementation in Western Australia

The ability of a model to be practically implemented requires that the assessment process take into account factors specific to Western Australia. These factors can include:

- the size and structure of the building industry – for example, the size of the building industry may have implications for economies of scale in the provision of home indemnity insurance. The high level of concentration of the building industry in Western Australia, may mean that some models are not practical because of the high costs of a significant builder failing; and

- the structure of housing and builder industry associations – this will be of particular relevance for the assessment of industry based models.[196]

[196] Implicit in the use of the criterion is an acknowledgment that some models may be appealing from a theoretical standpoint but may not suit the existing dynamics of the Western Australian building industry.

7.2.2 Stability of the Model

Stability of the model refers to the degree of certainty that, once implemented, the model will not be subject to any significant upheaval (for example, a decision by an insurance provider to exit the market). Ideally, a model should exhibit a high degree of stability such that it can be relied on to continue over the long term and hence provide the required degree of protection to consumers on an ongoing basis.

It is important to consider that the stability of a model has implications for the Government. It is ultimately the responsibility of Government to replace or resurrect any arrangements if, for whatever reason, they fail to function appropriately. Such a responsibility typically involves costs and may force the Government into making reactive, rather than well-informed and conceived, policy decisions.[197]

The Authority considers that a model must demonstrate a high degree of stability over the long term so that it can continue to operate. In this way, the model can, over the longer term, achieve the objective of protecting consumers; while at the same time negating the need for ad hoc and costly Government intervention. Model stability may be compromised if insurers with large market shares choose to exit the market at short notice, or if the provider(s) of insurance are forced to exit the market due to the aggregate costs incurred from the collapse of one or more large builders.

In general, the Authority considers that a model has a low degree of stability if it seeks to utilise private sector insurers where there is a lack of competitive supply response from these private sector insurers. For example, the existing model with only two private sector insurers (of which only one is capable of servicing the entire market if it needed to) is not considered to provide a high degree of stability.

All else being equal, models with the highest degree of stability are likely to be those in which the Government provides the insurance. This is because the Government is assumed to have both the willingness and financial capacity to maintain a consumer protection scheme if a workable model were able to be implemented.[198]

7.2.3 Benefits and Costs

Government intervention in a market will always create costs whether they be administrative costs, compliance costs or costs that arise through distortion of free functioning market mechanisms. In all cases of government intervention in a market it is important to establish that the benefits of the intervention exceed the costs. The costs and the benefits of the Authority's recommended model will be considered to ensure that the model delivers net benefits to the community.

Still such models may provide examples of targets to work towards over the longer term and hence have been included in this report.

[197] Similarly, there will be costs on builders if home indemnity arrangements fail. For example, builders may be required to secure alternative insurance in the event of a failure of arrangements. Such a process may be costly in terms of time, money and lost work.

[198] As a case in point, the Government, through the Insurance Commission of Western Australia, has provided third party motor vehicle insurance on an ongoing basis since at least 1949. See Insurance Commission of Western Australia, 2012, *Annual Report 2012*, p.15.

7.3 Evaluation Criteria

7.3.1 The Level of Consumer Protection

As established earlier in this report, consumer protection is the objective of Government involvement in the market for home indemnity insurance. Of the two types of risk faced by consumers - risks of incomplete construction and risk of defective work - it is the incomplete construction risk, where the case for consumer protection is strongest.

The degree of consumer protection offered by the various models is a key criterion in their evaluation. All other things being equal, a model that offers a high level of consumer protection will be preferred to a model that offers a lower level of consumer protection.

The Authority will take into account the following factors in determining whether a particular model offers a high, medium or low degree of consumer protection:

- *Whether home indemnity insurance is mandatory or voluntary* – (all else being equal) mandatory schemes offer a higher level of consumer protection than voluntary schemes. This is because it is highly likely that under voluntary schemes some consumers will elect not to participate; some of these consumers may suffer large losses if the builder they employ dies, disappears or becomes insolvent.[199]

- *The length of the warranty period* – (all else being equal) the longer the warranty period, the greater will be the degree of consumer protection. Some of the models presented in Chapter 6, shorten the existing six year warranty period[200] and thus offer consumers a lower level of protection.

The Authority contemplated whether the degree of consumer protection afforded by different models is affected by the willingness of different types of insurance providers (private insurers, government insurers or industry insurers) to payout insurance claims. It could, for example, be argued that private insurers are more inclined to dispute an insurance claim than a public insurer because of the profit-making motive held by private insurers. However, the Authority considers that this is not necessarily the case and found no evidence to support such a proposition.[201] On this, the Authority shares the view arrived at by the Senate Standing Committee on Economics in its review of mandatory last resort home indemnity insurance:

> Some submissions seemed to imply that complaints of this sort arise from the toughness of the profit-motivated private insurer, and would not arise in a government scheme. This is not necessarily so. The possibility of disagreement about whether work is defective, or about the cost of rectification, exists in either case. A government insurer also has a duty not to pay more than is fair on claims.[202]

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[199] It has been reported that the take up rate was approximately 44 per cent under the voluntary home indemnity insurance scheme that operated in Western Australia prior to 1997. The Authority notes that some consumers who did not voluntarily purchase insurance may have made a rational decision to self insure. See, Ministerial Media Statement, 1996, *Legislation Dealing with Builders' Indemnity Insurance*, February.

[200] And matches the existing six year warranty period that applies to consumers under the *Building Services (Complaint Resolution and Administration) Act 2011* if their builder is still trading and available.

[201] Through the course of this inquiry, the Authority has been made aware of many instances of consumer dissatisfaction with interstate home indemnity schemes where the insurance is provided by the government.

[202] Senate Standing Committee on Economics, 2008, *Australia's Mandatory Last Resort Home Warranty Insurance*, p. 32.

7.3.2 Affordability to Consumers

The costs of any measure introduced to protect consumers are likely to be (ultimately) borne by the consumers that are protected.[203] All else being equal, models that deliver the same level of consumer protection for a lower premium are superior to those that are more expensive.

7.3.3 Extent of Government Involvement

Some models require the involvement of Government in the provision of insurance and this is for good reason. Government involvement may be required if other objectives, such as consumer protection or stability cannot be achieved without it. However, the Authority has a preference for models that do not necessitate the involvement of Government acting in the role of an insurer. The provision of insurance is not a core role of Government and is something that would likely be done better by private sector insurers. Government involvement in the provision of insurance may result in:

- costs being borne by the Government, and ultimately taxpayers;
- risks being borne by the Government, and ultimately taxpayers;
- situations where political motives interfere with policy motives, hence limiting the effectiveness of the policy; and
- inefficiencies that may not exist in a model whereby insurance is provided by the private sector.[204]

7.3.4 The Degree of Consumer Choice

In principle, there is a compelling argument to allow consumers the freedom to decide upon the level of protection they wish to purchase against the risk of builder failure. Such freedom enables consumers to weigh up the costs and benefits of any purchasing decision and act appropriately. Different consumers will have different perceptions of the benefits that can be derived from a particular good or service.

All else being equal, a model that enables some degree of consumer choice about the type of coverage will be preferable to one that enables little or no choice.

7.3.5 Compliance Costs

This criterion refers principally to the costs borne by builders and/or consumers in complying with the requirements of the model. As is the case for affordability, the lower the adherence costs placed on consumers and builders the more attractive a model will be. Indirect compliance costs include costs such as:

- the time and money costs associated with completing the necessary paperwork; and
- the degree to which a model might interfere with the business operations of a builder.

[203] The Authority considers that such an outcome is not only likely but also optimal; the consumers that stand to benefit from protection should pay the relevant costs associated with the provision of that protection.

[204] These matters are discussed in more detail in section 9.6.

8 Evaluation of Hurdle Criteria

The purpose of this chapter is to assess the alternative models that were presented in Chapter 6 using the hurdle criteria described in Chapter 7.

8.1 Assessment of Models against Hurdle Criteria

There are three hurdle criteria that any model must satisfy to be considered as a model that could justifiably be adopted in Western Australia.

These hurdle criteria are:

- *Can the model be implemented?* For a model to be considered as a legitimate option, it must be demonstrated that it can feasibly be implemented within the Western Australian context. Taking into account, factors such as the structure of the building industry, existing government regulations and policy and the structure of housing and builder based industry associations.

- *Is the model stable?* The stability of the model refers to the degree of certainty that, once implemented, the model will not be subject to any significant upheaval. For example, that which may arise as a result of a large builder failing.

- *Do the benefits exceed the costs?* A model should only be implemented if it can be established that it would deliver net benefits to society.

Commencing with the status quo, the models are assessed against the first two hurdle criterion in this chapter. An analysis of the final criterion (benefits and costs) is conducted once a final model is selected. This approach saves on the need to do a benefit cost analysis for each of the models identified.

8.1.1 Model 1: The Status Quo

The *status quo model* represents the existing home indemnity insurance arrangements in Western Australian. Key features of these arrangements are that home indemnity insurance is mandatory and it is provided by private insurers with the Government providing reinsurance to the main private insurer.

This model provides cover to consumers for loss of deposit (up to $20,000); and losses due to incomplete construction (up to $100,000); and for defects incurred within a six year period commencing at the completion of construction (also up to $100,000).

8.1.1.1 Comments on Implementation

The *status quo model* is currently operating in Western Australia and hence can clearly be implemented.

8.1.1.2 Comments on Stability

The Authority considers that the *status quo model* is not sufficiently stable on grounds that it has not elicited a competitive supply response from private insurers. As a consequence, the State Government would be placed in a vulnerable position if the State's near monopoly provider, QBE, were to exit the market.

QBE currently accounts for about 90 per cent of the market and Calliden the remaining 10 per cent. Calliden has neither the financial capacity nor the risk appetite to fill the market gap that would arise were QBE to exit the market.

The possibility of QBE exiting the market is a realistic one. Throughout the course of this inquiry, QBE has indicated to the Authority the difficulties that it faces in provision of this product and provided indications as to its lack of profitability.[205] [206] Also indicative of the possibility of QBE exiting the market is the recent announcement by the South Australian Government that QBE is withdrawing from the South Australian home indemnity insurance market.[207]

The track record of the provision of home indemnity insurance by private insurers in Western Australia (and Australia) demonstrates the instability in the market under its existing arrangements. Many private insurers have entered and withdrawn from the market since the introduction of mandatory arrangements in 1997. At one point prior to 2009 there were six insurers offering home indemnity insurance in Western Australia. However, competitive conditions in the provision of home indemnity insurance did not last long.

The State Government would be placed in an undesirable position if QBE were to exit the market for home indemnity insurance. New arrangements would need to be established rapidly to ensure that residential home construction could continue unimpeded. Past cases of insurers exiting the market demonstrate this point. In its report to the Authority, PWC comments on the "covered contract" arrangements that the Government implemented following the exit of Vero from the market:

> Covered contracts are home indemnity insurance contracts which were underwritten by a third party insurer but 100% underwritten by the State Government ie there is a full risk transfer to the State Government.
>
> Covered contracts were used to incentivise Calliden and QBE to quickly enter the market following the exit by Vero. Under the arrangement the State Government retained 55% of the premium.

The *status quo model* is not considered stable and the potential costs that would arise should there be a failure in the model, particularly to Government, would be significant. For this reason, the *status quo model* is assessed as not passing the hurdle criterion on stability.

8.1.1.3 Conclusions

The *status quo model* is not considered further because it does not meet the hurdle criteria of stability.

The Authority notes that it may be inevitable for there to be a continuation of the current model in the short term while there is a transition to new arrangements. The Authority is

[205] On this, PWC noted in its report to the Authority, "it is unlikely that additional insurers will have much appetite to participate in the current HII [home indemnity insurance] structure and arrangements, relative to other commercial and domestic classes of insurance." See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 20.

[206] PWC state that a large builder collapse in Western Australia "may be the catalyst for the exit of private insurers from the market, even though most of the cost would be borne by the Government's $10 million cap indemnity. See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 8.

[207] Deputy Premier John Rau, News Release, *QBE to Exit Building Indemnity Insurance Market*, 14 March 2013.

not opposed to such a course of action and accepts, given the timing of this review, that a continuation of the status quo is a reasonable approach in the short term.

If the status quo is to be continued in the short term, the Authority recommends the Government take some of the findings of the PWC review into consideration. These findings are briefly summarised here and can be seen in detail in the PWC report, as referenced:

- *Lack of transparency* – PWC noted that under the current arrangements there is a lack of transparency that limits the ability of Government to understand and evaluate the functioning of the scheme. According to PWC, "the State Government should ensure that detailed contract level data is received on a regular basis." And that by using this data, the Government "should ensure the premium charged and any risk sharing agreements in place are reviewed on an annual basis".[208]

- *Premium structure* – PWC also noted that if the current scheme were to continue, "the distribution of premium should be altered to more accurately reflect the cost to the Government, its exposure and the capital required to be held to support the reinsurance exposure. This will result in an increased premium but limit the downside risk to the Government in the event of a major builder collapse. Currently the Government holds 39% of the total risk...but retains only 10% of the premium."[209] [210]

- *Indexing of parameters* – the Authority holds the view, supported by PWC findings, that key parameters need to be indexed over time. Key parameters that should be indexed are the level at which the Government's reinsurance arrangement is triggered (currently set at $10 million) and also claim limits (currently set at $20,000 for loss of deposit and $100,000 for non-completion or defect costs).[211]

8.1.2 Model 2: Private Limited Coverage

The private with limited coverage model is similar to the *status quo model*. The primary difference is that the private with limited coverage model offers a shorter warranty period (two years rather than six years).

8.1.2.1 Comments on Implementation

The Authority considers that there is potential for this model to be implemented. QBE and Calliden (and one other insurer) have indicated to the Authority that there would be a willingness to consider such a model. By reducing the warranty period from six to two years many of the issues associated with the long tail are reduced greatly.

8.1.2.2 Comments on Stability

A home indemnity insurance model that relies on private insurers would need to be capable of generating a competitive supply response from a number of private insurers in order to be assessed as stable.

[208] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, pp. 18-19.

[209] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 23.

[210] On the issue of premium structure and risks, PWC has estimated the estimated maximum loss faced by the Government under the existing arrangements to be in the order of $200 million. See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p. 21.

[211] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, pp.24-25.

The Authority considers that the private *with limited coverage model* has the potential to generate a competitive supply response from insurers because the insurable risk[212] is more appealing to private insurers (non-completion) is retained, while the insurable risk that is less attractive (defect risk) is minimised.

Minimising the defect risk (currently offered under the *status quo model*) would make it easier for insurers to calculate the premiums necessary to remain profitable. On this concept, PWC has noted that insurers operating under an arrangement characterised by a shorter defect period "will be limiting the period of exposure to a particular builder" and that "the short tail nature of the contracts will allow insurers to more accurately forecast the loss ratio and recognise faster any profits/losses arising from the portfolio."[213]

The Authority has assessed this model as being stable and has tested this conclusion to the extent that it is practical to do so at this stage. However, the ultimate stability of the model will depend on the degree to which it elicits a competitive response from a number of private sector insurers. This hypothesis will have to be tested fully by Government if this model is pursued.

8.1.2.3 Conclusions

This model passes the hurdle criteria. Further consideration is warranted.

8.1.3 Model 3: Fidelity Fund

A fidelity fund refers to a financial instrument to which members of the fund contribute money. The money collected in the fund can then be used to provide compensation to consumers that incur losses due to the death, disappearance or insolvency of a builder. The Authority has considered the *fidelity fund model* in the context of it being operated by an industry association.[214]

8.1.3.1 Comments on Implementation

Fidelity fund arrangements are used to protect people who construct new dwellings in the Australian Capital Territory and have also recently been implemented in the Northern Territory. In both cases, the funds are managed by the Master Builders Association.

While it is feasible for a *fidelity fund model* to be implemented in these jurisdictions, the Authority considers that it would be more difficult to implement such a model in Western Australia.

This is primarily because the Western Australian building industry is highly heterogeneous. That is, there is a very diverse array of builders operating in the State. Specifically, there are a small number of very large builders and a large number of very small builders. It is difficult, even for expert insurers, to provide supply the two components of home indemnity insurance for such a diverse market. The Authority considers it unlikely that an industry association would have the necessary insurance related expertise to successfully operate a fidelity fund that offers both non-completion and defect risk insurance. PWC noted that:

[212] Principles of insurable risk were discussed in chapter 5 of this report.

[213] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.28.

[214] For the purposes of evaluating this model, it has been assumed that the fidelity fund would provide coverage for non-completion risk and defect risk.

> A fidelity fund is best in a situation where the markets and risks are evenly distributed and numerous. This does not exist in the WA residential housing market. Fidelity funds have performed well in the ACT and NT where the market[s] [are] much smaller and the concentration of risks are smaller.[215]

The dominance of large builders in the market also requires that a fidelity fund has sufficient capital reserves to cover any potential large claim events (as is discussed in more detail for the stability criterion below). The Authority considers that industry associations would have difficulty establishing the capital reserve required to support a stable fidelity fund that could offer protection to consumers for losses incurred for both non-completion and defects indentified during the warranty period.

8.1.3.2 Comments on Stability

As noted above, the Authority considers that the *fidelity fund model* is not inherently suited to the provision of home indemnity insurance (including non-completion and defect risks) in Western Australia. Ultimately, this lack of suitability translates into a relatively high risk of failure. In its review of a fidelity fund model, PWC found that the risk of fund failure was high and ultimately this risk would be transferred to Government as it would be forced to either bail out the fund or become a provider of home indemnity insurance.[216]

PWC modelling indicates that a fidelity fund would be most vulnerable in its early years of operation as it would struggle to accumulate sufficient capital reserves needed (estimated to be about $67 million in its early years of operation).[217] It is highly improbable that building association would have access to this amount of capital. Simulation modelling undertaken by PWC indicates that there are high risks that the fund would be placed in a vulnerable financial position.[218]

An alternative approach was modelled in which the fidelity fund commenced with a starting capital base of $5 million and operated with a government guarantee (charged to the fund at a rate of 8 per cent of the value of the guarantee). PWC modelling shows that over a ten year period, it would be expected (indicated by the mean modelling result) that the fund would call on the government guarantee twice; and that there would be a 25 per cent probability of the guarantee being called on three times and a 5 per cent probability of it being called upon six times within ten years.[219]

The Authority considers that a *fidelity fund model* would be unable to provide a stable vehicle to protect consumers against risks incurred both during the construction and warranty periods. Ultimately the Government would carry a high level of risk as the provider of last resort protection if a fidelity fund model were implemented.

8.1.3.3 Conclusions

The *fidelity fund model* does not pass the hurdle criteria and hence is not considered further.

[215] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.34.
[216] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, pp.33-34.
[217] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.36
[218] Defined as a position in which the fund has less capital than required.
[219] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.67.

8.1.4 Model 4: Builder Based Model

Under the *builder based model* it is the building industry associations that provides guarantees to consumers that the work undertaken by their member builders will be completed or rectified in an event where the original builder dies, disappears or becomes insolvent. Effectively, if one member builder fails, another member builder of the association will complete the contract, with the consumer transferring the contract to the second builder and paying them for the remaining work to be completed.

8.1.4.1 Comments on Implementation

The Authority considers that is it unlikely that the *builder based model* could be implemented in Western Australia. This is because the building industry is served by two separate industry associations that each target different segments of the building industry.[220] The Authority considers that a *builder based model* would be most effective in situations, such as in the Netherlands, where the industry is represented by a single and dominant industry representative.

8.1.4.2 Comments on Stability

It has been indicated throughout this chapter that the provision of home indemnity insurance in Western Australia is a complex task and one that requires a large amount of expertise and access to a large amount of capital. The Authority does not consider that the two building associations to have the resources needed to provide a stable vehicle for consumer protection, particularly given the potential for very large financial losses to be incurred.

8.1.4.3 Conclusions

The *builder based model* does not pass the hurdle criteria and hence is not considered further.

8.1.5 Model 5: Government Full Coverage

The *government full coverage model* is similar to the status quo except for the fact that it is the Government, rather than the private sector, that acts as the primary provider of insurance, and hence the primary collector of premium revenue.

8.1.5.1 Comments on Implementation

The Authority considers that the *government full coverage model* is capable of being implemented. The New South Wales and Victorian Governments have been operating a *government full coverage model* since 2010 and there is no reason why a similar model could not be implemented in Western Australia.[221]

8.1.5.2 Comments on Stability

The Authority considers that the government full coverage model would be stable.

[220] The Master Builders Association in Western Australia predominantly represents smaller builders while the Housing Industry Association in Western Australia predominantly represents larger builders.

[221] The Government would require sufficient time and resources to build up the skills and capacity to be able to effectively provide home indemnity insurance services. However, transitional arrangements could be put in place, such as out-sourcing some tasks to private insurers, until the Government has built up sufficient understanding and expertise in this insurance product.

The Western Australian Government has the financial capacity to meet any large claims that could arise from the highly concentrated nature of the Western Australian building industry (such as the failure of one of the larger builders).[222] As such, a government-scheme would be able to withstand and recover from significant failures in a way that private and industry association schemes may not be able to.

PWC modelling indicates that the Government would be capable of operating the insurance scheme with a high degree of stability (or low risk of failure), and even profitability in some scenarios. The mean result from PWC's modelling simulations show that the Government would generate a small profit over time. This profit could be invested back into the building industry if desired or could be used to lower premiums.[223]

The Authority considers that it would be politically very difficult for the State Government to abandon a Government-provided home indemnity scheme once it had been established unless some other suitable consumer protection measures could be implemented.

8.1.5.3 Conclusions

This model passes the hurdle criteria. Further consideration is warranted.

8.1.6 Model 6: Government Limited Coverage

The only significant difference from the *government full coverage model* is that the *government limited coverage model* offers a shorter defect period (two years rather than six years).

Implementation

The Authority considers that *government limited coverage model* is capable of being implemented for the same reasons as outlined for the *government full coverage model*.

Stability

The Authority considers that the *government limited coverage model* would be very stable for the same reasons as outlined for the *government full coverage model*.

Conclusions

This model passes the hurdle criteria. Further consideration is warranted.

8.1.7 Model 7: Government Opt-Out

Under the government *opt out model*, consumers would be able elect to opt out of purchasing any form of home indemnity insurance.

[222] PWC estimates that the initial capital required by the Government to ensure it has sufficient reserves would be in the order of $67 million. See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.43.

[223] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, pp.43-45.

8.1.7.1 Comments on Implementation

The Authority considers that *government opt out model* is capable of being implemented as it has been established earlier in this chapter that the Government would be capable of underwriting a home indemnity insurance scheme.

8.1.7.2 Comments on Stability

The Authority considers that government opt out model would be stable because, as discussed earlier in this chapter, the Government is deemed to have sufficient financial resources to meet potential losses.

8.1.7.3 Conclusions

This model passes the hurdle criteria. Further consideration of the model is warranted.

8.1.8 Model 8: Private Ancillary

Under this model, the Government provides a basic or minimum level of protection to consumers. For example, the maximum payout could be restricted to significantly less than $100,000 (perhaps $50,000) and the defect period could be shortened with the maximum defect payment capped at well below the current cap of $100,000. The intent behind the design of the model is that it would provide consumers with a minimal level of mandatory protection while also encouraging the private sector insurers to voluntarily provide additional ancillary cover, which could be voluntarily purchased, by consumers.

8.1.8.1 Comments on Implementation

While the model has theoretical appeal,[224] the Authority does not consider that it would be an easy model to implement, especially in the short term. The model is an entirely new and untested.

For the model to be successfully implemented, private insurers would need some considerable time to design and develop their product offerings. It would also take time to negotiate how they would integrate their ancillary cover with the basic offering of Government. It is also not clear whether the private insurers would consider the markets created by the model to be attractive.

8.1.8.2 Comments on Stability

The Authority considers that the components of home indemnity insurance provided by the Government under this model to be very stable. If this model were to be implemented, it would be with the intention of generating a competitive supply response from private insurers to provide a stable market for ancillary cover, such an outcome is far from certain.

8.1.8.3 Conclusions

This model does not pass the hurdle criteria of being able to be implemented in the short to medium term but the framework presented could be an option for consideration as part

[224] This appeal being the minimisation of the role of Government while still providing consumers with a basic level of protection while taking advantage of the ability of private sector insurers to enter the market and offer innovative products to consumers who wish to purchase additional cover.

of a longer term process of developing a sustainable approach to home indemnity insurance in the long term.

8.1.9 Model 9: Private with Industry Supplement

Under this model, private sector insurers would be asked to provide mandatory insurance protection for consumers only against losses brought about by non-completion due to death, disappearance or insolvency of a builder. The product provided by the private sector would not be required to incorporate defect insurance for the six year period following completion.

This model offers flexibility as to how insurance could be provided for defect risk by an organisation other than a private insurer. For the purposes of evaluation, it is assumed that building industry acts as the provider of insurance against defect risks and that it does so using some type of fidelity fund arrangement. The Authority considers that such an outcome would be preferable to the Government being the provider of the warranty insurance though notes that the Government as a provider is considered to be a workable alternative if industry was unwilling to perform the role.

Commenting on such a model, PWC noted:

> There is some appeal in divorcing the two risk components to allow more accurate assessment and pricing of the risk and reduce the cumulative exposure to an individual builder.[225]

8.1.9.1 Comments on Implementation

The Authority considers that the privately provided, non-completion component of the model could be implemented given that some private sector insurers (including QBE and Calliden) have expressed a willingness to consider such a model (that is, providing insurance for non-completion risk only).[226]

It is less certain whether the building industry would be willing to provide insurance for the defect risk component of the model. However, the Authority considers that it is in the best interests of the industry for this product to be available to consumers and hence there is an incentive for the industry to provide the product. The Authority also holds the view that the building industry is capable of providing this product.

Modelling undertaken by PWC indicates that defect risk insurance on its own could be provided with a capital base that is an order of magnitude lower than that needed for the provision of construction period insurance.[227] Commenting on the concept of the provision of defect risk insurance, PWC stated that "warranty exposure is small and easily manageable."[228]

[225] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.31.

[226] In discussing the concept with insurers, one of the key views put forward is that non-completion risks differ markedly to defect risks and that this difference requires insurers to treat the two products separately. It follows that it would be relatively easy from the perspective of the insurers to split the two types of risk.

[227] Indicative estimates show that the initial capital required for the provision of non-completion insurance may be in the order of $60 million to $70 million while the capital required for the provision of warranty insurance may be less than $10 million. See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, pp.27-32.

[228] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.ii.

8.1.9.2 Comments on Stability

The Authority considers that the non-completion risk insurance component of this model has the ability to be stable due to its potential to elicit a competitive private sector supply response. The Authority also considers that defect risk insurance has the potential to be stable over time if provided by either industry or Government and adequate resources are dedicated to the operation of the product.

8.1.9.3 Conclusions

This model passes the hurdle criteria. Further consideration is warranted.

8.2 Conclusions

After applying the hurdle criteria to the nine models, the Authority considers that the following five models warrant further consideration because they are each implementable and stable:

- private limited coverage;
- government full coverage;
- government limited coverage;
- government opt out; and
- private with industry supplement.

These five remaining models are assessed against the evaluation criteria in the following chapter.

9 Evaluation of Other Criteria

In this chapter, the remaining models are considered in the context of the Authority's evaluation criteria.

9.1 Evaluation Criteria

In Chapter 7 of this report, the Authority identified five evaluation criteria which it considered potentially useful to distinguish between alternative models.

- *the degree of consumer choice* – (all else being equal) a model that enables some degree of consumer choice will be preferable to one that enables no choice;
- *the level of consumer protection* – (all else being equal) the greater the degree of protection for consumers the better;
- *the affordability to consumers* – (all else being equal) the more affordable the model for consumers the better;
- *compliance costs* – (all else equal) the lower the indirect costs (such as time costs) incurred by parties such as builders and consumers in complying with the requirements of the model the better; and
- *the extent of government involvement* – (all else equal) a model characterised by less government involvement is superior to one that necessitates more government involvement given that the greater the degree of government involvement, the higher the likely costs and risks incurred by government.

The first two criteria are considered by the Authority to be important measures by which to assess the models. The latter three criteria, also important, are taken from the Terms of Reference for this inquiry.[229].

9.2 Consumer Choice

There is always a compelling argument to allow consumers the freedom to decide their own purchase decisions. In brief there are two issues that constrain the ability to give consumers free choice as to the purchase of home indemnity insurance, these issues (discussed in depth earlier in this report) are:

- it has been demonstrated that in the absence of sufficient information, it would be difficult for consumers to make well-informed choices; and
- it is unlikely that a private sector insurance market would exist if consumers were granted the ability to choose.

The *government opt out model* is an attempt to address the above two issues so as to enable consumer choice. It is the only model that offers consumers with full choice to opt

[229] Under the Terms of Reference, the Authority must give consideration to the red tape burdens on the insurance and building industries (compliance costs); possible implications for home affordability; and costs and financial risks to the State Government.

out of both components of home indemnity insurance.[230] Hence, this is the only model discussed as part of consideration of this criterion.

While both stable and implementable the Authority has a number of reservations about the government opt out model, these are:

- *the problem of adverse selection* – as noted earlier in this report, private sector insurers have expressed (and demonstrated) a reluctance to participate in voluntary or opt out home indemnity insurance markets. This is predominantly due to the problems of adverse selection and expectations of relatively low take up rates (which, according to insurers, would make it difficult to accumulate sufficient reserves). These problems would be encountered by Government if it were the provider of insurance under an opt out scheme.[231]

- *high administrative costs* – the administrative costs incurred in running an opt out scheme would be higher than in other models. This is due to the need to inform consumers of the risks and choice available to them and to process decisions on whether to opt out or in. What is more, these high administrative costs will only be able to be recovered from consumers who choose to opt in and purchase insurance thus on a cost per policy written basis, an opt out model is potentially an expensive option.[232]

- *possible poor consumer protection outcomes* – consumer protection is not compromised if consumers make rational decisions not to purchase insurance[233]. However, consumers often fail to make rational decisions about purchasing insurance policies for a variety of reasons, including perceived search costs; misprocessing behaviour; and budget constraints.[234] The Authority is not convinced that the underlying objective of achieving consumer protection would be adequately achieved under an opt out model.

- *large risks to the Government* – the Authority believes that there will always be a tendency for consumers to look to the Government to assist them if they incur large financial losses in purchasing a house (even if they had explicitly chosen to opt out of an insurance scheme).[235] In such a situation (particularly in the case of a large builder collapse), it would be difficult for the Government to refuse to offer assistance. If the Government were to relent and offer financial assistance then

[230] As discussed in chapter 6, under this model consumers can choose to purchase full insurance cover provided by the Government (equivalent to that available under the government full coverage model) or they can choose to opt out, thus not purchasing insurance and receiving no financial protection in an event where costs are incurred due to the death, disappearance or insolvency of their builder.

[231] Rosen, H.S., 2002, *Public Finance*, McGraw-Hill Irwin, Sydney, pp. 529.

[232] High premiums may turn consumers away. The fewer consumers that purchase the insurance the higher will be the premiums thus a cycle of upwards pressure on premiums is possible.

[233] Relevant information may include knowing, amongst other things, about the availability of home indemnity insurance, the cost of the premiums, coverage of the policy and the probability of an insurable event occurring.

[234] Kunreuther H. and Pauly M. 2005, 'Insurance Decision-Making and Market Behaviour', *Foundations and Trends in Microeconomics*, Vol. 1, No.2.

[235] Commenting on the ability of consumers to opt out of insurance programs, Rosen notes: "individuals who can opt out of a social insurance program may believe that is they put themselves in a sufficiently desperate situation, the government will feel obliged to come to their aid." See, Rosen, H.S., 2002, *Public Finance*, McGraw-Hill Irwin, Sydney, pp. 180

the functioning of the model would likely break down as a form of the free rider problem would be encountered.[236]

For the reasons stated above, the Authority has reservations about recommending a government opt out model.

9.3 Consumer Protection

As established in earlier chapters of this report, the principle objective of the existing home indemnity insurance regulations (and any possible future home indemnity insurance scheme) is to protect consumers. The case for Government intervention to achieve the consumer protection objective was made using the Authority's consumer protection framework (detailed in Chapter 5).

Given the importance of this objective, the Authority considers that the models that have the potential to offer high levels of consumer protection should take precedence over the models that offer only limited protection.

Having considered the hurdle criteria (and also the criterion of consumer choice), the Authority finds that the high protection models are the:

- *private with industry supplement model*; and
- *government full coverage model*.

This is not to dismiss the other remaining models entirely (these being *private with limited coverage* and *government limited coverage*). If either of the above "high" consumer protection models can prove to (i) offer a workable solution to the problem (ii) perform well in the context of the remaining evaluation criteria; and (iii) deliver net benefits to the community, then the Authority will consider them to be preferable to the "low" consumer protection models.

Given the above, further consideration is given to the private with industry supplement model and the government full coverage model.

9.4 Affordability

For the purpose of evaluating affordability, the Authority has assumed that the two remaining models deliver the same level of protection to consumers. That is, under both models, consumers are afforded coverage of non-completion risks and warranty risks (for a period of six years following completion of construction).[237] The only difference between the two models is the parties who provide the coverage: these being private insurers and the building industry in one model and the Government in the other model.

The Authority considers that over the long term, the private with industry supplement model has the potential to deliver greater affordability to consumers. This is because implicit in the private with industry supplement model are incentives that will work to drive efficiencies, and hence affordability, these are:

[236] That is, consumers would know that there is an avenue to receive financial assistance even if they elect not to purchase insurance. In knowing this many will be unlikely to purchase insurance.

[237] This assumption is made so that affordability and compliance costs can be considered in the context of two models that provide the same outcomes for consumers.

- *the profit motive incentive of the private sector insurers* – in a competitive market, the pursuit of profit among private parties will, over time, translate to efficiencies and affordability for consumers; and

- *incentives created by the fact that industry representatives themselves are the providers of warranty insurance* – as is the case with most models of self regulation, there is an incentive held by the industry representatives to impose minimal burden on the parties being regulated. It is because of this, that self-regulation often results in low cost regulatory outcomes. The Self Regulation Taskforce notes:

> Self-regulatory schemes tend to promote good practice and target specific problems within industries, impose lower compliance costs on business, and offer quick, low cost dispute resolution procedures. Effective self-regulation can also avoid the often overly prescriptive nature of regulation and allow industry the flexibility to provide greater choice for consumers and to be more responsive to changing consumer expectations.[238]

The Authority considers that these incentives will have the effect of driving efficiencies and ultimately delivering better affordability outcomes than could be expected under a *full government model*, where such incentives exist only in a very weak form, if at all.

9.5 Compliance Costs

The Authority considers that there is no ability to clearly distinguish the *government full coverage model* and the *private with industry supplement model* on the basis of compliance costs. This is because there are opposing factors that drive compliance costs in each of the two models.

In the context of compliance costs, the government full coverage model:

- has the relative advantage that it is a “one stop” solution - builders only need purchase insurance once for each building project undertaken and this purchased insurance provides cover for non-completion and defect risks; and

- has the relative disadvantage of being a government model in which incentives to deliver efficiencies are not as strong as would be expected in a model run by the private sector.

Put another way, the private *with industry supplement model*:

- has the relative advantage of being considered able to extract greater efficiencies over time due to the implicit incentives in the model; and

- has the relative disadvantage in that insurance for each building project will be split into two separate products: one product for the non-completion risks and one product for the defect risks.

Given the reasons outlined above, the Authority considers that there is no clear basis to distinguish the government full coverage model and the private with industry supplement model on the basis of compliance costs.

[238] Taskforce on Industry Self-Regulation, 2000, *Draft Report*, p. 9.

9.6 Government Risks and Involvement

Considering the *government full coverage model* and the private with industry supplement model in the context of potential government risks and involvement does provide for a clear distinction between the two models. On this criterion, the Authority has a clear preference for the *private with industry supplement model* because it avoids the need for Government to act as a provider of home indemnity insurance.

The Authority considers that the provision of insurance services is not a core role for Government. The private sector (with its knowledge of insurance markets and the building industry) is in a far better position to efficiently and effectively provide insurance than the Government is.

On this concept, the Authority notes the following points:

- *Government involvement creates unnecessary risks* – the provision of insurance (particularly a complex product such as home indemnity insurance) requires very specific skills and expertise that may not be readily accessible by the Government. There is no guarantee that Government would be capable of providing insurance without incurring losses.[239] Such losses would ultimately have to be borne by all taxpayers even though for most, there would be no direct benefits arising from the provision of the insurance.

- *Government involvement is unlikely to be efficient* – the Authority considers that the provision of insurance by private sector insurers who are subject to competitive pressures and incentives to earn profits will deliver better efficiencies than a Government provider of insurance.[240]

- *The potential for political pressure to interfere with policy motives* – there are inherent conflicts in the direct government provision of insurance. For example, if not addressed properly, these conflicts may make it difficult for government to refuse to pay claims - particularly in large and high profile cases of builder failure - even though technically they may be justified in doing so. Such conflicts may limit the effectiveness of the model.[241]

9.7 Conclusions

The Authority considers the *private with industry supplement model* to be potentially the most effective in meeting the required objective of consumer protection. This conclusion is based on the ability of the model to:

[239] For example, a National Competition Policy Information Sheet on Compulsory Third Party Motor Vehicle Insurance released in 2000 indicated that the former Government monopoly provider of insurance in New South Wales was in debt by more than $400 million ten years after it closed.

[240] The merits of the public provision of insurance versus private provision has been considered in numerous National Competition Policy Reviews. In its 2005 inquiry into National Competition Policy Reforms, the Productivity Commission referred to a number of reviews into the provision of compulsory third party insurance and workers' compensation (at the time provided by government owned monopoly insurers) that had reached the conclusion that competition should be introduced in the supply of insurance. See, Productivity Commission, 2005, *Review of National Competition Policy Reforms*, Inquiry Report No. 33, p.268.

[241] Such conflicts are not particularly prevalent in the Government provision of reinsurance because in this role the Government acts in accordance with commercial contracts negotiated with insurers. There is no direct involvement between the Government and members of the community.

- deliver affordable outcomes for consumers;
- engage an efficient, dynamic and knowledgeable private sector; and
- keep unnecessary Government intervention and risks to a minimum.

9.7.1 Concluding Comments on the Construction Period

The intent of the *private with industry supplement model* is to engage the private sector so as to access efficiencies and expertise where sufficient private sector interest exists (that is, in the provision of coverage for non-completion risks).

The Authority considers that the provision of insurance covering the construction period requires more insurance based knowledge and expertise than does the provision of defect risk insurance.[242] It is also the period for which greater capital reserves are required to be able to withstand potential large losses.[243]

It is in the construction period that the risks faced by consumers are highest due to the potential costs that can be incurred if a builder is unable to complete a house (due to death disappearance or insolvency). It is primarily for this reason that the Authority considers that it should be compulsory for builders to hold home indemnity insurance to protect consumers for the construction period.[244]

The Authority expects there to be a reasonable level of interest by private sector insurers in the provision of insurance for the construction period alone. However, the Authority considers it unlikely that there will be scope for the Government to cease its current role as a provider of reinsurance. The prime reason for this is that the capital reserves required to be held by the insurers are large (given the potential for large losses arising from the collapse of one or more major builders) relative to the small size of the market and the premium pool that it generates. The provision of Government reinsurance helps reduce the capital requirements and hence the opportunity costs incurred by the insurers in providing this product.[245] This issue is discussed in further detail in Chapter 11.

9.7.2 Concluding Comments on the Warranty Period

Relative to the provision of non-completion insurance, warranty period insurance is characterised by a more regular claims profile with (i) lower claims costs; (ii) more regular claim frequencies; and (iii) lower claims variability. These characteristics make the provision of insurance more suited to the operation of a simpler insurance model such as fidelity fund. Such a fund[246] could be operated by the building industry associations.

[242] One insurer described the methodology for estimating risks and premiums for the construction period as a case by case type approach. This approach contrasts to the "portfolio approach" adopted for the warranty period. The portfolio approach is based on the premise that a whole portfolio of risks is assessed within which the expected frequency and value of claims over time can reasonably be estimated.

[243] Indicative PWC estimates of the estimated maximum loss in construction period insurance is in excess of $500 million while the estimated maximum loss in the warranty period is estimated to be less than $1 million. See, PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.29.

[244] The Authority notes that a shift to voluntary insurance for the construction period would be very likely to reduce the attractiveness of this market to private insurers.

[245] Also noting that the Authority has been advised that there is no appetite among private reinsurers to provide a similar service.

[246] Or funds if it were the case that the two main building industry associations in the State elected to operate their own separate funds.

The design of this component of the model is based on the premises that there is merit in the pursuit of industry self regulation where possible. On this, the Authority concurs with a finding put forward by a Commonwealth Self Regulation Taskforce (consisting of representatives from a range of industry and consumer groups):

> Industry self-regulation is increasingly being seen as an alternative means of promoting fair-trading, ethical conduct and streamlining compliance with agreed product and service standards in an industry. While industry self-regulation can advance consumer confidence in products and individual companies, it can also promote good business practice.
>
> [A self-regulation mechanism] is often more flexible and less costly for both business and consumers than direct government regulation. [247]

The Authority considers that the flexibility of a self regulation approach combined with the incentives created would work to deliver benefits to builders and consumers that could not be achieved through the implementation of alternative models (and in particular a full government model). These benefits include:

- *Knowledge benefits* – by nature, building industry associations hold significant knowledge and understanding of the building industry and the practitioners that work within it. The Authority considers it advantageous to access this knowledge because it means that the warranty protection can be provided by the industry itself with the knowledge that is necessary to ensure disruptions and costs on builders (and hence ultimately consumers) are minimised.

- *Incentive benefits* – in a model where the building industry associations are effectively the providers of warranty insurance (through the use of a fidelity fund for example) there is an inherent incentive to keep builder contributions as low as possible. This can be done by ensuring builders adhere to appropriate building standards and maintain appropriate business practices so that warranty claims are minimised. Building industry associations are well-placed to influence the behaviour of builders in these regards because of the close relationship and existing communication channels that exists between building industry associations and builders.

It is the view of the Authority that the warranty component of the insurance could be voluntary if it was demonstrated that there was sufficient interest from industry in providing a readily accessible form of insurance. The builder-based model presented in Chapter 6 (as used in the Netherlands) provides a useful framework for the operation of warranty period insurance.

Under such a model, the building associations would impose a levy on their members such that they become parties to a fidelity fund. Consumers would then be free to choose their builders (in the absence of mandatory warranty provisions) with knowledge that builders who are registered members of an association would hold insurance while those builders who are not registered members would not.

As stated in Chapter 5, the Authority believes that the imposition of government restrictions such as the requirement for insurance to be mandatory should be avoided *if possible*. In the case of warranty period protection for consumers, the Authority believes the avoidance of a mandatory requirement is possible. This is because the costs potentially incurred by consumers in the warranty period are likely to be significantly less than in the non-completion period. Also because the Authority believes that the industry has an incentive to provide some form of protection to its consumers so as to create a

[247] Taskforce on Industry Self-Regulation, 2000, *Draft Report*, p. 15.

level of consumer confidence in the industry. The existence of this incentive negates the need for a costly and restrictive requirement for mandatory warranty insurance.

On matters of implementation, the Authority holds the view that warranty insurance should only provide consumers with protection in the event that structural defects (rather than any defects) are encountered.[248] Such an approach would minimise claims made (thus lowering costs for all) and would limit claims only to those instances where there is a strong case for the need for a consumer protection mechanism. The Authority does not view warranty period protection as being a vehicle by which consumers should be able to claim for relatively minor and cosmetic defects, or defects brought on by "wear and tear".[249]

There should always be some onus on consumers to acknowledge that the construction of a new house does inevitably involve some risks. Insulating consumers against all risks is not ideal. In addition to being costly, the insulation of consumers against all risks would potentially lead to moral hazard. For example, in a fully protective environment, consumers might have a tendency to pay little regard to choosing a builder and to monitoring the building process. In the long term, such an outcome would not be to the benefit of consumers or builders as it would limit the proper functioning of incentives that are essential to a competitive market.

The Authority also considers the industry to have sufficient knowledge of the building industry to be able to determine an appropriate length for the warranty period and that the Authority is not averse to a warranty period that is shorter than the existing period of six years.

Based on the research, analysis and consultation undertaken as part of this review, the Authority considers this model to be implementable in Western Australia. The Authority recommends that Government engage with private sector insurers and the building industry to fully test it for feasibility. The undertaking of full and proper discussion and negotiation is ultimately the only way to properly ascertain market sentiment and to identify potential barriers to implementation.

[248] The provision of insurance for structural defects only could be achieved by specifically defining the word structural as has been done in New South Wales in its Building Regulations: "a structural element, in relation to a building, means a component or part of an assembly which provides necessary supporting structure to the whole or any part of the building." See, *NSW Home Building Regulation 2004*.

[249] On the matter of non-structural defects and potential costs to the consumer, the Authority considers that policy resources would be better served in targeting the implementation and enforcement of standards of work rather than being directed to the imposition of restrictive insurance type mechanisms.

10 Do the Benefits Outweigh the Costs?

The purpose of this chapter is to determine whether the benefits arising as a result of the Government intervention required to protect consumers through the recommended model of home indemnity insurance exceed the relevant costs of the provision of that protection.

Included in the conclusions drawn on the recommended model was the concept stated in Chapter 9 that consumer protection for the warranty period (as provided by the industry) could be made to be voluntary provided that there was sufficient interest and ability among the industry to provide a readily accessible form of protection to consumers.

The analysis undertaken in this chapter is targeted toward considering a scenario where consumers are protected for both non completion and defect risks and ascertaining whether the indicative benefits of such an outcome exceed the costs. The counterfactual scenario is that consumers are not protected from potential losses incurred during the construction and warranty periods.

10.1 Introduction

In Western Australia, a regulatory impact assessment is required before the implementation of new or amended regulatory proposals.[250] One of the requirements of the regulatory impact assessment process is the requirement to undertake a cost benefit analysis. A cost benefit analysis is a quantitative assessment of the costs and benefits of a proposed regulatory measure.[251]

This chapter is not intended to stand either as a full regulatory impact assessment or a highly detailed cost benefit analysis. The Authority considers that such a task falls within the remit of State Treasury and would more suitably be performed once a fully specified policy response has been formulated.

The Terms of Reference of this inquiry require the Authority to consider, in broad terms, possible alternatives to the existing home indemnity insurance arrangements in the State. The Authority has done this by assessing the merits of different frameworks of government response to the matter of home indemnity insurance.

As a result, this chapter is intended to demonstrate broadly that the Authority considers it very likely that the benefits of its recommended framework will, once implemented, exceed the costs. Its purpose is to demonstrate that there is merit in pursuing the recommendations put forward and fine tuning them for implementation through detailed analysis and stakeholder consultation.

In the remaining sections of this chapter, the Authority considers several analytical approaches to assess whether the model recommended by the Authority (being the mandatory requirement for builders to hold home indemnity insurance for the construction period) would deliver net benefits to the community. The Authority found that these

[250] The requirement to conduct regulatory impact assessments has been implemented in accordance with Western Australia's commitments as a signatory to the Council of Australian Government's Regulation Reform Plan.

[251] Underpinning the concept of cost benefit analyses is the concept of Pareto improvement. According to the Office of Best Practice Regulation: *"a policy should only be implemented when those who gain from the policy could compensate those who lose, and still be better off. Such a policy is said to offer a potential Pareto improvement." See,* Department of Finance and Deregulation, 2009, *Best Practice Regulation Guidance Note: Decision rules in regulatory cost-benefit analysis*.

alternative approaches support a finding that net benefits arise from the recommended model.

10.2 The Costs and Benefits in Brief

In the early chapters of this report, the case for some measure to protect consumers as a result of builder failure was demonstrated to be robust. It was argued that in the absence of a consumer protection measure, consumers would stand to incur large financial (and emotional) losses arising from builder failure and that consumers could not reasonably be expected to make informed decisions about the relevant probabilities of incurring such losses when choosing a builder. It was also established that consumers could not insure against such losses in a purely market-based approach – home indemnity insurance is not readily offered by private sector insurance in the absence of some form of government intervention.

It is ultimately the benefit of consumer protection that the Authority considers to be most relevant to this analysis. In pursuing an approach to protect consumers, the Authority has settled on one in which it believes is most efficient. By seeking to engage both the private sector and industry the Authority considers that the appropriate incentives will be in place to drive ongoing efficiencies and ultimately this will be to the benefit of consumers.

For the private sector providers of insurance, the relevant incentive is the profit motive. By seeking to engage the private sector to provide insurance for non-completion, the Authority is targeting a competitive supply sector response. The pursuit of profit by insurers in such a setting will translate to efficiencies and consumer benefits as insurers must compete, as they do in other markets, for market share based on prices and service offering.

For the industry provider of warranty insurance, the relevant incentive is the maintenance of consumer confidence in the housing industry. By offering an adequate service, in which consumers can have confidence, the industry stands to benefit as will consumers.

In sum, the Authority considers the case for consumer protection to be strong and it considers its recommended approach to be one of the most efficient of the available approaches and thus it will be capable of delivering net benefits to consumers over time.

The specifics benefits are:

- *The avoidance of large losses for consumers* – case history has shown that consumers could stand to lose in excess of $100,000 if their builder dies, disappears or becomes insolvent. For many consumers such a loss would be crippling and would likely lead to significant financial and emotional difficulty, possibly over a long period of time.

- *Consumer confidence* – even consumers who do not call on home indemnity insurance arrangements would benefit from the “peace of mind” of knowing that they are protected financially from potential losses arising from the death, disappearance or insolvency of their builder. In purchasing insurance, it is important to acknowledge that consumers are in effect passing on their risks to others who arguably are more capable at managing those risks. The concept of purchasing insurance to avoid risk brings value to consumers whether they end up having to use it or not.

- *Industry stability* – it has been noted that the housing industry is inherently cyclical but the case has also been stated by many that mandatory home indemnity insurance has helped, through the creation of consumer confidence and the rigorous financial testing of builders, to bring a greater degree of stability to the industry and that ultimately this has benefitted both consumers and the industry. The Authority concurs with this view and considers the stability generated by a mandatory home indemnity insurance arrangement to be a benefit.

- *Avoidance of risks to Government* – the Authority has heard anecdotal evidence suggesting that prior to the introduction of a mandatory home indemnity insurance scheme in Western Australia there were many calls on Government to assist consumers who had incurred losses as a result of the death, disappearance or insolvency of their builder. There is every reason to expect that such outcomes would repeat themselves if mandatory insurance were removed. It is not appropriate for Government to be in a position of frequently having to provide large-scale financial assistance to consumers that suffer these types of losses. Such an outcome places largely unpredictable risks on Government finances and ultimately costs all taxpayers, even though only benefitting a few. An arrangement whereby only those that stand to benefit from the protection incur the costs of protection (as in a mandatory insurance scheme) is far preferable from both an efficiency and equity perspective.

The specific costs are:

- *The payment of a premium by consumers to insurers and industry* – it is almost inevitable that in order to receive protection, consumers will have to make some payment for it. The Authority considers the premiums paid under existing arrangements (about $1,000 for a house of average value) provides adequate value for consumers and that it is unlikely to interfere with decisions to purchase a new house, simply because such a cost accounts for a small share of the total costs of building a house.[252]

- *The administrative costs in establishing the arrangements* – these costs are those incurred by Government in introducing regulations and include things such as drafting legislation. Costs such as these are once off costs and in the case of home indemnity insurance are not considered to be prohibitive particularly because the recommended approach could be achieved with modifications to existing legislation of the *Home Building Contracts Act 1991* and its supporting regulations. Administrative costs would also be incurred by the home building industry were it to provide warranty insurance but the Authority expects that these could be recouped over time from the operation of the scheme.

- *Compliance costs* – these are costs incurred by builders in complying to the relevant regulations. Most builders pass the financial costs of home indemnity insurance on to consumers but they still incur time costs in completing paperwork and responding the requests of insurers. The Authority has taken these costs into consideration throughout the process of considering different arrangements. Attempts were made to identify possibly arrangements that would not create compliance costs for builders but no suitable alternatives could be identified.[253]

[252] The ability for the size of the premium to provide a signal to consumers about the perceived riskiness of a builder is, in the Authority's view, a small benefit that arises through the operation of a mandatory home indemnity insurance scheme because it helps consumers to make a more informed decision when engaging a builder.

[253] The process by which insurers (whether they be private sector, industry or government insurers) assess the riskiness of different builders and calculate premiums accordingly is considered to be an important, and

> Still, the Authority considers that one of the most effective ways to keep compliance costs to a minimum is to encourage a competitive supply response from insurers (so as to deliver a competitive outcome on the basis of the service provided to builders) and to engage industry (as a representative of builders) to also offer part of the insurance package.

On balance, in a qualitative sense, the Authority considers that the benefits of implementing and operating the model put forward would exceed the costs.

The Authority has identified a number of other pieces of evidence that support this conclusion. These are discussed below.

10.3 Willingness to Pay

Approximations of the willingness of consumers to pay for insurance can be gleaned from the other insurance markets in which consumers can voluntarily choose to purchase insurance. The existence of voluntary insurance markets indicates that many consumers are willing to accept small annual losses in order to be protected from occasional catastrophic losses. When consumers do choose to purchase voluntary insurance, it is inherently because their assessment of the benefits accrued in doing so exceed the costs involved.

Examination of the willingness of consumers to pay for other types of insurance shows that many voluntary lines of insurance deliver benefits to consumers that are similar to those that may be accrued through the purchase of home indemnity insurance.

10.3.1 Claims Frequency Data

Claims frequency refers to the ratio of the number of claims paid by insurance companies to the number of policies written. Claims frequency is an indicator of how likely it is that an individual will successfully make a claim having purchased an insurance policy for a particular class of insurance. Essentially, the indicator shows the probability by which a consumer will successfully activate the insurance after having purchased it.

Using data provided by QBE and Calliden for the 2011/12 financial year, the Authority estimates the claim frequency rate for home indemnity insurance, under the existing arrangements, in Western Australia to be approximately 0.4.[254] Put another way, this ratio indicates that one claim is paid for each 250 policies written.

Table 10.1 provides a comparison of claim frequency rates observed in different lines of insurance.

unavoidable, aspect of home indemnity insurance arrangements because ultimately it is the actions of builders that are being insured against.

[254] Calculated simply as the number of claims paid in 2011/12 divided by the number of policies written in that same year. If anything, the claims frequency rate of 0.40 may be an understatement of the true rate as more claims are likely to be paid over time relating to policies written in 2011/12. The finding broadly concurs with informal advice provided to the Authority by PWC and by available data on the claims frequency rate in Victoria which is estimated at 0.67. See, Essential Services Commission, 2012, *Performance of Victoria's Domestic Building Insurance Scheme 2011-2012*.

Table 10.1 Claims Frequency Ratios for Home Indemnity Insurance and Components of Home and Contents Insurance

Type of insurance	Claim frequency (%)	Average claim size
Home and contents – liability component[255]	0.03	$46,500
Home and contents – fire component	0.17	$38,000
Motor vehicle theft	0.27	$7,500
Home indemnity insurance	0.40	$40,000

Source: Insurance Statistics Australia Limited and data provided by QBE and Calliden.

The claims frequency ratio for home indemnity insurance compares favourably with those for the voluntary classes of insurance such as the fire and liability components for which the magnitudes of claim sizes are similar. This analysis shows that consumers are willing to voluntarily purchase other lines of insurance that deliver similar benefits (in terms of claim frequency) to those of home indemnity insurance.

This finding indicates that, in the mind of consumers, the benefits of protecting themselves against risks of similar probability and impact to those covered by home indemnity insurance, exceed the costs.[256]

10.3.2 Loss Ratios

The loss ratio for a class of insurance refers to the ratio of the value of claims to the value of the gross written premium. This measure estimates the proportion of the total premiums paid back to consumers in the form of claim pay outs. A loss ratio greater than 100 per cent means that over 100 per cent of the premium income has been paid out in claims. A typical target loss ratio for insurers is 75 per cent.[257]

Table 10.2 provides a comparison of loss ratios observed in different lines of insurance and across different home indemnity insurance schemes. The Authority notes that the loss ratios are not directly comparable as they are from a number of different sources and are known to have been calculated on different bases. However, the Authority considers that the data is useful for providing a broad indication of the loss ratio for home indemnity insurance with other insurance classes.

[255] This component of home and contents insurance provides protection in the event that somebody sues the owner of the dwelling for an injury sustained while visiting.

[256] If this is the case, one could ask why it is necessary to make home indemnity insurance mandatory. The primary reason for this is that home indemnity insurance would not be offered by the private sector in the absence of mandatory provisions. Further, there are sufficient grounds to conclude that consumers lack the ability to make an informed judgement about the need for home indemnity insurance. These matters were discussed in depth in chapter 5.

[257] Australian Competition and Consumer Commission, 2002, *Second insurance industry market pricing review*, pp. 12.

Table 10.2 Loss Ratios for Home Indemnity Insurance and Components of Home and Contents Insurance

Type of Insurance	Loss Ratio(%)
Total motor vehicle insurance	66
Total home and contents insurance	49
Home indemnity insurance (QBE)	[redacted] [258]
Home warranty insurance scheme (New South Wales)	40 – 80 [259]
Domestic building insurance (Victoria)	44 [260]

Source: Insurance Statistics Australia Limited, QBE, Finity and Essential Services Commission.

QBE's projected final loss ratio[261] for home indemnity insurance in the 2012 calendar year is forecast to be [redacted][262], indicating that QBE expects to pay out more in claims than it received in premiums.

While a net loss ratio of above 100 per cent is not sustainable, the point of this analysis is to show that historically, the net loss ratio in home indemnity insurance has not been unreasonably low, particularly when compared to other classes of insurance (such as motor vehicle and home and contents insurance). This position is further supported by the loss ratios for home indemnity insurance in other selected States, which have between 40 and 80 per cent.

A very low net loss ratio (for example, around 20 per cent) would have indicated that home indemnity insurance does not deliver tangible benefits to consumers. However, the evidence suggests that, rather than low, net loss ratios in home indemnity insurance have often been relatively high.

This result supports the finding the claims frequency data that home indemnity insurance delivers benefits to consumers that are similar to those delivered by other voluntary forms of insurance. Such a result is indicative of a situation in which the benefits of the insurance are assessed as being greater than the costs.

10.4 Submissions Received

The Authority consulted extensively with interested parties during the preparation of this Draft Report and plans to conduct further consultation in preparing the Final Report. The Authority took into account comments made in submissions to the inquiry and in one-on-one consultations with stakeholders in determining whether the benefits of the scheme outweigh the costs.

[258] This is QBE's projected final loss ratio for the 2012 calendar year.

[259] This is the range of net loss ratios achieved under the Home Warranty Insurance Scheme between 2006 and 2008, which are the years that are nearest the completion of their claims cycles. Source: Finity, 2013, Supplement to Quarterly Reports: Observations on Scheme Progress to 30 June 2012.

[260] Average net loss ratio achieved by insurers in Victoria's domestic building insurance scheme between 2002 and 2005. Source: Essential Services Commission, 2012, *Performance of Victoria's Domestic Building Insurance Scheme 2011-2012*.

[261] The predicted final loss ratios are greater than the actual annual loss ratios to experienced by QBE to date. This reflects that additional claims may still need to be paid in future years.

[262] Information provided in a memo to the Authority, 18 January 2013.

During the consultation process, some stakeholders expressed concerns about the existing arrangements for home indemnity insurance and suggested alternative options or amendments to the existing arrangements. However, the Authority notes that in spite of these concerns, no stakeholder recommended that the home indemnity insurance arrangements be abolished in entirety.

The Authority also notes that some stakeholders were critical of the existing arrangements acknowledged that they had yielded benefits. For example, the Housing Industry Association acknowledges that the home indemnity arrangements have contributed to an improvement in the stability of the building industry with a lower incidence of builder failure rates since the scheme became mandatory.[263]

Others that were critical of the existing arrangements suggested an expansion of the scheme. For example, the Consumer Association of Western Australia indicated a need to address the lack of competition amongst insurers and expressed a preference for a Government underwritten compensation fund. However, they did not express a view that the scheme should be abolished. To the contrary, the Consumer Association supported an expansion of the existing arrangements to provide consumers with compensation for building projects that do not meet the value thresholds under the existing arrangements.

From the stakeholder consultations, the Authority concluded that while there may be flaws in the existing arrangements, there are no demands for the arrangements to be abolished in its entirety or even made voluntary. While this conclusion on its own does not establish that the benefits of mandatory home indemnity insurance schemes exceed the costs it does provide support for such a hypothesis.

10.5 Practices in Other Jurisdictions

The Authority took into account the existence of home indemnity insurance schemes in the jurisdictions that it reviewed in determining whether the benefits of the scheme outweigh the costs.

In researching home indemnity insurance schemes for the purposes of this inquiry, the Authority identified at least ten countries that have implemented home indemnity schemes (the majority of which are mandatory).[264] The Authority notes that the home indemnity schemes in some countries have a long history. As a case in point, a home warranty scheme (establishing the concept of builder liability for defects) was introduced in France in March 1804 under the Code of Napoleon.[265]

In addition, all Australian States and Territories (with the exception of Tasmania) have established some form of mandatory home indemnity insurance measure. The South Australian Government conducted a National Competition Policy review of the State's home indemnity insurance scheme in 2001. This review concluded that the benefits to the community as a whole of a legislatively mandated building indemnity insurance scheme of some form outweigh the costs that such a scheme imposes.[266] It is known that the schemes in most other States and Territories have passed through other forms of policy

[263] The Economic Regulation Authority, November 2012, Consultation with the Housing Industry Association.

[264] These countries are Canada, China, France, Ireland, Japan, Netherlands, South Korea, Sweden, United Kingdom and United States. See, Organization for Housing Warranty Japan, 2005, *Housing and Home Warranty Programs World Research*, Tokyo.

[265] Organization for Housing Warranty Japan, 2005, *Housing and Home Warranty Programs World Research*, Tokyo, p. 73

[266] Government of South Australia, 2001, *National Competition Policy Review of the Building Work Contractors Act 1995*, Adelaide, p.12.

review process, none of which resulted in a recommendation to abolish mandatory home indemnity insurance provisions.[267]

The widespread adoption of mandatory home indemnity insurance arrangements does not, on its own, support the hypothesis that the benefits of mandatory home indemnity insurance exceed the costs.

However, this finding, when coupled with other evidence presented in this chapter forms part of a suite of evidence that provides support to the hypothesis.

10.6 Conclusions

The Authority considers that the weight of evidence suggests that the benefits of a home indemnity insurance scheme are likely to outweigh the costs. This conclusion is made on the basis of:

- a qualitative review of the benefits and costs;
- evidence on consumer willingness to pay for other forms of voluntary insurance that yield similar benefits to home indemnity insurance;
- submissions to this inquiry that provided either explicit or implicit support for a continuation of some form of home indemnity insurance;
- practices in other jurisdictions both in Australia and internationally demonstrating that some form of mandatory home indemnity insurance exists in many economies around the world.

The conclusion suggests to the Authority that its recommended model (*private with industry supplement*) will deliver net benefits to the community.

[267] Recent reviews of home indemnity insurance (none of which support an abolition of mandatory insurance) include: Standing Committee on Economics, 2008, *Australia's mandatory Last Resort Home Warranty Insurance Scheme*, Canberra; NSW Legislative Council, 2007, *Inquiry into the Operations of the Home Building Service*, Sydney; Victorian Legislative Council, 2010, *Inquiry into Builders Warranty Insurance, Melbourne*; Government of South Australia, 2001, *National Competition Policy Review of the Building Work Contractors Act 1995*, Adelaide.

11 Implementation Issues and Impacts on Consumers

This chapter contains commentary on a number of implementation issues in the context of the recommended model and also contains indicative estimates of the likely impacts of consumers.

11.1 Government Reinsurance and Premiums

As noted in Chapter 9, the Authority considers it unlikely that there will be scope, within its recommended model, for the Government to cease its current role as a provider of reinsurance.

The prime reason for this is that the capital reserves required to be held by the insurers are large (given the potential for large losses arising from the collapse of one or more major builders) relative to the relatively small size of the market and the premium pool that it generates.

Actuarial advice provided by PWC indicates that, considered in the context of the existing home indemnity insurance arrangements with the Government's reinsurance of losses above $10 million, the capital required to provide home indemnity insurance is in the order of 125 per cent of the annual premium revenue. For other long tail classes of insurance such as workers compensation insurance and compulsory third party insurance, the capital required amounts to approximately 80 per cent of premium.

According to PWC:

> Without the State's indemnity or commercially affordably reinsurance cover, the insurance market's involvement in HII in WA is unlikely or if offered, the premiums would have to increase significantly.
>
> The concentrated home construction market creates a catastrophe risk far greater than in other Australian jurisdictions and compare to other insurance classes.[268]

The capital requirements of the insurers are unlikely to change markedly under the Authority's recommended model in which the product provided by the private sector insurers is insurance for the construction period only. This is because the determinant of required capital is the estimated maximum loss that insurers face.[269] Losses incurred due to warranty claims only make up a very small portion of the estimated maximum loss and hence removing the warranty period does little to change either the maximum loss or the required capital.

The Authority is not opposed to a continuation of some form of Government reinsurance program as has existed in recent years provided that the Government is able to recoup an amount of premium revenue that is commensurate with the risks it bears. On this the Authority notes that it is estimated that, under existing arrangements, the Government

[268] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.20.

[269] The estimated maximum loss is the total potential cost incurred from a specific event occurring at a particular time. In the context of this paper it is estimated as the total cost of completing all contracts and covering all outstanding warranty claims in the event that all the insured builders die, disappear or become insolvent. The estimated maximum loss is not adjusted for the probability of the event occurring.

currently retains approximately 39 per cent of the estimated maximum loss, yet recoups only approximately 10 per cent of premium revenue.[270]

The Authority accepts that there would likely be an increase in total premiums paid by consumers if the Government were to recoup a share of the premium revenue that was reflective of the risks borne. However, the Authority considers it necessary that (i) the full costs of the insurance are passed to the consumers who stand to benefit from the insurance; and (ii) that the Government earn a revenue stream reflective of the potential losses that it may, at some point, incur.

If the existing home indemnity insurance arrangements were to continue such that both the main insurer and the Government were to recoup premium revenue in accordance with the distribution of risks, then aggregate premiums (for the construction and warranty period) would be likely to increase above current levels. The extent of the required premium increase is not clear at this point in time. However, the Authority considers that full Government compensation would not render home indemnity insurance unaffordable, noting that at present, premiums only account for about 0.4 per cent of the cost of constructing a new house.

Modelling by PWC indicates that actuarially fair premiums charged under a model such as that recommended by the Authority are broadly consistent with premiums charged under the existing model with full Government compensation. Ultimate premium outcomes under the Authority's recommended model cannot be known with certainty due to the following variables:

- the degree to which other private insurers enter the market under the proposed model or the degree to which existing insurers reallocate capital given the changes;
- the response by insurers to potential negotiations on the risks and premium sharing arrangement; and
- the approach taken by industry in providing warranty protection (including the length of the warranty period, the maximum payout limits, and the degree to which a profit is pursued).

[270] PWC, 2013, *Analysis of Home Indemnity Insurance Scheme Designs,* Final Report to ERA, p.24.

12 Ground Subsidence

The Terms of Reference for this inquiry require the Authority to consider whether there is scope for the State's home indemnity insurance arrangements to address the costs to homeowners of damage caused by ground subsidence due to underlying geological causes rather than builder or developer default. The merits of including protection for ground subsidence within home indemnity insurance arrangements are assessed in this chapter.

12.1 About Ground Subsidence

Put simply, ground subsidence (referred to from here on as "subsidence") is the sinking of landforms.[271] Subsidence can cause structural defects to buildings and, in extreme cases, make buildings uninhabitable. In such extreme cases, home owners can lose the value of both the house and land, as extreme cases of subsidence can cause irreparable damage to houses and render the land unfit to build on. In less extreme cases, owners might be able to take steps to stabilise the land and repair the associated damage.

There are several signs of subsidence occurring including: new cracks in walls[272]; widening of existing cracks; 'rippling' in wall paper; or difficulties opening and shutting doors or windows. However, these effects may also occur when a new house is 'settling', or in cases where there is dampness in the house, or changes in seasonal temperature (which can cause wood to expand) and hence are not strictly demonstrative of cases of subsidence.

Subsidence can be either the result of human activity (such as mining or underground water extraction) or the result of naturally occurring land conditions such as karsts. Karsts are a type of landscape formed from the dissolution of soluble rocks including limestone, dolomite and gypsum. They are characterised by sinkholes, caves, and underground drainage systems.[273]

Buildings that are constructed over karst terrain or old mine shafts can be affected by subsidence. Geoscience Australia observed that:

> Caves represent potential ground stability hazards to surface structures and engineering work. Caves and karst regions have been globally recognised as a geologic hazard with collapse and subsidence being of greatest concern. Collapse potential can only be evaluated by the nature and distribution of cave types within the region.[274]

A pictorial depiction of karst is provided in Figure 12.1.

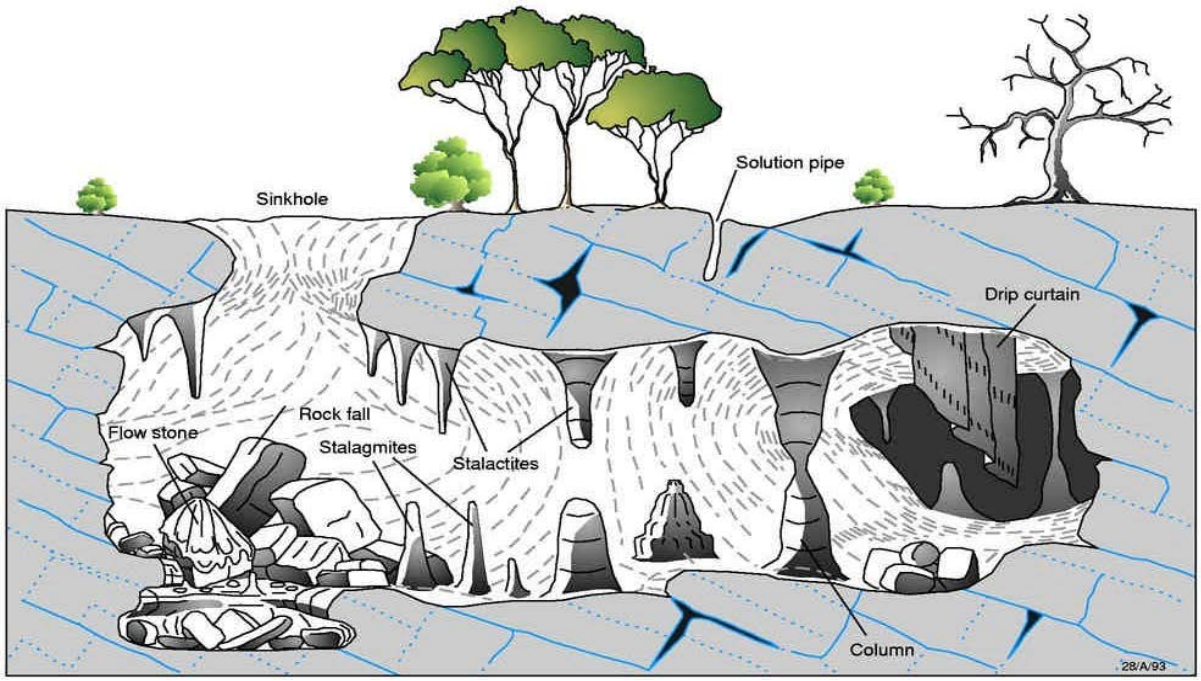
[271] Collins, English dictionary, *Subsidence.*

[272] The Queensland Building Services Authority considers that cracks over 5mm wide that it may be possible to repair or that may require whole or partial replacement of the wall, noticeable bulging of walls, and windows and doors that stick and distort exceed the expectations of the Australian Standard AS2870. Source: Building Services Australia, A homeowners guide to subsidence and acceptable tolerances specified in Australian Standard AS2870.

[273] University of Texas, undated, *What is Karst*.

[274] Geoscience Australia, 2003, Review of karst hazards in the Wanneroo Area, Perth Western Australia, p. 4.

Figure 12.1 Schematic Diagram of a Karst Terrain



Source: Geoscience Australia, 2003, Review of karst hazards in the Wanneroo Area, Perth Western Australia, accessed from www.ga.gov.au on 30 January 2013.

Ground subsidence can also be caused by certain soils, particularly clay soils, which are reactive to changes in ground water levels and thus cause the ground to swell or sink.

The causes of subsidence can be separated into 'at fault' and 'no fault' subsidence. The Authority considers at fault subsidence to include those causes that could be predicted, detected and prevented with some reasonable level of effort. Such causes may include leaking drains, man-made excavation and the extraction of groundwater. In contrast, no fault causes of subsidence are those that could not be reasonably predicted, detected or prevented. A cause of no fault subsidence may include building over unknown caves, despite undertaking rigorous survey work.

The Terms of Reference of this inquiry require the Authority to give consideration only to no fault subsidence.

12.2 The Nature and Significance of Ground Subsidence in Western Australia

12.2.1 Areas Prone to Subsidence

Parts of the greater Perth metropolitan area (City of Wanneroo) and Western Australia more generally (Margaret River and Shark Bay) have certain geographic features that make some areas more prone to subsidence than others.[275] The City of Wanneroo is one area that has been identified as having geological conditions that are conducive to subsidence.

A 2003 report by Geoscience Australia noted that:

[275] Geoscience Australia, 2010, *Karst Hazard*.

> Known karst hazards in Wanneroo include; holes developing on private property, a rock fall, exposed caves with inappropriate coverings, and roads and houses built over caves and pinnacles. These hazards pose a risk to the community as personal, structural and environmental damage may occur.[276]

Suburbs that have been identified as containing medium to high risks from karst lanscapes include: Two Rocks, Yanchep, Eglington, Carabooda, Alkimos, Butler, Nowergup, Merriwa, Ridgewood, Mindarie, Clarkson, Neerabup, Tamala Park, Carramar and Ashby.[277] The Australian Bureau of Statistics estimates that there are about 23,500 private dwellings in these suburbs.[278]

Other suburbs (particularly in areas adjacent to the City of Wanneroo, such as in the City of Joondalup) may contain karst risks, but these do not appear to be as well documented.

12.2.2 Known Cases of No Fault Subsidence Damage

The Authority undertook extensive research and stakeholder consultation to identify known cases of subsidence damage to houses in Western Australia. One of the key findings of this piece of work is that knowledge and documentation of the number of cases of subsidence in Western Australia is limited.

Through its work, the Authority was made aware of five cases (each occurring within the past five years) in which no fault subsidence has caused significant damage to houses in Western Australia.[279]

- two houses in Secret Harbour;
- one house in Mount Lawley;[280]
- one house in Mullaloo; and
- one case in which a private swimming pool collapsed into a sinkhole in Woodvale.[281]

It is noted that two of the known significant cases of ground subsidence occurred in Mullaloo and Woodvale, which are in the City of Joondalup. The City of Joondalup is adjacent to the City of Wanneroo, where karst hazards have been identified as a potential problem.

12.3 Existing Measures of Protection for Consumers

There are relatively few formal consumer protection measures in place to protect consumers from damage caused by subsidence in Western Australia. Formal measures include building and site preparation standards designed to prevent instances of subsidence damage. Informally, the State Government has provided payments to some consumers who have encountered significant damages resulting from subsidence.

[276] Geoscience Australia, 2003, *Review of Karst Hazards in the Wanneroo Area*, Perth Western Australia.

[277] Geoscience Australia, 2003, *Review of Karst Hazards in the Wanneroo Area*, Perth Western Australia.

[278] Australian Bureau of Statistics, 2013, Census data quick stats search.

[279] It is only the fact that property owners in the cases above have sought (or are seeking) compensation for damages that has enabled the Authority to identify them.

[280] The Authority was unable to obtain any details on the ex gratia payment for the house in Mount Lawley.

[281] Extract from Hansard, 2007, Mrs Judy Hughes and Mr Fran Logan, *Pilkington Family- Sinkhole Formation Grievance*.

12.3.1 Preventative Measures

There are measures in place to ensure that buildings are constructed to a standard to withstand a reasonable level of ground subsidence. The Building Code of Australia (Code) and the Australian Standards AS 2870 Residential Slabs and Footings (the Australian Standard) provide guidance and minimum requirements to protect consumers.

Local governments are required to ensure that building applications comply with the design requirements of the Code before granting building approval.[282] The Code needs to be followed to the extent that building service practitioners comply with the Deemed-to-Satisfy Provisions or Alternative Solutions of the Code.[283]

The Australian Standard is designed to ensure that builders take the necessary action to reduce the probability of ground movement that can affect dwellings. The Australian Standard classifies land according to the expected ground surface movement and the depth to which this movement extends.[284] Both the Code and the Australian Standard require that a builder engages an engineer or other suitably qualified person to assess the site and soils for building suitability. The extent of necessary ground levelling and footings are then determined according to these classifications. The engineer must design a footing system to work with certain design criteria dependent on the soils and area conditions. The footing should accommodate normal movements caused by seasonal volume changes in soils and weather.

A builder would not be liable for damage caused by subsidence if the builder has acted in accordance with relevant regulations regarding ground testing and site preparation.[285]

12.3.2 Government Provided Measures

There are no formal mechanisms for protecting or compensating consumers affected by 'no fault' ground subsidence in Western Australia. However, there have been instances of the Western Australian Government providing ex gratia payments to home owners affected by subsidence on an ad hoc basis. Of the cases identified above:

- owners of the two houses in Secret Harbour were able to sell their house and land to State Government for $370,000 each (the land is now considered not fit to build and the houses at the time of purchase had next to no value due to the damage incurred); and

- the owner of the house in Mount Lawley received an ex gratia payment of unknown value from the State Government.

In addition, the Minister for Housing, aided by the Building Commission, is also currently assessing a claim for an ex gratia payment for the affected home in Mullaloo.

The State Government has not established any formal criteria for determining whether an affected home owner is eligible for compensation for damage caused by no fault subsidence. However, judging from case histories, key factors that appear to affect the Government's decision on whether to offer compensation appear to include:

[282] Building Commission, 2012, *Codes and Standards*.

[283] The Deemed-to-Satisfy Provisions or Alternative Solutions are minimum requirements for a builder to ensure subsidence does not occur.

[284] Standards Australia, 2011, *Residential slabs and* footings.

[285] Three cases of subsidence set precedence that if the builder has followed the requirements set by the Building Code and the National Standards they are not liable for subsidence.

- whether any parties (such as the builder or developer) can be held liable for the damage caused by ground subsidence;
- whether the Government had a role as a land developer; and
- whether the affected home owner could have reasonably known that their dwelling could potentially be affected by ground subsidence.

12.3.2.1 Interstate Approaches

Currently, Queensland is the only Australian jurisdiction that has formal regulatory provisions requiring that homeowners be covered against subsidence damage. This cover is provided through the State's mandatory home indemnity insurance scheme, which is provided by the Queensland Government through the Building Services Authority.

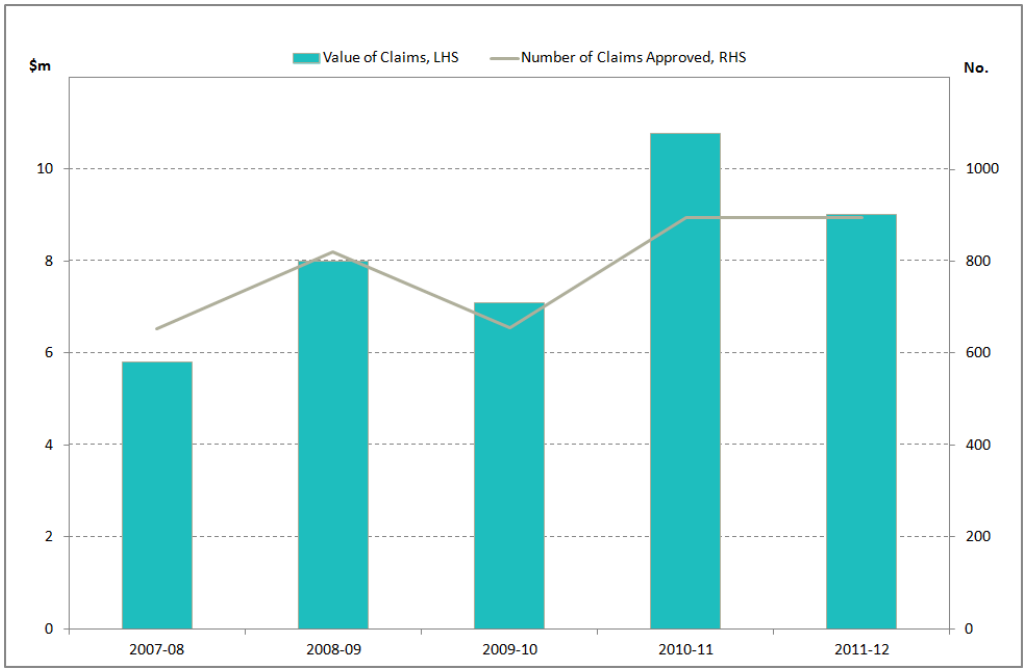
As per home indemnity insurance cover in Queensland, subsidence cover is provided on a first resort basis, meaning that cover is granted regardless of fault, providing the builder adhered to the Building Code of Australia. In practice this means that the insurer will fund repairs and not seek compensation from the builder or engineer if it can be established that the Building Code was adhered to. It the Code was not adhered to then the insurer will seek compensation from the builder.

Some specifics of the Queensland arrangements include:

- the period of cover for subsidence is six years and six months from the date of payment of the insurance premium;
- the subsidence claim must be made within three months of the damage becoming evident; and
- the maximum payout for is $200,000 or the cost of replacement value, whichever is less and this includes a maximum of $5,000 for alternative accommodation, removal or storage costs.

The number and cost of approved ground subsidence claims in Queensland (totalling approximately 900 in 2011/12) is high relative to the handful of known cases of subsidence damage in Western Australia (Figure 12.2).

Figure 12.2 Number and Value of Subsidence Costs in Queensland



Source: Building Services Authority, Annual Report 2011-2012, pg. 18.

The significant difference in the magnitude of cases in Western Australia and Queensland is most likely due to geological conditions in each of the two states. The majority of Queensland homes are built on reactive clay soils. These soils are subject to expansion and contraction depending on seasonal weather and site conditions. In contrast, the majority of homes in the Perth metropolitan area are constructed on sandy soil. Sandy sites and rocky terrain are usually not prone to the expansion and contraction experienced by reactive clay soils.

12.3.3 Private Sector Measures

The Authority is not aware of any private insurers that offer (or are willing to offer) insurance against damage caused by subsidence in Australia. Both Calliden and QBE expressed unwillingness to offer ground subsidence insurance. Calliden stated that it subsidence insurance:

> would be considered a new risk product and Calliden could not offer [an] opinion without deep actuarial analysis. We would anticipate an assessment would require detailed seismic data[286] to track historical trends. Once received Calliden would have to make a judgement if a form of cover could be viable and then formulate relevant underwriting criteria before a submission to reinsurers.[287]

[286] Seismic data is data relating to earthquakes or other vibrations of the earth and its crust (Source: The Oxford Dictionaries, *Seismic.)*

[287] Calliden submission to the Economic Regulation Authority's Issue Paper on Home Indemnity Insurance (2012).

12.4 The Case for the Inclusion of Subsidence Cover in Home Indemnity Insurance

The specific task given to the Authority in the Terms of Reference is to investigate the suitability of including protection for subsidence damage in the State's home indemnity insurance arrangements. This issue is considered below.

12.4.1 Submissions on the Matter

Comments were made on ground subsidence in eight of the fourteen submissions received by the Authority in response to the Issues Paper.

No support was expressed in these submissions for extending the current mandatory home indemnity insurance arrangements to include homes affected by ground subsidence. It was suggested in three submissions (none of which were provided by insurers) that there may be a viable market for private insurers to offer ground subsidence insurance as an independent insurance product. However, as indicated above there is a clear reluctance on behalf of insurers to offer subsidence insurance. Both Calliden and QBE expressed this sentiment directly to the Authority during informal discussions and Calliden also expressed it in a submission to the Issues Paper.[288]

The main objections to including coverage for ground subsidence in home indemnity insurance were:

- the lack of information and data surrounding subsidence including costs, occurrences and the price of insurance (stated by four submitters); and
- a reluctance to complicate home indemnity insurance even further (stated by four submitters).

The Housing Industry Association made the following observations on the specific circumstances in Western Australia:

> HIA does not consider that there is a case for the introduction of [ground subsidence] insurance in WA.
>
> So far as HIA is aware, there is no significant subsidence problem in WA home building. HIA notes that a very high proportion of WA homes are built on sand plane where adequate site classification procedures exist.[289]

The Housing Industry Association also noted the high cost of home indemnity insurance in the Queensland model.[290]

Kazien Construction suggested an alternative model in the form of a mutual fund run by the State Government. Under this model, no fault ground subsidence could be insured by the mutual fund up to a maximum of $50,000. If the fund administrator finds that the subsidence is the fault of a builder, engineer or other party the costs should be recovered from the responsible party.

[288] Calliden, 2012, submission to the Economic Regulation Authority's Issue Paper on Home Indemnity Insurance.

[289] Housing Industry Association, 2012, submission to the Economic Regulation Authority's Issue Paper on Home Indemnity Insurance.

[290] Insurance premium for a $250,000 house in Queensland costs approximately $2,200 (exclusive of GST), in Western Australia it costs $1,200 (exclusive of GST). Queensland's premium is higher as they offer subsidence insurance and has a first resort home indemnity scheme.

12.4.2 The Authority's View

The Authority's view is guided by the following observations:

- The nature of the risks relevant to home indemnity insurance (being builder collapse and the occurrence of defects) are completely different to those that would be relevant to some form of no fault subsidence scheme (being poorly understood geological factors). Given this disparity of risks, the Authority can see no reason to bundle the two products together.

- Related to the above is that it is clear that private insurers are unwilling to provide no fault subsidence insurance and attempting to include subsidence coverage would limit the ability to engage the private sector in a privately run home indemnity insurance scheme.

- The ability to protect consumers from the costs of no fault subsidence damage via a home indemnity insurance mechanism is highly limited because home indemnity insurance is only relevant to new dwellings whereas all dwellings are susceptible to damage from subsidence. In 2011, new homes constructed accounted for only 2.5 per cent of the State's stock of separate houses.[291]

- Given the limited number of cases of no fault subsidence resulting in significant damage costs, it is unlikely that the benefits associated with including subsidence cover in home indemnity insurance arrangements would exceed the costs.[292] These costs would include administration costs associated with drafting the appropriate legislation; compliance costs on builders and consumers in adhering to the regulations; and transition costs incurred by insurers in coming to terms with the new regulations and gaining an ability to ascertain subsidence risks. These latter costs would inevitably be passed on to consumers.

12.4.3 Conclusions

For the reasons stated above, the Authority concludes that the State's home indemnity insurance arrangements should not be extended to include coverage for ground subsidence. This conclusion addresses the requirements of the Terms of Reference. The following sections contain additional analysis on the case for consumer protection as it relates to no fault subsidence.

12.5 Options for Protecting Consumers

The Authority considers that some form of consumer protection measure for damage incurred by subsidence may be warranted if it can be established that the benefits of the consumer protection measure exceed the costs. Using the consumer protection framework developed earlier in this report, the Authority finds that:

[291] Source: Australian Bureau of Statistics, January 2013, Cat No. 8752.0 *Building Activity*, Australia, September 2012 and Australian Bureau of Statistics, October 2012, 2011 Census *QuickStats,* Western Australia.

[292] Noting that the benefits of such an approach are even more limited if it is considered that they would only be attributable to owners of *newly constructed* houses that incurred significant subsidence damage as it would only be newly constructed houses that are covered under a model where subsidence cover is provided through home indemnity insurance.

- consumers stand to incur large financial losses, with extreme cases of subsidence causing irreparable damage to houses and rendering land unfit to build on;

- consumers cannot reasonably be informed about the risks they face from no fault subsidence when they purchase a home, given the expense of geotechnical investigations[293]; and

- consumers are not able to access a market-based solution to protect themselves because private sector insurers do not offer subsidence insurance.

In exploring alternative options for a consumer protection framework, the Authority considered the suitability of the following approaches, which were developed by the Department of Commerce:[294]

- *Legislation of mandatory warranty provisions for new houses* – this option is not deemed suitable for no fault subsidence simply because there is no rationale for a builder having to honour a warranty that stands against something that is neither due to the fault of the builder or within the control of the builder. Furthermore, warranties on new houses would not provide cover for all owners of existing houses in Western Australia. There is no clear rationale in only providing protection for owners of new houses (which, as noted above, in 2011 accounted for only 2.5 per cent of the State's stock of separate houses) as subsidence may affect existing and new houses.

- *Establishment of a mandatory fidelity fund* – under this option either home builders[295] or consumers would make a contribution to a fidelity fund that could then be used to provide payment to consumers adversely affected by subsidence. As in the case above, the Authority considers that there is no clear rationale in only providing protection for owners of new houses. Furthermore, the Authority considers it unlikely that the administrative and compliance costs associated with such an approach would be justified by the benefits as measured by the consumer protection offered simply because of the very limited number of cases of significant subsidence damage.

- *Application of a mandatory government levy* - this option would involve the State Government adding a levy to an existing fee or tax (such as local government rates or land tax) in order to raise sufficient funds to pay claims for dwellings affected by ground subsidence. While attractive in that all owners of houses could be targeted, the Authority again considers it unlikely that the administrative and compliance costs associated with a mandatory levy would be justified by the benefits as measured by the consumer protection offered simply because of the very limited number of cases of significant subsidence damage.

12.5.1 Conclusions on a Consumer Protection Framework

The Authority considers that there is a case for some form of consumer protection framework to be implemented to provide assistance to consumers who incur significant damage costs due to no fault subsidence.

[293] The Housing Industry Association indicated in its submission to the Authority that geotechnical reports for a residential block may cost up to $3,000.

[294] Department of Commerce, March 2011, Properties Impacted by Subsidence, Unpublished memorandum to Minister for Commerce.

[295] Noting that it would be likely for builders to pass contribution costs on to consumers.

However, the Authority considers that any formal and regulated policy response cannot be justified at this time because it would be difficult to demonstrate that the benefits of such a response would outweigh the costs. This conclusion is based on two rationales:

- one, the limited number of cases of no fault subsidence resulting in significant damage costs in Western Australia (totalling only five in the past five years) means that the consumer protection benefits that would result from a formal and regulated policy response would, in aggregate, be limited; and

- two, the lack of robust information on the nature, causes and costs of no fault subsidence makes it difficult to form a defensible policy response. In such a situation the risk that a poorly informed government intervention would do more harm than good is considered by the Authority to be high.[296]

Due to the potential for large individual losses and the inability of consumers to protect themselves the Authority is not averse to a continuation of the current approach of informal ex gratia payments to consumers.

However, there is some scope to improve current arrangements of providing ex gratia payments to people that are severely affected by ground subsidence. This is primarily because some of the key aspects of the current arrangements are poorly defined, for example, the Authority notes that:

- there is no well-established or clear process for an individual whose dwelling has been affected by ground subsidence to apply to the Government for relief;

- no single Government agency has been specifically tasked with managing ground subsidence cases or has been allocated a budget for compensating individuals that are affected by ground subsidence; and

- no criteria have been established for assessing claims for relief, potentially resulting in inequitable decisions being made between claimants.

The Authority does not suggest that a continuation of the current ex gratia approach is either a truly effective or costless long term policy response, but given the existing circumstances, the Authority finds that the approach is administratively simple and likely to be less costly than other responses.

A greater focus on information collection on the costs of no fault subsidence would be beneficial in considering a more formal policy response over the longer term.

[296] It is unavoidable that governments will have to make policy decisions in the face of considerable uncertainty. However, dealing with uncertainty in an irresponsible manner can lead to poor policy outcomes. There are many ways in which policymakers can behave irresponsibly in relation to risk, including ignoring uncertainty, making panicked or hasty decisions and waiting for a crisis before acting. In contrast, responsible policy making in relation to risk involves working with the knowledge base available being aware of its limitations, acting proportionally and making considered decisions when there is no crisis). Source: CPB/MNP/Rand Europe, March 2007, *Dealing with Uncertainty in Policymaking*, Final Report on the conference Dealing with Uncertainty in Policymaking, 16 and 17 May 2006, The Hague.

Appendix 1 Terms of Reference

INQUIRY INTO WESTERN AUSTRALIA'S HOME INDEMNITY INSURANCE ARRANGEMENTS

TERMS OF REFERENCE

I, CHARLES CHRISTIAN PORTER, Treasurer and pursuant to section 38(1)(a) of the *Economic Regulation Authority Act 2003* request that the Economic Regulation Authority (the Authority) undertake an inquiry into the effectiveness of Western Australia's Home Indemnity Insurance (HII) arrangements, which are established by the *Home Building Contracts Act 1991*.

In conducting the inquiry, the Authority is to consider and have regard to:

- how Part 3A of the Act currently operates, including measures taken by the State Government to underwrite the private provision of HII since the Act was amended in 2002;
- whether there is an ongoing need for the mandatory provision of HII;
- alternative regulatory models that could be applied in Western Australia to replace or improve current arrangements, including the establishment of a fidelity fund; and
- whether the scope of the State's HII arrangements, or whichever regulatory model is recommended, should also address the costs to homeowners of damage caused by ground subsidence due to underlying geological causes rather than builder or developer default.

In its assessment of the options, the Authority must give consideration, but need not be limited, to the:

- red tape burdens on the insurance and building industries;
- possible implications for home affordability; and
- costs and financial risks to the State Government.

The Authority will release an issues paper as soon as possible after receiving the terms of reference. The paper is to facilitate public consultation on the basis of invitations for written submissions from industry, government, consumer groups and other relevant stakeholders.

A draft report is to be made available for further public consultation on the basis of invitations for written submissions. A final report is to be completed by no later than the close of business on 30 April 2013. Note that to accommodate the timing necessary to implement new arrangements, no extension of time is possible beyond this date.

HON C. CHRISTIAN PORTER MLA
TREASURER; ATTORNEY GENERAL

Appendix 2 Stakeholder Consultation

In conducting this inquiry, the Authority has consulted with the following stakeholders:

Artique Homes Pty Ltd

BGC Pty Ltd

Building Commission (Department of Commerce, Western Australia)

Building Ethics Australia Pty Ltd

Calliden Insurance Ltd

CGU Insurance Ltd

Consumers' Association of Western Australia

Department of Lands, Planning and the Environment (Northern Territory)

Department of the Justice (Tasmania)

Department of Treasury (New South Wales)

Department of Treasury (Western Australia)

Economic Regulation Authority Consumer Consultative Committee

Finity Consulting Pty Ltd

Housing Industry Association Ltd

Insurance Commission of Western Australia

Kaizen Construction Pty Ltd

Ken Little Homes Pty Ltd

Master Builders Association of Western Australia

Master Builders Fidelity Fund (Australian Capital Territory)

Master Builders Housing Council (Western Australia)

NSW Home Warranty Insurance Fund (NSW Self Insurance Corporation)

QBE Insurance Group Ltd

Queensland Building Services Authority

Vero Insurance Ltd

Wesbuilders Cooperative