

PART 1: REVIEW'S PURPOSE

In commissioning this report the Ministerial Council on Consumer Affairs set the following objective and terms of reference:

Objective:

To explore the systemic issues in the domestic building indemnity/home warranty insurance industry with a view to identifying a competitive home warranty insurance scheme, which is viable in both the short and longer term and provides an appropriate level of protection for homeowners as consumers.

Terms of reference:

- Identify and analyse the appropriateness of the current home warranty insurance schemes in providing appropriate consumer protection by an adequate number of providers in an efficient competitive market;
- Analyse the long term sustainability of the current home warranty insurance schemes (including a comparative analysis of the various States and Territories schemes and other models);
- Identify those aspects of home warranty insurance which are common to State and Territory based schemes; and
- Suggest any potential reforms and their costs and benefits which may lead to appropriate consumer protection and greater national uniformity or consistency.

The inquiry will:

- Consult with and invite submissions from State and Territory authorities, consumers, industry, relevant industry and consumers associations, APRA, and other interested parties.

PART 2: INDUSTRY BACKGROUND

Home builders warranty insurance

The history of home builders warranty insurance (HBWI) in Australia is recounted by one industry source¹ as follows:

'Consumer protection of new homebuyers against builder failure began in Australia in the early 1970's when a compulsory indemnity scheme was introduced in Victoria. The scheme was run by two companies linked to the Housing Industry Association and the Master Builders Association of Victoria. These privately underwritten schemes were subsequently taken over in 1983 by the government-owned Housing Guarantee Fund Ltd.'

'The adoption of statutory home warranty insurance to provide confidence for consumers in the home building process was not taken up in other states until more than a decade later. In the early 1980's statutory housing indemnity was introduced in South Australia and was underwritten by a panel of private sector underwriters. By the end of the 1980's mandated private sector warranty schemes were operating in South Australia, Tasmania and the ACT, and government underwritten schemes in Queensland, New South Wales and Victoria. A voluntary, privately run insurance scheme was also operating in Western Australia.'

'During the 1990's government run enterprises came under scrutiny, particularly where there was capacity for similar functions to be performed by the private sector.'

To cut a long story short by the mid 1990's both NSW and Victoria decided to cease offering government HBWI and open their markets to private competition within a detailed regulatory framework. In Queensland the government owned insurer, the Building Services Authority (BSA), continued to operate with an exclusive franchise. In the Northern Territory, the Territory Insurance Office (TIO) remained the only provider of HBWI because of lack of interest by private insurers.

All states and territories continue to mandate HBWI, but until recently half the jurisdictions (Queensland, NSW, Vic and Tas) prescribed 'first resort' schemes and the other half (WA, SA, ACT and NT) 'last resort' schemes. The difference between these two approaches is explained later.

The home building process

Home builders warranty insurance (HBWI) cannot be examined in isolation of the home building process. Indeed as we shall see later, the success of a HBWI scheme depends largely on containing insurance claims by having a regulatory framework that encourages a good standard of building and provides a mechanism for quickly resolving disputes.

¹ Housing Industry Association of Australia, 'Submission on Home Warranty', 14 January 2002, page 1.

Chart 1 (see Appendix 6 for all charts) depicts in simple terms the basic steps involved in building a home in most jurisdictions at the start of 2002. These steps can be summarised as follows:

1. **Builders' Licensing:** Builders in all states, except Tasmania and the Northern Territory, need to be licensed or registered. To be licensed a builder must be of 'good character' and have the requisite technical qualifications and skills. In addition they must produce a certificate of eligibility for insurance obtained from an insurer. Only in Queensland do they also have to pass a financial viability test. In other jurisdictions they are not permitted to start building until they have HBWI policy, which they have to obtain from a private insurer.
2. **Building Standards:** In erecting homes, builders are meant to abide by the Building Code of Australia and associated standards issued by Standards Australia. The code largely cover structural matters (for example, footings, slab, frame, windows, doors, roof, storm water) rather than services (for example, electricity, gas, telephone, water and sewerage) and finishes (for example, cement rendering, ceilings, painting, inbuilt wardrobes, light fittings, carpets, etc). The purpose of the code and standards appears to be to ensure the human health and safety of a building, not to protect its buyer against faulty materials or workmanship that affect its appearance.
3. **Building Advice:** The first step for a consumer interested in becoming a homebuyer is to seek advice. This may involve buying a book on the subject, obtaining brochures from the relevant state or territory department of consumer affairs (sometimes called by other names such as 'fair trading' or 'business and consumer affairs') or one of the building industry associations (HIA or MBA), and visiting building and home display centres which also offer advice and information. At this point the homebuyer may also contact a conveyance solicitor and arrange finance with a bank, building society or mortgage broker. About half of homebuyers approach a large project home builder (for example, A.V. Jennings, Henley Properties Group, Masterton Homes, Clarendon Homes, Devine Pioneer Homes, etc) who actively market a packaged solution consisting of a range of display homes for inspection, ready-made designs and drawings, standard building contracts, building management and construction and in some cases serviced land sites. The balance buy completed homes from speculative builders and multi-unit developers or use an architect or draftsman to produce a design and then engage a builder or build it themselves.
4. **Building Contract:** Before contracting a builder it is necessary for the buyer to have drawings, specifications and schedules for their home that can be attached to the building contract that the builder will sign and which can be submitted for development and building approval. If a homebuyer either buys a project home, unit or townhouse off the plan the developer will have arranged the plans and specifications in advance. For custom-built homes a homebuyer will have to engage a draftsman or architect to prepare the drawings and specifications. Standard plain English building contracts are available from various sources including building industry associations, Standards Australia and state and territory governments. Project home developers also offer such contracts to consumers. Homebuyers using an architect or draftsman normally ask three or more builders to tender for the work. With project homes the developer usually undertakes the building as part of a total package. The final contract signed with the builder should make reference to all

specifications and drawings, the total price of the work, the start and finish dates, a schedule for making progress payments and a mechanism for approving any design variations, prime costs or provisional sums.

5. **Warranty and Insurance:** Each builder under state or territory legislation is obliged to warrant his workmanship and building materials. In addition he is required to take out home builders warranty insurance before starting any building work above a certain value (which varies from state to state). Insurance policies may relate to a single building job or all the work a builder plans to do over a year. In the case of annual policies the builder may issue his own insurance certificates per job. For individual jobs the insurer will issue the insurance certificate.
6. **Development and Building Approvals:** The owner or their project manager (often an architect or builder) submits an application for development of the site to the local government authority (that is, local council). If the development application is rejected the owner may appeal to a special tribunal (for example, Land and Environment Court in NSW). In most states once the development consent has been given, approval for erecting the building itself (called a construction certificate in NSW) may be obtained from either the local council or a private surveyor (named a Principal Certifying Authority in NSW) accredited to undertake this task.
7. **Building Construction:** Constructing a home involves several basic stages with progress payments made to the builder at the end of each stage.
 - (a) **Site** — selection, geo-technical engineering and legal considerations in choosing a block of ground, surveying it and preparing it for building work;
 - (b) **Base** — covers that part of the structure between the foundation (site) and the top of the ground floor. It includes footings, sub-surface or agricultural drainage, retaining walls, ground to floor systems (for example, isolated piers, stumps, posts, columns and posts and or continuous wall-like base structures made of concrete blocks, brick or stone) and timber floor frames or concrete slabs.
 - (c) **Envelope** — includes timber wall framing, brick veneer construction, sheet and board claddings, solid masonry construction, interior linings, windows, doors, roof frames and covers and ceilings.
 - (d) **Services** — includes storm water drainage and disposal, sewerage disposal, sanitary plumbing, cold and hot water reticulation, hot water systems, gas supply, electrical systems, telephone wiring, security alarm systems, computer cabling, etc.
 - (e) **Finishes (exterior and interior)** — includes ‘fixing out’ the building (for example, skirtings, cornices, architraves, linings, angles and other trims), kitchens, bathrooms, robes, presses and other in-built cupboards, fireplaces, stairs, cabinet joints, natural or synthetic surface finishes (for example, cement render, timber, plywood, chipboard, tiles, pavers, stone, cork, vinyl, linoleum, carpet, plastic laminates, wall papers, paint, etc) and optional additions (for example, special insulation, garages or carports, verandas, pergolas, awnings, decks, patios, terraces, barbeque areas, swimming pools, sauna baths), landscaping and external driveways and paving.

- (f) Practical completion — when the house becomes reasonably fit for habitation and qualifies for an occupancy certificate. Some finishing trades like painting and floor coverings may still to be outstanding.
 - (g) Final completion — when everything in the contract, drawings, specifications and schedules has been done and the builder can claim his final payment.
 - (h) Maintenance — the defects liability period during which any structural or non-structural defects have to be corrected by the builder as part of his statutory warranty.
8. **Building Certification:** In most states the builder may select the local council or an accredited private surveyor as Principal Certifying Authority (the term used in NSW) to certify the structural components of their work. This generally means that the site, base, envelope and the storm water and sanitary drainage component of services need to be approved. In addition when the building is fit for habitation from a health and safety aspect an occupancy certificate has to be obtained from the principal certifying authority. Principal Certifying Authorities (PCA) generally rely on evidence of self-testing and compliance certification by normal and specialist trades that undertake the works they perform. Authorised professional associations such the Building Surveyors and Allied Professional Accreditation Board (BSAPAB), the Royal Australian Planning Institute (RAPI) and the Institute of Engineers, Australia (IEA), accredit private certifiers. Recently the NSW Government announced that it would reinstate government accreditation of private certifiers.
 9. **Building Disputes:** If a dispute arises between a homebuyer and their builder several courses of action are open. The most common is for both parties to negotiate a satisfactory outcome. When this is not possible the homebuyer may lodge a claim with the HBWI insurer if the builder has died, become insolvent or disappeared. If the builder is still trading the homebuyer may lodge a HBWI claim in states with 'first resort' insurance schemes, but as we shall see later the chances of being paid out are slim unless they have exhausted other avenues of dispute resolution. At the start of 2002 only Queensland and Western Australia offered a tangible alternative to mediation or litigation. In these two states a form of official conciliation and arbitration exists. Special government investigators (attached to their builder licensing/ registration agencies) may visit a building site, inspect alleged defects, give an opinion as to whether the builder needs to rectify anything, conciliate a satisfactory outcome and if this is not possible make a determination that is binding on the builder. In Western Australia the powers of the investigator are more circumscribed than those in Queensland. The builder or consumer may of course appeal an investigator's decision, but in most cases the investigator's verdict is accepted.
 10. **Appeals Mechanism:** Where a builder still exists and the consumer cannot reach agreement with him on outstanding issues the next course of action is usually to appeal to a dedicated building disputes tribunal that exists in NSW, Victoria, Queensland and Western Australia. In the other states and territories legal redress is only possible through the ordinary civil courts.

Home building activity and employment

The estimated value of new home building commencements in 2001-02 is \$26.6 billion.² Of this amount \$22.9 billion (86 per cent) represents new dwellings and the rest renovations. If alterations and additions, not approved by local councils, are included, total renovations come to over \$18 billion a year.

In all about 155,000 homes will be built this financial year of which 70 per cent will be detached houses, 26 per cent units and town houses, 3 per cent public housing and 1 per cent conversions of existing homes. About half of all detached houses are project homes rather than custom built homes.

At present NSW and Victoria represent the lion's share of home building, but over the next property cycle Queensland, whose dwelling activity has been subdued since 1994, is expected to overtake Victoria as the second largest home building market in Australia (see Chart 2).

Home building activity generally moves in a five-year cycle (typically three years up and two years down). Australia-wide the last cycle peaked in mid 2000 with new dwelling starts falling by a third over the ensuing twelve months. The sharp fall was exacerbated building work brought forward to avoid the GST that applied from the 1 July 2000. Due to the Commonwealth Government's 'first home owners grant' the recovery from this 'bust' was quick with new starts rising by an estimated 37 per cent over the course of 2001-02. BIS Shrapnel, the well-respected building forecaster, expects a fall-off from this new peak of 16 per cent during 2002-03.

The sharp jump in activity over 2001-02 meant that builders who could not obtain adequate HBWI after the collapse of HIH/FAI in March 2001 found their businesses contracting in a rising market. The softening of the market expected over the next twelve months should help alleviate any backlog in insurance applications, but leave many builders frustrated that because of insurance difficulties they missed a mini-boom.

On the other hand there is little to suggest that the HBWI crisis retarded building activity overall or resulted in price gouging as a consequence of reduced competition from builders whose activity levels were capped by insurers. For instance between January 2001 and January 2002 the average cost of building a square meter of a house in all capital cities rose by only 2.1 per cent³. Rises varied in mainland capitals from minus 10.6 per cent in Darwin to plus 7.3 per cent in Adelaide. Brisbane and Perth experienced falls of 4.9 per cent and 4.1 per cent respectively while Sydney, Melbourne and Canberra had rises of 5.4 per cent, 2.1 per cent and 2.4 per cent respectively. Hobart had a very high rise (49.6 per cent), but because of its small size this may be a statistical aberration.

Home building activity, including alterations and additions accounted for just over two thirds of all building activity in Australia in 2001-02. In 2000-01 building and non-building construction accounted for 6.1 per cent of national output and 7.5 per cent of total

2 BIS Shrapnel forecast of new dwellings commencements in 2001-02, March 2002.

3 Based on unpublished ABS data kindly obtained by the MBA at the request of the National Inquiry.

employment.⁴ Between 1974-75 and 2000-01 construction output grew in real terms by an average annual rate of 2.2 per cent, which was two-thirds the rate of growth of the total economy.⁵

Between 1984-85 and 2000-01 total employment in construction rose by an average of 2.0 per cent per annum, which compared favourably with that for the economy as a whole of 1.8 per cent.⁶

Average weekly full time earnings in construction in August 2000 was \$809, which was on par with the average for all Australian industries of \$801.⁷

Over the fourteen years to 1998 labour productivity rose by an average annual rate of 1.0 per cent which was higher than that for most overseas jurisdictions; USA (0.4 per cent), Large OECD (0.2 per cent), Small OECD (1.2 per cent) and Selected OECD (0.8 per cent).⁸ According to the Productivity Commission, over the five years to 2000-01 average labour productivity in construction expressed in constant 1999-00 prices was lower than for the market economy as a whole (\$24.70 per hour versus \$31.10 per hour) while capital productivity (measured in terms of annual output per \$100 of capital employed) was very high compared with all market sectors (\$127.70 versus \$43.60).⁹

Builder licensing/registration requirements differ markedly between governments. Tasmania and the Northern Territory do not require builders to have a licence to operate. In the other jurisdictions the scope of licensing varies from being very broad (Queensland and NSW) to very narrow (WA). No two states follow the same licensing requirements or use the same classifications; hence published data on building practitioner registrations is not comparable (See Chart 3).

In February 2001 there were 285,400 construction tradespersons and plumbers and another 157,800 workers in non-trade on-site construction activities (for example, mobile construction plant operators, concreters and construction and plumbers assistants, insulation and home improvement installers) in Australia.¹⁰ In the 1996 Census of Population and Housing 44.1 per cent of building and construction tradespersons had a skilled vocational qualification (that is, degree, diploma or associated diploma), 1.8 per cent had a basic vocational qualification, 45.1 per cent had no formal qualifications and 6.5 per cent would not state their qualifications.¹¹

4 R. McLachlan, C. Clark & I. Monday, *'Australian Service Sector: A Study in Diversity'*, Staff research Paper, Productivity Commission, March 2002, page 15.

5 Ibid., page 21.

6 Ibid., page 54.

7 Ibid., page 41.

8 Ibid., page 101.

9 Ibid., page 93.

10 See *'Skill trends in the building and construction trades'*, National Centre for Vocational Education Research Ltd in association with the Department of Employment, Workplace Relations and Small Business, South Australia, 2001, page 5.

11 Ibid., page 10.

In 2000, the age profile of trade and non-trade occupations in the construction industry was as follows:¹²

- Under 25 years of age — 18.4 per cent;
- 25-44 years of age — 49.3 per cent; and
- 45-64 years of age — 32.2 per cent.

The highly cyclical nature of building and construction results in periodic difficulties in recruiting and retaining skilled labour. Nevertheless, the industry has relatively strong levels of workforce retention; 41 per cent compared with 38 per cent for all trades. Also a high proportion of building workers progress to managerial and supervisory positions.¹³

Home building warranties and insurance

As previously mentioned all builders have to warrant completing a home they start, constructing it without defects (that is, provide an acceptable standard of workmanship and building materials) and abiding by their contractual obligations. In states with 'first resort' HBWI schemes the insurer is theoretically obliged to not only compensate for loss of deposit on, non-completion of or defects to a building if the builder dies, becomes insolvent or disappears, but also to do so if the builder is still trading. In practice, however, insurers expect a homebuyer to exhaust all other avenues of appeal before claiming on their insurance policy. Effectively 'first resort' is little different to 'last resort' except that it results in homebuyers having false expectations about their insurance rights.

Should governments try to enforce 'first resort' legislation, private insurers would quickly withdraw from the market. As mentioned later the sooner some governments end the cruel hoax of 'first resort' insurance the sooner consumers will come to accept that home building is not insured in the same way as a motor vehicle, house and contents or medical and hospital treatment.

Last resort insurance means that the homebuyer can only make an insurance claim if their home has not been completed or has defects due to the builder dying, disappearing or becoming insolvent. Where the builder is still trading the consumer has to pursue them to fix any faults.

Under 'last resort' schemes the homebuyer has no insurance redress for contract termination or breaches and according to one submission to the National Inquiry there is also some doubt about whether these rights are available under 'first resort' schemes.

A simplified summary of the differences between statutory warranties, first resort insurance and last resort insurance is given in Chart 4.

All jurisdictions in Australia require HBWI. Until recently, the three biggest states and Tasmania also provided for 'first resort' insurance, even though insurers themselves admit it exists more in theory than in practice.

¹² Ibid., page 26.

¹³ Ibid., 32.

Recently NSW and Victoria joined the ‘last resort’ camp, leaving only Queensland and Tasmania with professedly ‘first resort’ schemes. Ironically, the Northern Territory, which so far has practiced ‘last resort’, now plans to switch to ‘first resort’. Whether it is tilting at windmills or genuinely intent on implementing such a scheme is not clear. Chart 5 shows the present position of legislated insurance schemes Australia-wide.

A more detailed comparison of HBWI schemes throughout Australia is provided in Appendix 4 (Part A).

The National Inquiry undertook an Internet survey of HBWI schemes in four other countries; Canada, USA, UK and Germany. The results are shown in Chart 6. Except for three provinces in Canada and two states in the USA, these countries unlike Australia have purely voluntary HBWI arrangements. Of those with mandatory schemes two (Ontario and Quebec) restrict insurance to a monopoly supplier (like Queensland) while the other three (British Columbia, Louisiana and New Jersey) permit a contestable market. It is not entirely clear from publicly available information which overseas schemes limit their insurance coverage to a builder’s death, insolvency or disappearance.

For a more detailed summary of overseas HBWI schemes see Appendix 4 (Part B).

HBWI — a unique market

The HBWI market in Australia is unique, not only in respect to non-insurance markets, but also to other insurance markets, including those specialising in long tail liabilities (for example, life, public liability and professional indemnity including medical liability).

Chart 7 highlights the main differences between HBWI and a typical consumer market such as a supermarket (for example, Coles or Woolworths). The main thing that stands out is that except for the supply and price of HBWI (which for all intents and purposes are not officially restricted), every other aspect of HBWI in Australia is different to a normal market situation.

Essentially governments have freed up the supply of insurance, but regulated the content and made the demand obligatory. Complicating the equation is that HBWI is taken out by a different identity (the builder) to the beneficiary (the homebuyer). Hence, the consumer has no choice over which policy is chosen. In most cases it is not until they make a claim that the true nature of the insurance becomes apparent to them.

Also the costs to the seller (the insurer) are not known in advance. Indeed with building defects (as opposed to non-completions) it is normally not until the seventh year of the policy that insurers can be confident of the final cost of claims. With governments regularly changing insurance conditions, past claims patterns are no guide to the future. Given these difficulties and past losses, it is not surprising that few insurers are interested in this market. This makes the market less competitive than it should be.

For many builders the problem is not just one of escalating insurance premiums, but more importantly an inability to obtain insurance cover for a level of planned activity. As we shall see later private insurers switched from being ‘St. Nicholas’ to being ‘Uncle Scrooge’ as they became more concerned with stemming losses than winning extra market share. At the same time builders found that insurers expected them to back up their insurance either with personal assets or an adequately capitalised business since ‘two dollar companies’ were no longer insurable.

Private, public and other insurance models

Private competitive model

Outside Queensland and the Northern Territory, all existing HBWI is provided by private insurers. NSW and Victoria switched to private insurance after abandoning their monopoly government models in 1996-97. In WA, SA, Tasmania and the ACT private insurers have provided HBWI since the late 1980s.

The structure of the private HBWI industry is illustrated in Chart 8. At present there are three insurers, two of whom are big and the other one small. In order of size they are:

- Royal SunAlliance whose agent is HIA Insurance Services, commonly identified by its product's brand name – HOW (Home Owners' Warranty), which was previously owned by HIA, but now jointly belongs to AON Risk Services and Parnell Cranston;
- Allianz Australia Insurance whose agent is Dexta Corporation, which until recently was managed by the same team that ran HBWI for FAI and then HIH until Dexta was founded in 1999; and
- Reward Insurance whose agent is its subsidiary Australian Home Warranty and is owned by Murray Nugent, the former head of Victoria's government-owned Housing Guarantee Fund.

Allianz recently threatened to withdraw from underwriting policies since Dexta could not renew its arrangements with several global reinsurance companies. To prevent this happening the NSW and Victorian Governments filled the breach and reinsured a significant share of Dexta's business in their own states. Dexta ceased to write new policies in other states leaving HIA Insurance Services and Australian Home Warranty to take up the slack.

HIA has close links with HIA Insurance Services (it previously owned it and now receives leasehold payments for the intellectual property it left behind) while the MBA's links with Dexta are much looser. Both HIA and MBA receive payments from their respective insurance agents for offering them each exclusive access to their members. The MBA switched to Dexta after the collapse of HIH/FAI to which it was previously tied. With the withdrawal of Dexta from WA, SA, ACT and Tasmania the MBA no longer has a preferred insurer in these states. Instead in most of these jurisdictions it is working on establishing a discretionary mutual fund as an alternative to HBWI for its members.

The private competitive model used in all states bar Queensland and the Northern Territory is supposed to have certain advantages and disadvantages. These are summarised in the box below:

Private competitive model

Claimed advantages	Alleged disadvantages
<ul style="list-style-type: none">▪ Lower policy premiums due to competition.▪ Better services and more innovative policies due to competition.▪ Ward lower risk builders with price discounts.▪ Weed out high risk builders who generate most claims.▪ Employ top insurance professionals with actuarial and other skills.	<ul style="list-style-type: none">▪ Insurers may fail (for example, FAI/HHI, British Columbia's NHW) or need support (for example, Dexta).▪ Emphasis on financial not technical insurance criteria favours bigger builders.▪ Criteria for insuring builders may fluctuate with insurer sentiment.▪ Borderline insurance claims usually rejected.▪ Harder to obtain and analyse industry claims data.▪ Higher operating costs from fragmenting market's economies of scale.▪ Private insurers by linking up with building industry associations compromise their neutrality.

In practice the private competitive model delivered low premiums and better services to begin with, but now it is more expensive, more risk averse and less customer oriented than its claimed advantages would suggest. Except for RSI, there has also been a complete turnover of private insurers in the last five years giving concern about the stability of the model.

HHI Insurance, which after its merger with FAI Insurance accounted for about 30 per cent of HBWI policies in Australia (and reportedly half in NSW), collapsed in March 2001 leaving debts of around \$5.3 billion. HHI's takeover of FAI in 1998 strengthened its influence on HBWI because before that it controlled only about 5 per cent of the market. Evidence now coming to hand would suggest that HHI and FAI, at the time of their merger, each had shortfalls in their total insurance reserves of as much as \$150 million and \$1.0 billion respectively.

With hindsight many observers now blame HHI's aggressive quest for market share before its collapse, for the under-pricing of general insurance including HBWI. HHI is Australia's largest corporate failure. This has cast a pall over the insurance industry and resulted in questions about the sustainability of a private competitive model, especially for long tail insurance such as HBWI.

The recent decision by Allianz to cease underwriting new business for Dexta when it could not persuade its private re-insurers to renew their mandate also raised concern about the future of the model. However, as we shall see later the health of the HBWI market has more to do with the regulatory framework of the building industry and the mechanisms available for resolving building disputes than the ownership and market status of insurance itself. As for the viability of individual private insurance companies this is being addressed by a tightening of APRA's prudential requirements, especially those relating to capital adequacy, financial reporting and internal governance.

Government monopoly model

Queensland and the Northern Territory (NT) still offer government insurance when it comes to HBWI. The Queensland Building Services Authority (BSA) has an exclusive franchise over HBWI whereas the Territory Insurance Office (TIO) enjoys a monopoly by default, not intention. The small scale of the NT's market and its regulatory framework does not appeal to private insurers.

In NSW and Victoria the former monopoly government-owned HBWI providers, the DOFT (incorporating the previous Building Services Corporation) and the Housing Guarantee Fund respectively, still meet the claims on policies that were taken out before private insurance was introduced. All jurisdictions with private insurance have undertaken to meet any claims against HBWI policies issued by HIIH/FAI before it collapsed in March 2001.

The position with respect to government insurers is depicted in Chart 9.

Queensland's BSA has a lot in common with the former HBWI providers in NSW and Victoria. It not only provides insurance for the state's building industry on an exclusive basis, but also acts as the government's builder registry and consumer complaints bureau. Like several insurers in Canada its charter is not-for-profit. It does not come under APRA's supervision or capital adequacy guidelines. Its slim equity base (\$2.6 million of net assets in its general fund at the end of 2000-01) would suggest that it depends on an implicit government guarantee even though no formal guarantee is in place.

The government monopoly model as practiced in Queensland and Quebec (Canada), like the private insurance model, has its supporters and detractors. The arguments of each are summarised in the box below.

Government monopoly model

Claimed advantages	Alleged disadvantages
<ul style="list-style-type: none">▪ Stable scheme since premiums can always be adjusted to match costs of claims.▪ Can capture economies of scale of total market.▪ Fixed-rate premiums make insurance applications easier and help smaller builders.▪ More sympathetic to borderline cases.▪ Combine registration and insurance criteria to filter out high-risk builders.▪ Use insurance data to target building problems.▪ External re-insurers (as BSA uses) ensure commercial disciplines are not forgotten.	<ul style="list-style-type: none">▪ Political constraints on pricing may cause under-reserving.▪ Monopolies by nature are not cost conscious or product innovative.▪ Public service pay and conditions may be an obstacle to attracting necessary expertise.▪ Business failure could be expensive to taxpayers, especially if they have not previously earned a return on insurance.▪ Bigger builders may be forced to cross-subsidise rest of industry.▪ Internal conflicts may arise between insurer, registry and consumer protection roles.

Government monopoly insurers such as the NSW Building Services Corporation were discredited by the mid 1990's. The Trade Practices Commission after reviewing homebuyer problems in 1993 strongly recommended 'opening the market up to full and private competition'. The Dodd and Crawford reports in NSW found significant deficiencies in the

management and operations of the BSC, including a poor data base, sloppy record keeping, no actuarial analysis of future claims liabilities, outmoded computer systems, and a serious conflict of interest between its role as an insurer on the one hand and its obligations as a building regulator and guardian of consumers on the other. In Victoria the Public Accounts and Estimates Committee found the Housing Guarantee Fund to be less than an optimal solution to providing HBWI. The result was that by 1996-97 both NSW (under Labor's Bob Carr) and Victoria (under Liberal Jeff Kennett) had decided to ditch the government monopoly model in favour of a contestable private market.

Queensland's Building Service Authority survived this paradigm shift. However, by 1999 it too faced a crisis related to security of payments of builders. The reforms that followed not only addressed the security of payments issue, but also:

- Tightened builders' registration (disallowing bankrupt builders from starting up again for five years);
- Overhauled insurance requirements (by introducing stricter financial criteria); and
- Improved consumer complaints handling (by making building registry inspectors available to conciliate and arbitrate defective work on-site and upgrading the review role of the Building Tribunal)

The new measures, which were developed in conjunction with builders' associations, saw a major shakeout in the industry and an immediate stabilisation of insurance claims.

However, in 2000-01 the BSA experienced an unexpected jump in claims that resulted in a \$6.9 million operating loss. At the start of 2001-02 the BSA lifted its premiums to allay concerns expressed by its re-insurers. As a result the re-insurers (which included world giants such as Gerling Global Re, Munich Re and Employers Re) agreed to renew their reinsurance contracts (which cover 75 per cent of BSA's insurance exposure) for a further three years. This was fortuitous because the world re-insurance market was thrown into turmoil by the attack on New York's World Trade Center just two months later. Nevertheless, the BSA's main re-insurer when interviewed by the National Inquiry expressed full confidence in the BSA's ability to meet its future claims under existing insurance criteria and premiums. The BSA's financial results in recent years are shown in Appendix 5.

The BSA clearly enjoys certain advantages over private insurers in other states.¹⁴ It does not have to observe APRA's prudential standards including its capital adequacy requirements. Nor does it have to earn a rate of return on its assets or pay dividends and taxes (other than GST) since it has not been 'corporatised'. It can transfer moneys to its general (administrative) fund from its insurance fund. Its monopoly status means that it does not have to compete for customers and has only to set its premiums to cover its total costs, not individual builder risk profiles.

Though clearly advantaged by such privileges the BSA, unlike its former counterpart in NSW (the BSC), seems to have won the affection of both builders and consumers, thanks to

¹⁴ One exception is that until recently the BSA did not obtain government funding for its consumer protection activities, which in other states are provided by governments themselves.

the overhaul of its insurance and regulatory framework in 1999.¹⁵ Its premiums are now below those of other 'first resort' states. Indeed they would be even lower if Queensland did not offer insurance cover for subsidence not related to builder fault, a benefit not extended elsewhere in Australia. BSA's claim payouts for subsidence in 2000-01 were higher than those for either defects or non-completions. In other jurisdictions subsidence claim payouts are negligible.

Queensland's achievement in reforming its building and insurance industry processes through joint consensus of all parties is worthy of study by other states regardless of which model of insurance is chosen.

The BSA of course goes further and argues that having insurance, builder registration and consumer protection under one roof offers unique benefits that a private competitive model cannot match. Rather than posing a conflict of interest the BSA believes that having the power of both insurer and registry means that builders are more likely to heed its advice on rectifying building faults. Being not-for-profit means that it does not have to knock back borderline insurance claims in order to maximise returns. Furthermore strict firewalls supposedly separate each division of the BSA preventing a clash between insurance, registry and consumer responsibilities. Unlike the BSC its insurance claim, builder registration and consumer dispute decisions may be challenged before an independent review body, the Building Tribunal.

Yet it could be argued that the main strength of the Queensland model is its strong regulatory framework rather than its ownership structure. If insurance was divorced from builder registration and consumer protection (as is done in other states) the latter two functions could still be linked to give force to formal directions to builders to fix unsatisfactory work. Also the government could still insist on minimum financial criteria as a condition for obtaining insurance thereby achieving a 'course front end filter' for keeping 'cowboys' out of the building industry.

Free market model

As mentioned previously most of the overseas jurisdictions examined by the National Inquiry have voluntary rather than mandatory HBWI. One example of a free market system is Alberta in Canada (see Chart 10). This province has no builders' licensing (other than normal business registration requirements), no consumer protection regulations and relies on local councils (municipalities) to issue building permits and inspect constructions. Although HBWI is not compulsory, only 10 per cent of homebuyers go without it.

The Alberta HBWI market is completely contestable, but one insurer, the Alberta New Home Warranty Program (ANHWP), issues 85 per cent of policies. Cynics might argue that the success of Alberta is partly due to this market dominance since it gives the ANHWP considerable leverage over the behaviour of builders. For instance the ANHWP's 'Builder Choice' award which is limited to 50 per cent of builders and is based on asking each

¹⁵ The Queensland branch of the HIA told the National Inquiry that the ten biggest builders in the state were dissatisfied with the BSA since its uniform insurance rates meant that they were forced to cross-subsidise the insurance policies of the rest of the industry. However, one of these large builders was subsequently reported in the media as strongly endorsing the Queensland model.

homebuyer to rate their satisfaction with their builder, is a highly sought after credential that can make or break a builder’s reputation.

Another factor that compromises Alberta’s free market reputation is that the ANHWP is a not-for-profit company owned by the Canadian Home Warranty Council, an offshoot of the Canadian Home Builders’ Association. This too gives it considerable clout in dealing with builders.

The main competitors to the NHW are National Home Warranty (NHW) and Residential Warranty (RW). These alternative insurers are profit based, with the former incorporated in 1994 and the latter in 2001. RW focuses on modular and fabricated homes in rural areas leaving NHW as the only real alternative to ANHWP in ordinary housing.

Alberta is not a textbook example of a highly competitive market, but nor are other jurisdictions in Canada or the UK. In all Canadian provinces one insurer seems to dominate the market with at most one or two others nipping at its heels. In the UK the ‘Buildmark’ insurance scheme run by the National House and Building Council (NHBC), covers about 90 per cent of homes built.

Alberta incorporates an important ingredient critical to the proper functioning of any market. By publicising builders who score highly on consumer satisfaction (both on completion of a dwelling and the end of its defects liability period) the ANHWP equips homebuyers with the market intelligence to choose a builder other than on price. This simple device has proved powerful in disciplining builders and lifting building standards without resort to complex and costly building regulations.

Introducing such a mechanism in Australia might also work wonders. Once established and accepted ‘builder’s choice’ awards, or better still a publicly posted ‘centralized builders’ rating’ service (as available in Ontario), could become a substitute for many regulations that presently exist.

Supporters and critics of the free market model have well rehearsed arguments. These are displayed in the box below.

Free market model

Claimed advantages	Alleged disadvantages
<ul style="list-style-type: none"> ▪ Without regulations, insurers offer cheaper and more customised solutions. ▪ Builders’ insurance ratings replace registration as the homebuyer’s best safeguard. ▪ Homebuyers do not develop false safety-net expectations. ▪ Consumers take greater care in choosing a builder and buying a home. 	<ul style="list-style-type: none"> ▪ Naïve homebuyers who were not insured may suffer massive losses. ▪ Without mandated insurance, the premium pool may be too small to attract HBWI insurers. ▪ Without regulations insurance policies may prove inadequate. ▪ Consumers might sue government for negligent building practices as happened in British Columbia over leaky condominiums. ▪ Unregulated private insurers may go bankrupt leaving the state to pick up their liabilities.

Ironically British Columbia switched to a free market because its previous voluntary not-for-profit private monopoly insurer was bankrupted by C \$1.5 billion of claims arising from the leaky condominiums crisis referred to in the box above. By opening the insurance market the government hoped to diversify future insurance risk.

Notwithstanding the widespread application of the free market model in other countries, it is doubtful that it would be acceptable to a majority of Australians given the general expectation that governments will protect consumers from the worst excesses of a free market forces. However, improving consumer knowledge through devices such as 'Builder's Choice' awards or a publicly accessible 'Builder's Rating' service could lay the foundations for a more market-based approach that could ultimately make many consumer protection laws redundant.

Other models

Alternative insurance models to those canvassed above are:

- **Government as selective guarantor or underwriter of private insurers.** This model is creeping into Australia by default. The recent decisions of the NSW and Victorian governments to provide temporary reinsurance for a significant share of all new policies within their states issued by Dexta Corporation means that these states have reentered the general insurance business. In addition NSW has undertaken to underwrite all HBWI policies for high-rise dwellings (those above three storeys). NSW, Victoria and WA have also guaranteed to meet any insurance claims in excess of \$10 million related to any one builder. The greatest danger with governments getting back into insurance is that they may be drawn into the most risky areas that private insurers avoid. However, under present circumstances if governments want more than one large insurer and coverage for high-rise and large-scale home developments they may have no alternative but to become closely involved.
- **Government insurance competitor.** Under this model governments would create their own insurer to compete with private insurers to ensure a genuinely contestable market. Of course unless the government insurer was a genuinely 'corporatised' entity (that is, was required to pay normal taxes, a government guarantee fee on borrowings and earn a commercial rate of return on equity) it would distort the market and possibly scare off private insurers, a situation that may already exist in the Northern Territory. Another drawback of this model is that the government insurer may come to be seen as the insurer of last resort, exposing the taxpayer to additional risk.
- **Master-fund manager.** This model is similar to a government monopoly, except that it's outsourcing of management's role may dilute the government's control thereby defeating one purpose of government ownership. Proponents of this model argue that it is one way to ensure that the management of a publicly owned insurer was in expert hands, though the track record of some Australian private insurers would suggest otherwise.
- **Discretionary mutual fund.** The MBA with the help of Jardine Lloyd Thompson (experienced insurance brokers) is developing a fidelity fund that its members can contribute to and access for meeting warranty claims. This has much merit since it would put the onus on the Association to carefully police the building practices of its policyholders so as to minimise consumer disputes and claims. Consumers of course

might argue that insurers who are too close to builders won't act impartially in disputes and as such cannot be trusted. This may be true of 'first resort' schemes where the insurer expects the consumer to exhaust other avenues before submitting a claim, but is less likely with 'last resort' insurance where the grounds for compensation are more clear cut (that is, death, insolvency or disappearance of the builder). Another risk to consumers of a discretionary mutual fund is that unlike ordinary private insurers it does not have to comply with APRA prudential requirements (that is, adequately provide for all future claims). Once its funds were exhausted consumers would have no further recourse. To be fair this is not the intention of the MBA proposal, which plans to follow normal insurance guidelines even though its scheme won't come under the Commonwealth *Insurance Act 1973*. So far the ACT government has legislated to approve its establishment and it is understood that the Tasmanian government will soon proclaim a regulation to the same effect. The WA government is also sympathetic to the MBA's proposal, but it appears to be insisting on some reserve thresholds before it approves such a fund. The critical question for all fidelity fund type indemnity schemes is who will provide the default guarantee?

Groups like BARG and BFAIR believe that only a Queensland type government monopoly will do justice to builders and consumers. Yet other participants in the focus group convened by the National Inquiry agreed with the finding that reducing building faults, disputes and claims has more to do with the regulation of the building process than with the ownership and market franchise of the HBWI insurer. Consequently this report focuses on what can be done within the existing (mainly private) ownership and (mainly competitive) market structures to achieve better insurance outcomes. This is also consistent with the National Inquiry's terms of reference which require it to:

'Identify and analyse the appropriateness of the current home warranty insurance schemes in providing appropriate consumer protection by an adequate number of providers in an efficient competitive market.'

HBWI policies, premiums and costs

Chart 11 is the National Inquiry's best guesstimate of the state of the HBWI market in Australia. It is based on partial information about the industry provide by two insurers (RSA and BSA). The Inquiry is most grateful to these insurers for cooperating with the Inquiry's data requests. Unfortunately two other insurers, though promising to fill out the Inquiry's questionnaires, failed to do so. Like BSA and RSA, Dexta Corporation and Reward Insurance were helpful with their original submissions and in meeting personally with the Inquiry, but it was disappointing that they withheld basic data critical to putting together the jigsaw puzzle that constitutes the HBWI market.

If the guesstimates in Chart 11 are correct, the total size of the Australian HBWI market is \$157 million, with over 90 per cent of this concentrated in NSW, Victoria and Queensland. Hence it is not surprising that the policy stances taken by these three states sets the scene for the whole market, especially as far as overseas re-insurers are concerned.

Chart 12 shows the National Inquiry's estimate of average premiums per jurisdiction. These are obtained by simply dividing total premiums by total policies. Such a measure is imperfect because it includes both small policies and large ones. Hence states that have excluded most small building jobs from insurance (for example, WA & SA) may show a

higher average premium than they otherwise would. So too could states that have provided for high payouts for insurance claims (for example, NSW and Qld). However, insurance companies attribute the big discrepancy in average premiums between states to NSW, Victoria, Queensland and Tasmania promoting 'first resort' schemes while WA, SA and the ACT were offering only 'last resort' schemes.

Chart 13 shows that until recently Queensland's BSA's average premium was considerably above that of other states. However, following a sharp increase in the cost of private insurance premiums at the start of 2002, BSA's average premium it is now well below that of other states with 'first resort'. Queensland's achievement in holding average premiums below other 'first resort' states is particularly noteworthy given that its scheme offers a unique benefit-cover for subsidence due to causes other than builder fault. BSA payouts for subsidence in 2000-01 exceed those for either building non-completions or defects.

Whether the shift from a 'first resort' to a 'last resort' scheme in NSW and Victoria will see some reduction in average premiums is still not clear. The data in Charts 12 to 14 were collected before NSW and Victoria announced changes to their schemes. In any event, to the extent that the new premium levels better reflect the underlying frequency and cost of claims in each state, Queensland, which has the most generous scheme in Australia, can claim a better outcome than other 'first resort' states.

This is borne out by Chart 14. For both non-completions and defects the frequency and average cost of insurance claims in Queensland have been generally lower than for other 'first resort' states. Some of the raw data on which Chart 14 is based is considered 'commercial in confidence' so cannot be disclosed.

The strong rise in premiums in all states since 1998-99 can be attributed to a range of factors:

- A switch by insurers from chasing market share to stemming losses and setting aside higher reserves from 1999;
- The downturn in international share markets after mid 2000 reduced earnings on reserves, prompting insurance companies to resort to higher premiums to stave off losses;
- A sharp jump in the frequency of claims (that is, claims lodged as a proportion of all insurance policies outstanding) in 2000-01, partly as a result of builder exits following the introduction of the GST on 1 July 2000 (see Chart 15¹⁶);
- The disappearance of HIH insurance in March 2001, which removed the most aggressive price discounter from the market;
- Losses by the BSA in 2000-01, which prompted its re-insurers to demand higher premiums as a condition of renewing their re-insurance agreement;

¹⁶ In Chart 14 the higher proportion of claims lodged in Queensland is due to the BSA providing coverage for subsidence where the builder is not at fault, a benefit not bestowed on policyholders in other jurisdictions. Subsidence accounted for 35.3 per cent of all claims paid out by the BSA in 2000-01. Subsidence payouts in other states, which are limited to builder fault, are negligible.

- The September 11 attack on the World Trade Centre in New York which cost the insurance industry over US\$50 billion, prompting investors to demand higher returns on insurance stock to compensate for the increased risks perceived (see Chart 16);
- A growing realisation by HBWI insurers and re-insurers that their 'triangulation' models for calculating future claims costs, especially for building defects under 'first resort' schemes, were too conservative in their forecasts; and
- A concern by insurers that too little attention was being given by governments to improving building standards and complaints handling so as to diminish claims.

The rise in private insurer premiums was particularly sharp in the last year. In February 2002 HIA Insurance Services, the agent for RSA, announced premium hikes across the states of between 15 per cent (WA and SA) and 150 per cent (NSW). Its competitors followed suite. Yet insurers were still not satisfied that they could make money from HBWI. By March they were demanding a rollback of insurance coverage in the 'first resort' states as a condition of serving these markets. In the face of this revolt the governments of NSW and Victoria agreed to a joint package of measures to ensure the continuation of HBWI on a private competitive basis:

- The threshold for compulsory home insurance would be raised to \$12,000 (the same as for WA and SA);
- The minimum period of cover for structural defects would be reduced to 6 years (from 7 years in NSW and 6.5 years in Victoria previously);
- The minimum period for non-structural defects would be reduced to 2 years (no distinction between structural and non-structural defects existed previously);
- The mandatory requirement for builders of high-rise residential buildings (those above 3 storeys) to provide HBWI would be removed. (Note: NSW did not proceed with this exemption, but instead agreed to underwrite private insurance for this purpose);
- The maximum insurance payout (that is, excluding legal costs) for non-completion claims would be 20 per cent of the original building contract amount (bringing NSW into line with Victoria);
- A homeowner would only be able to claim under a HBWI policy if the builder was dead, insolvent or had disappeared (making insurance a 'last resort' as exists in WA, SA and ACT);
- The minimum statutory amount of cover (effectively the ceiling recognised by insurers) would be \$200,000 inclusive of legal and other costs (putting Victoria on par with NSW);
- Both states would use their best endeavours to harmonise their HBWI schemes and the specific processes to be followed by all parties (insurers, builders and homeowners) in a building dispute. (Note: This resulted in both states adopting early intervention mechanisms along the lines of Qld and WA, though NSW stopped short of giving builder licensing investigators powers to arbitrate disputes on-site);

- Insurers' liability in respect of total claims arising from the death, insolvency or disappearance of a builder would be capped at \$10 million per builder; and
- Both states would attempt to harmonise their reporting requirements for HBWI insurers.

These measures came into effect after legislative amendments were enacted in both states in April 2002. WA and SA said they would follow suit on the \$10 million limit per event. SA also said it would exempt high-rise apartments from insurance. As mentioned earlier it is not clear whether private insurers will reduce premiums to reflect the lower risks resulting from the above adjustments to their HBWI requirements.

PART 3: STAKEHOLDER COMPLAINTS

Research methodology

The findings of this chapter are based on eighty-five formal submissions and seventy-five meetings/discussions with stakeholder groups or individuals (see Appendices 1 and 2). Several people interviewed made no written submissions, but were approached because of they had building, insurance or other expertise relevant to the Inquiry.

It is not possible to present all the views and advice given to the Inquiry within the confines of this report. Instead an attempt has been made to synthesise the key complaints of consumers, builders (including kitchen, air-conditioning and other installers) and insurers.

Consumers' complaints

The National Inquiry did not receive any complaints from consumers outside NSW. This may not reflect consumer satisfaction with HBWI in other jurisdictions, but instead the absence of organised homebuyer groups in those states and territories. As a result the National Inquiry has had to rely solely on the views of BARG and its members for a consumer perspective on HBWI. Because BARG represents homebuyers who have had bad experiences with builders, officials and insurers its views represent the dissatisfied end of the consumer spectrum. Consumers who have not got into trouble buying a home of course have no reason to be vocal. The main grievances of the jaded homebuyer are:

- Homebuyers are not officially warned in advance of the pitfalls of buying a home;
- Builders shun responsibilities under their warranty;
- Consumer departments remain aloof from on-site building problems, only providing call-centre advice rather than hands-on help to resolve disputes;
- Insurers consider themselves a 'last resort', even in 'first resort' states;
- Both official and private building inspectors serve builder/insurer interests;
- Appeal avenues (for example, disputes tribunals and civil courts) are complex, slow and costly and tend to favour builders and insurers who are better resourced and more knowledgeable about dispute procedures than first time homebuyers.

The National Inquiry took personal evidence from many members of BARG who told horrific stories of bad experiences with builders, surveyors, officials, tribunals and insurers. It was not possible, nor within the terms of reference of the National Inquiry, to investigate these claims and form an objective view on their legal or technical merits. Nevertheless, the genuineness of feeling of these witnesses was hard to dispute. As recommended later, it would be worthwhile for the NSW Parliament's Joint Select Committee on the Quality of Buildings to visit the home sites of say a dozen of these complainants and with the help of independent surveyors assess whether their complaints about non-completions and defects should have been acted upon by builders or insurers. If there is evidence to this effect the

Committee should investigate why existing complaints handling procedures proved ineffectual in their cases.

The personal anecdotes of each BARG member are too involved and complex to recount here. But a typical tale, condensed to its essence, was as follows:

'We lived in an unfinished house for one and a half years. A report we commissioned from an independent engineer says it is structurally unsound. Yet the builder won't fix it and the local council, government, insurer and dispute's tribunal simply dither and won't enforce the builder's statutory warranty.'

Put simply, homebuyers such as the one above want 'speedy access to justice'. A typical view expressed by BARG members was:

'There is no one we can turn to for an objective and authoritative assessment of defects and a quick and just adjudication of claims.'

Builders' complaints

The two housing associations took opposite views on the gravity of builders' problems with HBWI. The MBA, BFAIR, the Wagga Wagga forum and many individual builders who wrote to the National Inquiry felt that HBWI as administered by private insurers had plunged the industry into crisis. By contrast officials and senior office bearers of the HIA felt that the problems were intense in the six months following the collapse of HIH (an insurer that covered MBA members), but subsequently receded as builders found alternate insurers (including HIA Insurance Services) and adjusted to the new reality that insurance was reserved for businesses with adequate equity and working capital.

The conflicting attitudes to HBWI have resulted in a chill standoff between the two associations. The views below reflect the bulk of those who put submissions to the National Inquiry. Builders who survived the insurance shake-up and perhaps profited from being able to obtain insurance when it was rationed did not volunteer their opinions to the Inquiry. According to the NSW Department of Fair Trading, when it wrote to 30,000 builders in October 2001 offering its help on HBWI only 1.9 per cent responded. The MBA agreed to check if its members' attitude on HBWI had been surveyed by any of its branches, but the Inquiry heard nothing further.

Yet the volume of submissions, the 1,200 'hard hats' who demonstrated outside the NSW Parliament at the end of May and the many builders that bothered to turn up to National Inquiry's hearings in each state and territory would suggest that a significant segment of builders feel emotional about this issue. Their major gripes can be summarised as follows:

- Insurers' financial criteria for assessing builders' insurance applications is unstated and arbitrary;
- Abysmal customer service by insurers (for example, many builders claimed that insurers are often not contactable, don't return phone calls, ignore correspondence and lose files);
- Long delays in issuing HBWI policies;

- Onerous insurance imposts (for example, personal indemnities and bank guaranties which insurers can activate at their own discretion);
- Insurers impose caps on a builders' turnover which for some builders are too low to run a business and for others stifle business growth;
- Builders' statutory warranties on non-structural work, including kitchens, bathrooms, fixtures and fittings were too long given the limited warranties on some manufacturers' appliances (for example, ovens, stoves, ventilation systems, light fittings, air-conditioning units, etc);
- Installers of kitchens, in-built wardrobes and air-conditioning units claim they are being charged HBWI premiums of between 5 per cent and 11 per cent of the value of their contracts (compared with under 1 per cent for builders generally) even though the incidence of insurance claims related to such work is negligible.

The following comment by one builder sums up the feelings expressed by many builders who have been in the industry for a long time and now face a daunting hurdle with insurance:

'I have been a builder for 25 years. I have never been insolvent, had an insurance claim or been in court. Yet I now have to put my house on the line and get a costly bank guarantee in order buy expensive insurance. What risk is the insurer taking?'

In one-sentence builders want adequate and fast access to insurance so that when they win new work they can warrant starting it on time.

Under present circumstance a group of builders told the National Inquiry:

'We're being forced to exit the industry, become sub-contractors, work illegally or operate through owner builders because of refusals, delays and caps to private insurance. This is not just a crisis in insurance, but a threat to our livelihoods.'

Insurers' complaints

The National Inquiry received submissions from each of the major HBWI insurers (RSA, Dexta and Reward) and their association (the Insurance Council of Australia) and interviewed each of them as well as several local and international re-insurers and brokers (See Appendices 1 and 2).

Insurers resented having become the 'bouncers' or 'gatekeepers' to the building industry because builders' registration requirements were not keeping out 'cowboys'. They did not enjoy playing the role of 'God' in deciding who could or could not build, but felt they *'had no choice given that governments no longer wanted to perform their traditional regulatory role.'*

Typical views expressed by insurers are summarised below:

- Why should we prop up under-funded builders? Builders are advised by their accountants and lawyers to shelter their assets by running sham phoenix or

\$2 companies (for purposes of signing building contracts and taking out HBWI) that don't meet their obligations to consumers, sub-contractors, suppliers and the tax office;

- We've have become building licensers by default because governments have wiped their hands of the onerous job of cleaning up the building industry;
- Governments think they can mandate insurance for any building activity regardless of the risk involved to the insurer;
- Governments keep changing insurance conditions with the result that past claims patterns are no guide to future risks;
- HBWI is a high risk low reward business;
- All insurers have lost money on HBWI; and
- Our investors won't fund building risks with 'long tail' claims whose costs can't be actuarially calculated.

One insurer made the following remark that struck a chord with his colleagues:

'Many builders on the advice of their lawyers and accountants strip their businesses of assets. Others chase work without the capital to support it. Some refuse to properly fill out insurance application forms. Yet they expect us to give them instant cover for death, insolvency, disappearance and building defects on the basis that they survived on their wits through every building crisis.'

What insurers want is a predictable, uniform national insurance market underpinned by a well regulated building industry.

They warn that:

'Governments can force builders to have HBWI, but they can't force us to cover unquantifiable risks.'

As illustrated earlier in Chart 7, the HBWI market is a unique beast in that almost everything is regulated except the insurers' ability to say 'No!' Unless governments offer their own insurance funds (which would be strongly resisted by their Finance and Treasury Departments because of the risks posed to taxpayers) doing something to contain escalating insurance claims is necessary for convincing insurers not to pick up their ball and bat and leave the game.

From the above feedback from stakeholders it is clear that they want:

- Swift justice (consumers);
- Accessible insurance (builders); and
- Sustainable insurance (insurers).

PART 4: MAIN FINDINGS

On considering the grievances of each stakeholder and examining the evidence or otherwise for each complaint, the National Inquiry's main findings are:

Consumers:

- Homebuyers have little understanding of the building process and its pitfalls, even though buying a home is the most important financial transaction most people make in their lives;
- Besides a builders basic registration history (which varies in accuracy and ease of accessibility between different states) and word of mouth there is no official or unofficial rating system that consumers can use for selecting a builder;
- The Building Code of Australia is ambiguous on the minimum standards of structures and silent on most non-structural matters associated with buildings. This makes the Code and its related (mainly non-mandatory) standards a poor reference point for resolving disputes over building work and materials;
- Many accredited private certifiers of buildings are too closely tied to builders to be seen as objective and impartial;
- Consumers wrongly assume that official inspectors (private certifiers or local councils) do more than vouch for the human health and safety of a building. Many falsely think they are also quality controllers concerned with checking the final fit-out and finishes of a building;
- Outside Queensland and perhaps Western Australia there have been insufficient official early intervention mechanisms for resolving building complaints on-site where poor workmanship or materials can be inspected first hand;
- Appeals tribunals for resolving building and insurance disputes either are non-existent (SA, Tas, ACT and NT) or complex, cumbersome and costly for consumers (others states) and in one case powerless regarding insurers (WA); and
- Outside NSW there is no organised consumer lobby group that represents homebuyers' interests. BARG, the NSW lobby group, would not survive but for the existence of a self-funded activist (Ms Irene Onorati) and a group of dedicated members with strongly felt grievances about their own building experiences.

Builders:

- Many small and especially medium sized builders are significantly undercapitalised. They often quarantine their personal assets from the corporate entities they use for running their businesses. Kingsway Financial Assessments, which closely monitors the

finances of builders who register with the NSW Department of Public Works and Services, showed examples of this to the National Inquiry;

- Many builders had difficulty obtaining adequate and timely private HBWI following the collapse of HIH in March 2001;
- The MBA (representing mainly small to medium sized home builders) and the HIA (whose membership extends from small builders to large project home developers) are divided over whether insurance problems are chronic or merely transitional;
- Builders require better guidance on financial criteria and better service from private insurers;
- For smaller to medium sized builders, financial statements alone may not be a good guide to the risks of their businesses. Two risk management experts who contacted the National Inquiry suggested that other data (for example, debtor and creditor days, building history, bank relations, customer references, etc) was necessary too.
- Kitchen, in-built wardrobe and air-conditioner installers have been paying an excessive proportion of their contract value on HBWI. When the National Inquiry brought this to the attention of one insurer they admitted it was correct, but claimed the premium was 1 per cent — 4.4 per cent of contract values under \$10,000, not the 5 per cent — 11 per cent claimed by installers. The discrepancy may be due to installers in NSW assuming that they would be subject to a premium increase of 150 per cent from February. However, this insurer assured the Inquiry that installers had been spared this rise. The insurer also said that the abnormally high premium to contract ratio of installers reflected the diseconomies of scale associated with administering small policies.

Insurers:

- Internationally, escalating claims, a share market crash and the World Trade Centre attack brought the insurance crisis to a head in 2001. Capital markets demanded higher premiums, especially for insuring risks (such as building defects) whose true costs emerge only slowly;
- Within the Australian HBWI market, which is heavily dependent on international re-insurers, problems were compounded by the collapse of HIH/FAI in March 2001 and media attention to leaking high rise buildings in Sydney (which rekindled fears amongst re-insurers of huge payouts as occurred after British Columbia's leaky condominiums' scandal);
- HIAS and Dexta had difficulty processing the flood of insurance applications from former HIH/FAI clients (most of whom were MBA members);
- Insurers switched from chasing market share to minimising risks, hiking premiums and stemming losses, especially after the fall of HIH/FAI;
- Many smaller to medium sized builders found that they now had to provide net tangible asset backing of 10 per cent — 20 per cent of their annual building turnover in

order to obtain private HBWI. This was well in excess of the maximum 5.2 per cent-6.6 per cent required of this class of builder by the BSA, the government insurer in Queensland;

- Neither state governments nor APRA specifically monitor the adequacy of insurer provisions for meeting future insurance claims from existing HBWI policies.

Stark realities

There are some stark realities that face anyone trying to find solutions to HBWI problems.

Firstly, governments outside Queensland are reluctant to underwrite HBWI unless there is no alternative. Even in Queensland the recent National Competition Policy legislative review of the BSA raised questions about the desirability of the Government providing insurance, notwithstanding the problems with private insurers in other states. The Northern Territory's proposed reforms are designed to make HBWI more attractive to private insurers so that the TIO does not have to remain the sole provider. Hence populist demands for governments outside Queensland to revert to publicly backed monopoly schemes are unlikely to be taken up unless private insurers withdraw from the market altogether.

Secondly, a shortage of HBWI insurers (only RSA now is a major insurer in all jurisdictions outside Qld and the NT) gives them the whip hand in setting insurance criteria and coverage. Demands that governments compel insurers to do 'what is in the best interests of consumers and builders' are naïve since insurers are not charities, but businesses that have to make a profit for their shareholders. Insurers are clearly not prepared to continue making losses due to a rising incidence of incomplete or faulty building work due in large part to inadequate regulatory frameworks governing insurance and home building.

Thirdly, homebuyers outside NSW are unorganised so they have little voice. In Queensland the government invited a representative of the local Consumers Association to join its meeting with the National Inquiry, but that person was unable to attend (though later communicated some views by phone). The Australian Consumers Association and its state affiliates did not make submissions to the National Inquiry. The absence of homebuyer views outside NSW may not be a reflection of satisfaction with existing arrangements, but simply consumers resigned to accepting that there is no one outside official channels that will take up their grievances. The National Inquiry was not able to establish whether there are a significant number of homebuyers outside NSW disenchanted with existing processes.

Fourthly, the Building Code of Australia is limited to the regulation of a building's structural integrity, not its quality. Unless the Australian Building Codes Board is prepared to broaden its brief to also covering non-structural matters and adopt a more prescriptive approach to defining building outcomes, government may have to set their own building standards for resolving disputes over building work. The Victoria Building Control Commission has already done this by publishing a 'Guide to Standards and Tolerances' for domestic building work that fills the gaps left by the Code, Standards Australia and the state's Building Act and Regulations. It achieved this outcome in consultation with Department of Fair Trading and Business Affairs and peak industry groups such as the AIBS (building Inspect Subcommittee), HIA, IEA, ICA, and MBA. Queensland's 'Technical Circular' for assessing defective building work fulfils a similar purpose.

Finally, although warranty defects attract a higher number of claims than non-completions, outside Queensland three quarters of insurance payouts in 2000-01 were related to non-completions. The vast bulk of these, as well as significant portion of defect claims, were related to builder insolvency, which in turn is a function of capital adequacy. Hence a well-capitalised home building industry seems a critical precondition to preventing insolvencies and thereby generating fewer insurance claims. But to achieve this without needless acrimony requires some consensus between builders, insurers and governments on what is an acceptable minimum financial requirement for each class of builder. Reaching agreement on this could go a long way to resolving builder protests about discriminatory insurance practices.

Analytical model

The above five 'stark realities' about home building and insurance set limits to the policy options that can realistically be considered for 'fixing' BHWI. However, these constraints do not make the outlook as bleak as it might appear since consumers, builders, insurers and governments do have a common interest, that is:

- A building process with fewer faults, complaints and claims; and
- A HBWI scheme that is accessible, affordable and sustainable.

Indeed while all parties disagree over who is to blame for the crisis, there is widespread agreement on shared goals, namely:

- Swift justice for consumers;
- Accessible insurance for builders; and a
- Sustainable market for insurers.

This is not to say that the interests of consumer, builder and insurer coincide on every single issue. But the welfare of each is inextricably linked. This is illustrated in Chart 18 that outlines the basic connections between the objectives of each party. The chart is an attempt to venture a simple, but robust conceptual framework for finding common solutions to interrelated problems.

Essentially it says:

1. To obtain *consumer justice*, homebuyers need better built homes, better home builders and better dispute resolution;
2. If consumers are less aggrieved they will make fewer insurance claims;
3. This will result in a more *sustainable insurance* scheme which combined with realistic insurance laws should attract more insurers into the market;
4. With more insurers the market will be more competitive giving (better) builders *accessible insurance* featuring reasonable insurance criteria and lower premiums; and
5. These benefits, in turn, will flow through to consumers in lower building costs and faster building starts.

To achieve a better building process and insurance market requires certain actions.

A better building process requires:

- Controlling builder risk by improving builder registration, business capitalisation, technical skills and managerial competence as well as consumer knowledge of builders' performance;
- Reducing construction risk by improving building standards, contracts, specifications, approvals, practices and inspections; and
- Solving building disputes by improving complaints handling, defects assessments, mediation and arbitration so as to avoid prolonged and costly litigation.

A better insurance market needs:

- A better building process as outlined in the previous paragraph;
- A stronger and more competitive environment through prudential supervision of HBWI reserves by independent experts and access to industry claims data by potential new entrants; and
- A realistic national regulatory framework by improving the consistency, stability, practicality and harmonisation of state laws and regulations.

Health check

If the objectives, processes and outcomes of this analytical model depict the 'ideal' situation, to what extent is the Australian building and insurance process deficient? Or put another way what are the missing links in the process?

Chart 17 attempts to answer this question. In doing so it recognises that an 'ideal' world conceived in theory is not possible in reality, because consumers, builders and insurers sometimes prefer a short term zero sum game to a longer term win-win solution. However, if sense prevails a cooperative approach is more likely to result in net gains for everyone than the present standoff, which fuels mistrust and perverse behaviour.

Tracking each of the steps in the home building process, what are the weak or missing links suggested by our conceptual framework?

1. Builders licensing

- Non-existent, too narrow or not enforced in some states;
- Where licensing exists, eligibility criteria are normally confined to technical qualifications and good character with no checks on financial viability or managerial competence; and
- Financial vetting is left to private insurers whose criteria for judging insurance applications are discretionary and secretive.

2. Building standards

- Official code covers only building structures, not services and finishes which are an integral part of builders' warranty and consumer protection;
- Official code is ambiguous since outcomes are not precisely defined leaving too much discretion to builders in the event of a dispute with consumers; and
- No official mechanism for flagging faulty building materials and processes so that builders can be alerted to them early.

3. Building advice

- Brochures on the pitfalls of building a home are published by each government, but they vary in quality and are not automatically given to new homebuyers; and
- Except for basic builder registration data, which is not always up-to-date or easily accessible, there is no official or unofficial rating of builders that would help homebuyers to make an informed decision when selecting a builder.

4. Building contract

- Though standard plain-English building contracts are now common, many have been designed by building associations or development companies rather than by a neutral third party intent on balancing the interests of consumers and builders; and
- Standard specifications that can be attached to contracts are less commonly used, though available through specialist providers such as Construction Information Systems Pty Ltd. Clear specifications are critical for resolving disputes over building work and materials.

5. Warranty and insurance

- The criteria that insurers use for judging builder eligibility for HBWI are unstated, unclear and subject to discretionary variation. This makes it difficult for builders to know what is precisely required of them to obtain insurance for a planned level of building activity;
- Insurers insist on being the last port of call for consumers with incomplete or defective building work even in jurisdictions that boast 'first resort' insurance protection for all homebuyers;
- Some work is not insurable in many states (for example, high rise) or the insurance is too expensive (for example, kitchens, built-in wardrobes, air-conditioning systems, etc);
- Building and insurance terms (for example, defect, claim, benefit, etc) are either not defined or vary in definition and interpretation between insurers;
- There is no current or historical data collected at either a state or national level on HBWI claims that could be used by governments to judge the comparative effectiveness of their regulatory regimes and accessed by prospective insurers to realistically price their policies;

- Neither individual state governments nor APRA evaluate the adequacy of each insurer's HBWI reserves for meeting claims against issued policies;
- The scope of building work and builders requiring HBWI varies between states; and
- Throughout Australia not all local councils or private certifiers insist on checking that builders have HBWI before issuing them with development and building approvals.

6. Development and building approvals

- Special engineering requirements (for example, geo-technical reports, building tie-downs in windy areas) are often overlooked in building approvals causing builders to either ignore or under-price them when submitting quotes in a competitive tender; and
- Private surveyors, who in most states are authorised to issue building permits and inspect and certify construction stages, sometime depend too heavily on a few large builders for most of their income. This may compromise their independence and objectivity. It certainly undermines consumer confidence in their professional judgments.

7. Building construction

- Private and local council surveyors are given wide latitude under state laws as to whether, when and how to inspect building stages. Often it is not mandatory for accredited surveyors to personally inspect each critical stage of a building before certifying it;
- Though not limited to the Building Code of Australia, most accredited certifiers see their responsibility as not extending beyond its parameters. These standards are largely concerned with human health and safety, not building quality or finishes; and
- In most states progress payments on buildings are not necessarily tied to the satisfactory completion of each building stage unless this is specifically provided for in the building contract.

8. Building certification

- Principal Certifying Authorities rely heavily on tradesmen (for example, bricklayers, concreters, carpenters) to self-test and verify individual building stages (for example, site, foundation and frame) or use an accredited certifier, with specialist knowledge in that area, to issue a compliance certificate for such work. One criticism of principal certifying authorities is that they rely too heavily on self compliance certificates and do not inspect each stage of work themselves; and
- Private certifiers in most states and territories are privately accredited and not publicly audited for the quality of their work.

9. Building disputes

- It is difficult for consumers to obtain an objective technical assessment of building defects that would be accepted by a dedicated disputes tribunal or court of law. This is because the Building Code of Australia allows builders considerable flexibility in the design, construction and materials they use for erecting a building and does not quantify a minimum outcome to be achieved; and
- Outside Queensland there are no official time limits on dispute resolution procedures. For example a dispute may go through mutual negotiation, mediation, arbitration, litigation and finally become an insurance claim without official guidelines or prompts to ensure the timely completion of each stage.

10. Appeals mechanisms

- Dedicated building disputes tribunals do not exist in each jurisdiction leaving disaffected consumers to pursue builders and insurers through the normal court system. Even where special tribunals exist the process can be daunting, complex, legalistic, slow and expensive for consumers. In one jurisdiction (WA) the disputes tribunal has no jurisdiction over insurers. Consumers claim that insurers and builders have an inherent advantage in tribunal and court proceedings because they are better-resourced and more acquainted with legal proceedings and technical building matters than homebuyers who are novices to litigation;
- Courts and building disputes tribunals sometimes lack the technical expertise to adjudicate on building matters. Consumers have accused courts and tribunals of relying on builders' evidence rather than taking independent building surveyors advice in forming a judgment about whether building work was defective or not;
- The decisions of building dispute tribunals are not always communicated to other arms of government (for example, builders registration bureaus or consumer departments) with the result that builders with a bad track record may escape wider attention. Likewise information obtained by building registries and consumer departments on builder malpractices may not be shared with disputes appeals tribunals; and
- Builders who are unsuccessful in obtaining HBWI have no avenue for appealing against insurers' decisions. Many builders feel this is a denial of natural justice because without insurance they cannot undertake new work, putting their livelihood at risk.

11. Industry oversight

- There is insufficient industry/government oversight of the whole building process, especially its appropriateness, effectiveness and efficiency. In some jurisdictions there are government/building industry consultative forums, but they do not monitor home building in a methodical or structured manner. Nor do they take sufficient account of consumer attitudes;
- Homebuyers outside NSW do not have a dedicated lobby group to represent their grievances to government. The Australian Consumers Association (ACA) has not acquired expertise in this area. Even in the case of NSW, BARG is a voluntary

organisation largely based on the activism of one individual who meets her own expenses; and

- Good builders receive little if any official recognition. This makes it hard for consumers to identify them and reward them with the bulk of work. By contrast, for other large transactions (for example, holidays, cars, mortgages, bonds, shares, unit trusts, super funds, etc) there are a variety of expert sources providing ratings and other independent advice to help buyers make a rational choice. Without this market intelligence it is not surprising that many homebuyers select a builder purely on price. They are not aware that the cheapest builder may be simply desperate to win a job because they are already insolvent or on the brink of it.

The above list is not exhaustive. Yet it highlights some of the gaps in the existing home building and insurance process brought to the attention of the National Inquiry in formal submissions and meetings. The next chapter explores possible options for remedying these weaknesses.

PART 5: POSSIBLE SOLUTIONS

In considering options to improve the building and insurance process it is useful to categorise them by which overarching objective it most directly serves, viz:

- Consumer justice;
- Accessible insurance; and
- Sustainable insurance.

As we have seen each objective depends on the other two for its success. So it follows that a particular option grouped under one objective is likely to serve the other objectives too. Where this is not completely the case, the potential conflict of interest is identified so that a proposal's merits can be balanced against its demerits.

The number of asterisks against each option indicates the importance assigned to it by National Inquiry based on its:

- Relevance to the key objectives;
- Likely impact on those objectives; and
- Political and administrative feasibility.

The priority rankings represent qualitative judgments since the Inquiry did not have the budget to undertake formal cost/benefit modeling. In any event such modeling would not capture all the factors necessary for making public policy choices.

Consumer justice

This objective seeks to improve the quality of construction and resolve disputes quickly.

Possible remedies are:

- Investigate BARG allegations*;
- License all building practitioners*;
- Disclose building warranties*;
- Broaden building codes**;
- Prior warning system**;
- Single standard contract**;
- Single standard specifications***;
- Transfer insurance to homebuyers;
- Engineering plan approvals*;
- Inspect critical stages***;
- Hold certifiers accountable;
- Reform private certifiers**;

- Broaden role of surveyors;
- Tied progress payments***;
- Require high-rise insurance**;
- Clarify status of claims*;
- Dispute resolution timelines***;
- Early disputes intervention***;
- Insurance appeals body***;
- Tribunal technical advice*;
- Tribunal powers*;
- Tribunal benchmarks**; and
- Homeowners advocacy group**.

Investigate BARG allegations*

NSW Parliament's Joint Select Committee on Quality of Buildings investigate and report on the merits or otherwise of say a dozen BARG case studies and what could be done if anything to avoid such episodes in future.

Pro: Would objectively investigate the grievances of a representative sample of BARG members and establish once and for all whether they are misplaced or valid.

Con: Matters specific to one state are outside the terms of reference of the National Inquiry. Also the NSW Parliament's Joint Select Committee may not accept advice from the National Inquiry.

Priority: Medium (in a national context, though high in NSW).

License all building practitioners*

License all home building practitioners including home builders, building supervisors, trade contractors, plumbers, gasfitters, electricians, surveyors, design and draftspersons in an individual, corporate and partnership capacity (for example, Qld).

Pro: Would ensure that qualified and competent personnel performed all home building jobs.

Con: Could be expensive to administer and enforce.

Priority: Medium.

Disclose building warranties*

Incorporate minimum builder statutory warranties in standard contract requirements as proposed in the BLA national framework.

Pro: Essential for consumer protection, especially under last resort scheme.

Con: May be difficult to obtain agreement on warranty conditions.

Priority: Medium.

Broaden building codes**

Broaden purpose of Building Code of Australia (BCA) and associated standards from purely protecting human health and safety to ensuring that home buildings are of a minimum acceptable quality.

Note: The BCA is mainly concerned with structural matters that relate to human health and safety. It is not concerned with a building's quality and appearance (that is, finishes and fit-outs). In 1994 the BCA shifted from prescribing specific building practices to describing broad building performance outcomes. In doing so it removed the requirement to meet minimum quantifiable standards of building outcomes. This has given builders and surveyors wide latitude in interpreting the BCA. Standards Australia publishes more detailed standards that align with the BCA, but like the 'deemed to satisfy provisions' in the codes these are not mandatory since builders under the BCA may pursue 'alternative solutions' based on undefined 'expert opinion', 'verification methods' or 'documentary evidence'.

Pro: Would provide objective benchmarks for certifying work and resolving disputes of a structural and non-structural nature in home building.

Con: Not all building outcomes may be quantifiable for purposes of setting objective standards. Also the Australian Building Code Board and Standards Australia may oppose such a move as going beyond their briefs. In that event the ABCB's terms of reference could be altered by COAG or alternatively state governments could issue their own guidelines as is done by Victoria ('Guide to Standards and Tolerances'), Queensland ('Defective Building Work Technical Circular') and British Columbia ('Workmanship and Materials Standards Guide').

Priority: High (as far as government's putting out their own guidelines).

Prior warning system**

Provide all new homebuyers with a guidebook/video (linked to a website) explaining the building process and its risks, consumer rights and obligations, a checklist of issues to consider and procedures to be followed in the event of a dispute.

Note: Most state and territory governments publish basic homebuyer guides, but these vary in content and quality. Few explain the actual steps involved from beginning to end of the home building process; the ACT's brochure 'A Guide to Building and Renovating Your Home' is a notable exception. Some provide a checklist of issues to consider (for example, WA and NSW). These brochures are sent to homebuyers only on request, not automatically

when they enter into a building contract. Books on home building are available from large bookshops, but those written for consumers concentrate on real estate rather than building matters. The few devoted to building focus on construction and largely ignore other subjects such as builders' registration, building codes and standards, consumer advisory services, building contracts, development and building approvals, HBWI, building certification, progress payments, dispute resolution, etc.

Pro: Would inform new homebuyers of key steps and approvals in the home building process and ways to mitigate risk at each stage.

Con: Kits, websites, CD-ROMS and videos could not alert consumers to all risks so a disclaimer would still be necessary to protect the issuer of these materials from errors of omission.

Priority: High.

Single standard contract**

Adopt one standard contract for all home projects between \$25,000 and \$200,000 designed by a neutral third party (for example, Government or Standards Australia).

Pro: Would protect the interests of both consumers and builders and ensure a fair and acceptable reference point for any disputes.

Con: Could preclude provisions for unique building designs, hence ceiling of \$200,000.

Threshold of \$25,000 would still allow various forms of abbreviated contracts for smaller building jobs (for example, rebuilding a decking).

Priority: High.

Single standard specifications***

Supplement the BCA and associated standards with a common set of minimum measurable specifications for incorporation in all home building contracts between \$25,000 and \$200,000.

Note: The Victorian BCC's 'Guide to Standards and Tolerances', Queensland BSA's 'Technical Circular on Defective Building Work' and non-government examples of standard specifications (for example, 'Natspec Domestic' published by Construction Information Systems Australia Pty Ltd) could be useful reference sources for drafting a standard set of specifications for use in all building contracts for low to medium priced homes.

Pro: Would provide clear and objective benchmarks against which building workmanship and materials could be assessed so that disputes over non-completions or defects would be easier to resolve on technical grounds. Would be easier to introduce than a complete overhaul of the scope and character of the BCA and associated standards.

Con: Could constrain innovation in building practices and materials which is why such core specifications should be limited to homes costing less than \$200,000 to construct. The document of course would need to be regularly updated to take account of new building techniques and products.

Priority: Very High.

Transfer insurance to homebuyers

Require consumers rather than builders to take out HBWI.

Pro: Would place responsibility and cost for insurance with the party that it is designed to protect. This would enable consumers to choose the policies that best suit them. More importantly it would signal to consumers which builders pose an insurance risk because of the higher premiums they attract.

Con: Impractical and costly in a private competitive model since each insurer would need to vet every builder in order to offer insurance to all homebuyers. A large cost of HBWI is determining the risk-adjusted premium of a builder.

Priority: Low.

Engineering plan approvals*

Require engineering requirements (for example, geo-technical findings and advice, wall frame tie-downs and bracing details) be included in plans and specifications submitted for local government approval.

Pro: Would help builders to provide more realistic quotes on jobs and avoid fundamental structural problems.

Con: Would add to the cost of preparing plans and specifications.

Priority: Medium.

Inspect critical stages***

Require building contracts to include formal on-site inspections/approvals of the outcome of each critical stage (footings and slab, frame and roof, wet areas and final dwelling) by an accredited certifier (for example, proposed new NT scheme).

Pro: Would help to identify building defects when it is least costly to fix them.

Con: Would add to the expense of home building. Also would not stop dishonest builders camouflaging defects during construction. Might require some modification to BCA and related standards.

Priority: Very High.

Hold certifiers accountable*

Hold principal certifying authorities personally liable for ensuring that their construction, compliance and occupancy certificates are consistent with development consents, building codes and standards, and state building acts and regulations (for example, proposed new NT scheme).

Pro: Would restore consumer confidence in the building inspection system.

Con: Would require additional resources to police. Would also result in higher certification fees because of the increased expertise, workload and risks involved with a more rigorous system of inspections and certifications.

Priority: Medium

Reform private certifiers**

Tighten regulation of accredited private certifiers that issue construction, compliance and occupancy certificates by:

- Reinstating government registration/accreditation of certifying authorities (for example, new NSW arrangements);
- Undertaking official audits of such certifiers on a random basis (for example, Vic, Qld); and
- Restricting the number of certifications a private certifying authority may do for a single home builders or require the accredited certifier to be chosen by the consumer instead of the builder (for example, New Vic legislation).

Pro: Should improve standard of inspections/certifications and give accredited certifiers greater independence in their dealings with builders since their formal accreditation would be at stake.

Con: Would require more government resources to undertake registration and auditing functions. Putting onus on consumers to select accredited certifiers could result in an increased demand on overburdened local councils to inspect and certify buildings. This may not be a bad thing if local councils subcontracted the work to private surveyors who could then operate independently of builders.

Priority: High

Broaden role of certifiers

Broaden the role of certifying authorities from purely enforcing the BCA and related standards (that are mainly concerned with human health and safety) to ensuring that contract plans and specifications (that also relate to finishes and fit-outs) are met.

Pro: Would bring surveyors' responsibilities into line with what home builders expect of them.

Con: Would increase the cost of inspecting and certifying dwellings significantly since both structural and non-structural matters would need to be surveyed.

Priority: Low (because homebuyers already have the option of hiring architects or surveyors to monitor compliance with building contracts, drawings and specifications if they are prepared to pay for this extra safeguard).

Tied progress payments***

Regulate maximum percentage of total contract price that may be paid for each stage of construction work (for example, Vic, proposed new NT scheme, Germany).

Pro: Should safeguard homebuyers from paying for work not done, a major cause of disputes. Would not prevent payments for individual tasks completed during a construction stage (a vital source of working capital for builders), but simply limit the maximum amount payable for that stage as a whole

Con: Maximum payment schedules may not suit innovative home designs or building techniques. Also unless defects were identified and rectified at each stage, overpayments could still occur.

Priority: Very High.

Require high-rise insurance**

Require developers to provide last resort insurance on high-rise units when selling them (for example, NSW).

Note: High-rise residential apartments in Sydney have experienced serious problems with water seepage and fire hazards. Without insurance, high-rise apartment owners would have no recourse if their developer/builder died, disappeared or became insolvent. As high-rise living becomes more popular in cities outside Sydney the demand by residents for adequate insurance protection will grow. Otherwise law suites may be mounted against building regulators. In British Columbia the government as building regulator became liable for the cost of repairing leaky condominiums when homebuyers found they could not access insurance.

Pro: Would protect high-rise buyers who are exposed under existing and proposed insurance exemptions in most jurisdictions.

Con: Private insurers at present are unwilling to offer such insurance even if they could check plans, specifications and construction stages prior to sale. All states other than NSW have excluded high-rise from insurance. An alternative to government reinsurance for such cover (the NSW approach) would be the introduction of a statutory fidelity fund to which developers would contribute to meet claims arising from their warranty obligations.

Priority: High.

Clarify status of claims*

Deem insurance claims as *rejected* (for example, NSW) if insurer does not respond within 90 days (for example, Vic) of receiving claim.

Pro: Would ensure that insurance claims were decided within a reasonable timeframe.

Con: May force insurers to reject complex claims that took longer than 90 days to assess or resolve.

Priority: Medium.

Dispute resolution timelines***

Introduce 3-4 week time lines for each stage in the complaints handling process to act as a trigger for governments, tribunals or insurers to intervene in unresolved disputes (for example, Qld, Ontario, Alberta, New Jersey).

Pro: Would ensure that disputes are quickly brought to a head and resolved through mutual agreement, assessor's mediation or orders, tribunal decisions or insurance payouts.

Con: Would require more resources being committed to dispute resolution than are committed at present.

Priority: Very High.

Early disputes intervention***

Appoint independent government investigators with building and interpersonal skills to check and mediate disputed work on-site (where mutual negotiation between consumer and builder has failed) and where necessary order rectification of defects (for example, Qld, WA, new Vic scheme and Ontario).

Note: An important reason for Queensland having the lowest average cost of any 'first resort' insurance scheme in Australia (notwithstanding having more generous cover) is its prompt intervention in resolving disputes. Of 47,000 constructions in 2000-01, 3,530 (7.4 per cent) involved disputes that were notified to the BSA. Of these 66 per cent were resolved without recourse to insurance. The 1, 266 that resulted in claims represented 2.6 per cent of all building jobs. 98.8 per cent of these claimants had their losses fully compensated by the scheme. Only a small proportion of BSA directives to builders to fix faults were appealed to the independent Building Tribunal (BT). In 2000-01, 83 per cent of reviews of BSA decisions by the Tribunal were decided in the BSA's favour. The ability of the BSA and BT to quickly resolve disputes before they become litigious is praised by both builder and consumer associations in Queensland. This is in sharp contrast to the situation in most other states.

Pro: Early intervention prevents disputes festering and thereby becoming acrimonious, protracted and expensive. Service charges could be used to deter vexatious complaints and help recover costs of such a service.

Con: Such an inspectorate should be a branch of the builders' licensing authority or disputes tribunal for builders to respect its directions. No conflict of interest should arise if licensing is separate from insurance (as it is outside Qld). The former NSW Building Services Corporation was criticised by the Dodd report for neglecting consumers because its primary concern was to protect its HBWI fund from claims. Queensland's BSA, which also has everything under one roof, professes to have a strict firewall between its insurance and building registry/consumer arms. Queensland also has the Building Tribunal to review consumer and builder complaints about the BSA.

Priority: Very High.

Insurance appeals body***

Where disputes arise with an insurer give claimants access to the General Insurance Enquiries and Complaints Scheme (GIECS).

Note: Insurance Enquiries and Complaints Ltd (IEC), a subsidiary of general insurance members of the ICA, operate GIECS. The scheme answers enquiries and complaints about general insurers and tries to resolve disputes about insurance claims within its mandate. If conciliation is not possible complainants can have a dispute referred to an adjudicator, panel or referee for a binding determination. Adjudicators may award compensation up to \$3,000 while a panel or referee may award amounts up to \$120,000. A panel or referee may also recommend amounts up to \$290,000. Claimants who are dissatisfied with a GIECS determination may still seek legal redress. Presently third party claims are limited to \$3,000, but these do not include claims under HBWI (where the beneficiary is a third party). The GIECS terms of reference would need to be amended by the board of the IEC in consultation with the scheme's members, the federal Minister for Consumer Affairs, ICA, ASIC and other parties (for example, ACA) for homebuyers to access it as an alternative to litigation in a building disputes tribunal or a civil court.

Pro: It would put HBWI on the same basis as most forms of other general insurance, giving claimants a quicker and less expensive avenue of appeal than dedicated building disputes tribunals and general courts.

Con: As mentioned above the GIECS is presently limited to third party claims under \$3,000. This ceiling would need to be lifted substantially if building insurance claims were accepted as being within the ambit of the scheme. With the sponsorship and support of the ICA this option stands a good chance of success.

Priority: Very High.

Tribunal technical advice*

Require specialist building tribunals to have independent building experts on staff to assist them with resolving conflicting evidence on technical matters. Charging plaintiffs a \$500 fee would help to fund such a move as well as deter vexatious, fraudulent and frivolous claims.

Pro: Would help tribunals to resolve disputes involving conflicting technical evidence requiring an understanding of building legislation, regulations, codes, standards, contracts plans, specifications, consents and compliance certificates. A tribunal-hearing fee of \$500 could reduce caseloads to a manageable level as well as help fund in-house technical expertise.

Con: Might not stop well-resourced defendants from using 'filibustering' tactics to thwart appeals.

Priority: Medium.

Tribunal powers*

Extend powers of all dedicated building disputes tribunals to cover not only builders, but also insurers (for example, Qld, NSW and Vic).

Pro: Would ensure that WA's Building Disputes Tribunal could order insurers to meet legitimate insurance claims.

Con: Insurers want dedicated building tribunals to concentrate on building disputes and leave it to an expanded GIECS or the normal courts to handle insurance matters.

Priority: Medium (unless GIECS was broadened to cover HBWI appeals in which case Building Tribunals might become less involved in insurance matters).

Tribunal benchmarks**

Require specialist building tribunals to adopt and report against key performance measures (that is, backlog, overload, claims ratio and attendance index) using NSW courts' model (see L. Glanfield & E. Wright 'Model Key Performance Indicators for NSW Courts', Justice Research Centre, Sydney, February 2002)

Pro: Would set clear benchmarks for assessing workload, timeliness, cost and efficiency of tribunals.

Con: Key performance measures cannot measure fairness of process or justice of outcomes.

Priority: High.

Homeowners' advocacy group**

Fund a national consumer advocacy group (for example, ACA or BARG) to establish a small dedicated office to help homebuyer complainants and to provide input to public policy deliberations.

Pro: Would fill a gaping void by providing a 'lightning rod' for disaffected homebuyers, many of whom do not trust official channels. Would also enable consumers to have their interests as homebuyers adequately represented to state and national governments. At present only producer interests (builders and insurers) are well represented in housing policy forums.

Con: Would need to be professionally managed or it could be a waste of money.

Priority: High

Accessible insurance

This objective is to make builders more attractive to insurers and to encourage insurers to use broader and clearer assessment criteria.

Possible options are:

- Upgrade builders' registration*;
- Exclude bankrupt builders**;

- Set financial criteria***;
- Enforce licensing and insurance*;
- Limit owner-builder activity**;
- Cap installation premiums;
- Exclude developers and spec builders;
- Centralised rating system**;
- Evidence based registry*;
- Require ongoing education*;
- Issue 'red flag' warnings**;
- Give 'builder's choice' awards***;
- Transparent insurance criteria**;
- Insurer code of conduct*;
- Insurance ombudsman; and
- Builders' insurance review panel***.

Upgrade builders' registration*

Upgrade builder registration by introducing national minimum industry competency standards for technical, financial and managerial skills and personal fitness/propriety along the lines proposed in the BLA national framework.

Pro: Would improve the quality of builders as tradesmen, project and business managers.

Con: May not get state consensus and in any event is a medium to long-term project.

Priority: Medium

Exclude bankrupt builders**

Stop builders who have become bankrupt from obtaining a building permit in an individual, partnership or company capacity for five years (for example, Qld).

Pro: Would help stem the main cause of large insurance claims (that is, builder insolvency) thereby making insurance more accessible to builders who manage their finances carefully.

Con: Would discriminate against builders whose insolvency was due to factors beyond their control (for example, clients defaulting on payments).

Priority: High.

Set financial criteria***

Insist on minimum equity and financial solvency as part of builders' registration/licensing conditions (for example, Qld and Ontario).

Note: The financial criteria used in Queensland for both builder registration and insurance purposes involves minimum net tangible assets (assets net of intangible assets minus liabilities), minimum liquidity assets ratio (current assets less inventory divided by current liabilities less current financial institution facilities), regular financial reporting (yearly, half yearly or quarterly) and independent auditing or review requirements depending on the size of the builder's annual turnover. The minimum net tangible assets to annual turnover ratio ranges from a low of 2 per cent for mid-sized big builders (\$50 million turnover) to 6.7 per cent for very small builders (under \$0.25 million turnover) and very big builders (over \$200 million turnover). The liquidity ratio is fixed at 0.8:1 for all builders. Very small and small builders need only report annually and half yearly while other builders (over \$2.5 million turnover) have to do so quarterly. Big builders (over \$10 million turnover) have to be properly audited while the rest need their accounts reviewed and signed off by an independent accountant who may not use a disclaimer.

Pro: A consistent financial entry standard such as used in Queensland would prevent a run down in builders' capital to inappropriate levels when the insurance cycle eventually reverts to more relaxed criteria. It would also place primary responsibility for deciding building industry entrance requirements with government where it belongs. A government sponsored dialogue between insurers and builders over what should constitute minimum financial criteria for builders' registration might influence the way insurers set their own criteria for builders.

Con: Would add a second tier of financial controls, which could be administratively cumbersome for builders and governments unless insurers enforced them in conjunction with their own financial criteria.

Priority: Very High (as this addresses builders' primary grievance).

Enforce licensing and insurance*

Police and enforce builders' licensing and insurance requirements more rigorously and increase penalties for breaches (for example, Qld, British Columbia).

Pro: Would ensure that all contractors in the building industry met minimum entry criteria and had warranties backed by insurance.

Con: Could be costly outside Queensland (where insurance and builders registration is done concurrently) unless local government development consents required sighting of insurance certificates (for example, WA, but not NSW).

Priority: Medium.

Limit owner-builder activity**

Make owner-builder permits conditional on attending a government approved building induction course (for example, Qld insists on a 50 hour TAFE course) and restrict permits to one per household every three years.

Note: The proportion of builders who are owner-builders is not known since not all take out owner-builder permits. However, anecdotal evidence from builders suggests that it is between 10 per cent and 30 per cent outside Queensland where it was reduced from 19 per cent ten years ago to about 3 per cent now.

Pro: Would alert consumers to the risks of building their own homes and discourage deregistered builders masquerading as owner-builders. Fewer owner-builders would increase the size of the HBWI market which might attract more insurers.

Con: May not deter uninsured builders from advising gullible homebuyers to become owner-builders in order to avoid HBWI costs.

Priority: High.

Cap installation premiums

Cap HBWI premiums on fabricated kitchen, inbuilt wardrobe and air conditioning installations to 2 per cent of contract.

Note: Installers claim that their HBWI premiums amount to 5 per cent to 11 per cent of the value of their work. One large insurer disputes this, but admits that the figure is still high (1 per cent to 4.4 per cent for jobs up to \$10,000) compared with what builders pay (usually under 1 per cent of a building's value). The insurer says the high fixed costs of issuing an insurance certificate results in the premium to contract ratio for a small building job, such as installation work, being magnified.

Pro: Would correct the present anomaly whereby installers' premiums far exceed those of builders, thereby encouraging massive HBWI evasion. Kitchen/inbuilt wardrobe/air-conditioning installations appear to generate few if any insurance claims.

Con: Lifting the insurance exemption level and shortening the non-structural term of HBWI would solve most problems. Following recent changes in NSW and Victoria only Tasmania and the ACT still pose serious problems for installers.

Priority: Low, except in the ACT and Tasmania.

Exclude developers and spec builders

Exclude developers and speculative builders from having to take out HBWI during construction, but require them to provide such insurance on the sale of their properties.

Note: Under present laws developers and spec builders are required to take out HBWI, but in NSW and Victoria are excluded from making claims.

Pro: Would put them on a level playing field with owner-builders. HBWI is designed for the end consumer not the builder, whether they are commercial or amateur. Developers and spec builders should carry their own commercial risks of non-completion. When they sell a completed home the buyer only needs protection for any defects that arise after the sale.

Con: Many developers sell off-plan (accepting 5 per cent-10 per cent deposits) so if insurance was not obligatory from the outset consumers could be left exposed. Even where this is not the case, developers and spec builders could be left stranded with incomplete buildings if their contractors failed and they had no insurance.

Priority: Low.

Centralised rating system**

Provide a centralised system of builder ratings based on registration status, investigator defect orders, insurance claims, disputes tribunal decisions and consumer feedback (for example, Ontario).

Pro: Would help consumers make informed choices when selecting a builder and encourage insurers to assess risks on a broader basis than financial criteria alone. Without adequate public data on builders' past performance, the home building market cannot reward reliable contractors and penalise inadequate ones. Instead consumers are forced to rely on price as their only guide. Yet choosing the lowest cost builder carries high risk because such builders are often on the brink of insolvency or cut corners that result in defects.

Con: May contravene privacy and competition laws. Could also attract legal action if ratings proved wrong. Yet Ontario, which posts its easy-to-use rating service on the Web, seems to have sidestepped these problems. So too have credit rating agencies (for example, Standard & Poors and Moodys Investor Services) that review the financial and other standing of governments, banks and corporations, entities more litigious than most builders.

Priority: High.

Evidence based registry*

Where a centralised builder rating service is not introduced, ensure that builder registrations take into account all building dispute appeal and insurance claim decisions (for example, Qld).

Pro: Queensland's integrated insurance, registration and complaints handling model has demonstrated the advantage of linking different information bases to builders' licensing.

In Queensland all parties (insurer, builder and consumer) can not only readily access the formal track record of builders, but also be confident that it is up to date and accurate. This is not always the case in other jurisdictions.

Con: Accessing disparate information for registration purposes is still inferior to a centralised rating system that can be accessed by all interested parties.

Priority: Medium (unless the aforementioned option is not adopted in which case it would be high).

Require ongoing education*

Make continuing education and professional development (especially of building standards, financial and insurance management, and regulatory changes) a basic condition of builder licensing renewal.

Pro: Should improve quality of building and level of regulatory compliance and thereby reduce insurance claims. For instance WA conducted successful insurance induction courses for all builders that helped them to cope with the new stricter financial criteria applied by insurers after the collapse of HIH.

Con: May slightly add to the cost of buildings since builders would need to recoup the extra costs and time associated with training and other knowledge gathering activities.

Priority: Medium.

Issue 'red flag' warnings**

Issue 'red flag' warnings on faulty building practices and materials based on feedback from building practitioners (for example, Alberta).

Pro: Would help builders to avoid repeating the mistakes of others in high risk areas such as water-proofing, complex joints, termite protection, fire protection, tie-downs and bracing, etc.

Con: Responsibility for issuing such warnings should be shared with building industry associations, possibly through a 'Watchtower Group' as proposed separately (see Part 6 — Conclusion).

Priority: High.

Give 'builders choice' awards***

Survey all new homebuyers' satisfaction with their builders and award 'Builders' Choice' status to those with above average scores (for example, Alberta).

Pro: In Alberta this simple measure greatly improved workmanship and significantly cut building complaints and insurance claims since builders realised that without a 'Builders Choice' award it was difficult to win business. The introduction of awards not only gave good builders the recognition they craved, but it also empowered consumers by giving them the market intelligence to choose a builder on their past performance, not just their tender price. 'Builder's Choice' awards and a centralised builder rating system could ultimately become the main device for ensuring better quality builders and building work, making many other regulatory safeguards redundant.

Con: Would need to be done objectively if there was not to be acrimony. To ensure the integrity of the process it could be over sighted by a 'Watchtower Group' (see Part 6 — Conclusion) and the results vetted by the Auditor General or a reputable private auditor. The awards could be announced on a regional or state basis in recognition of the localised nature of home building markets. The total cost of the exercise (unlikely to exceed \$50 per homebuyer) could be recovered from higher builder registration fees and or stamp duties on building contracts and HBWI certificates.

Priority: Very High.

Transparent insurance criteria**

Require insurers to disclose their broad basis for rating builders' financial risks and capping their turnovers.

Pro: Would help builders to arrange the necessary equity and working capital to support planned levels of building turnover.

Con: Insurers would still retain the right to withhold insurance for unstated reasons. However, it would oblige them to be more open than they are now.

Priority: High.

Insurer code of conduct*

Request HBWI insurers to apply the existing ICA 'General Insurance Code of Practice' to their dealings with builders and homebuyers.

Note: The ICA's code of conduct was introduced in 1994 and is a self-regulatory document designed to raise the standard of practice and service by participating insurers. It is administered by Insurance Enquiries and Complaints Ltd (IEC); a subsidiary of ICA members. Although no specific consumer redress is provided in the code, it requires participating insurers to establish both internal and external dispute handling procedures. The code is also meant to promote disclosure of information relevant and useful to consumers as well as encourage informed and effective relationships between consumers, insurers and agents. Insurers, who do not comply with the code, may face sanctions.

Pro: Would set clear benchmarks by which clients could hold insurers to account (for example, timeliness of answering phone calls and correspondence). Many builders and homebuyers complained to the National Inquiry of the poor treatment they received from insurers. This included loss of files, wrong data entry and long delays in processing documents.

Con: Would not correct the existing imbalance of power between HBWI insurers and their clients. Only a more competitive insurance market is likely to improve customer service.

Priority: Medium

Insurance ombudsman

Builders' warranty insurers fund an independent insurance Ombudsman to review individual builders' complaints about access to policies or alternatively extend the charter of GIECS to cover this role.

Pro: Would overcome the present iniquity whereby a builder must have insurance, but has no means of appeal if denied it.

Con: Could be costly unless Ombudsman's workload was confined to cases where other avenues had been exhausted. This might require a minimum application fee to deter vexatious or frivolous appeals as well as help pay for the position. However, based on feedback from the ICA the measure is unlikely to be acceptable to insurers because no other class of insurance provides for applicants to appeal if they are knocked back. Indeed the 'General Insurance Code of Practice — Guidelines for Implementation' (page 9) only requires an insurer that declines cover to inform the applicant that the IEC 'maintains a list of insurers writing particular classes of business and that the NIBA is able to provide a range of information about how and where insurance may be obtained.'

Priority: Low (based on its low chance of success).

Builders' insurance review panel***

Establish an independent panel, comprising representatives of private insurers, building associations and governments, to review complaints from builders about insurance application rejections or onerous turnover cap limits. Decisions would not be binding on insurers. A minimum application fee (say \$500) may be necessary to help fund the panel, deter frivolous or vexatious complaints and keep appeals to a manageable level.

Note: Royal SunAlliance has proposed such a scheme to the Western Australian Government that is sympathetic to the idea. While panel recommendations would not be binding they may encourage insurers to reconsider certain applications that were refused or had their insurance cover severely curtailed.

Pro: In the absence of an Insurance Ombudsman (see above) this may be the best alternative. RSA's initiative in floating this proposal gives it a good chance of success.

If nothing else, it would educate panel members about the requirements being imposed on builders by insurers and perhaps result in greater consistency in applying these standards.

Con: Review Panel would not have teeth since its findings would not be binding on insurers. If the Panel were given statutory powers, insurers would most likely exit from the HBWI market since they are not prepared to surrender their discretionary powers to accept or refuse insurance applications.

Priority: Very High (since builders want an insurance rejection appeals body and insurers may be receptive to it in this form).

Sustainable insurance

This objective aims to attract more insurers and re-insurers into the HBWI market by reducing its fragmentation, unknowns and risks.

Possible solutions are:

- Recognise general insurers;
- Harmonise terminology**;
- Capture market data***;
- Seek APRA's supervision*;

- Punish insurance fraud*;
- Use local councils for enforcement*;
- Integrate regional markets*;
- Lift minimum threshold***;
- Lower maximum sum insured*;
- Insure direct contractors*;
- Insure consumer agents*;
- Insure subcontractors;
- Exclude developers and spec builders as beneficiaries;
- Include external constructions*;
- Shorten claims lodging;
- Exclude unfathomable risk*;
- Adopt last resort insurance***;
- Shorten non-structural cover***;
- Limit non-completion claims*;
- Cap liability of insurers*; and
- Disallow contract trigger.

Recognise general insurers

Accept any general 'insurer' approved under the *Commonwealth Insurance Act 1973* as eligible to offer HBWI without further state approval outside Queensland.

Pro: Improvements to APRA prudential supervision of insurers (for example, better risk based capital adequacy, internal governance, market disciplines and self-assessment) has removed the need for separate state surveillance which in any case has been non-existent or minimal.

Con: Unless APRA was prepared to advise governments of the adequacy of individual insurer's capital and claims reserves, governments would remain in the dark about the financial viability of HBWI insurers. Without APRA's advice governments would have no alternative, but to do their own checks before agreeing to an insurer offering HBWI.

Priority: Low.

Harmonise terminology**

Require insurers, builders, tribunals and governments to use the same terminology and definitions.

Pro: A common lexicon of building and insurance terms (for example, meaning of 'developer', 'build', 'defect', 'claim', 'structural', 'non-structural', etc) would improve the consistency of insurance data and decision-making. Existing Victorian BCC guide to standards and tolerances and Queensland's distinction between structural and non-structural work could be the starting point for such a lexicon. Drafting such a document

could be assigned to an expert working party representative of insurers, builders, surveyors, architects, engineers, town planners, lawyers and regulators with expertise in home building.

Con: It may be hard to get consensus on some definitions. For instance the test for 'defects' may require agreement on objective building standards and allowable deviations from them.

Priority: High.

Capture market data***

Request APRA to collect and publish separate data on HBWI premiums, claims and payouts.

Pro: This would overcome the actuarial data gap, which is a deterrent to new insurers entering the HBWI market. All insurance underwriting requires access to reliable claims experience records. Also such data is necessary for monitoring the impact of government reforms on the insurance crisis.

Con: It may not be possible to collect historical data because it is possibly missing (for example, HIA/FAI) or withheld for proprietary reasons (for example, Dexta and HIAIS). Also historical data may not be a reliable guide to the future especially in states such as NSW and Victoria where regulatory requirements were recently changed. Nevertheless this should not be an excuse for delaying new data collection. The lack of public data on the HBWI industry is a serious barrier to new entrants who could inject increased competition. The BSA's uninterrupted database was cited as one reason for large re-insurers having more confidence in Queensland's scheme than other 'first resort' schemes in Australia.

Priority: Very High.

Seek APRA's supervision*

Request APRA to takeover prudential supervision of insurers' HBWI schemes and advise state governments of emerging problems.

Pro: APRA is better equipped to perform this task than state and territory governments. Also it would be in a position to review national, not just state based data.

Con: Gauging long tail liabilities is difficult, even for expert actuaries. APRA may not share its findings with governments, forcing them to collect their own data and do their own analysis. In that event a joint state approach to commissioning an expert actuary to undertake this task would make sense.

Priority: Medium.

Punish insurance fraud*

Make obtaining HBWI using fraud, misrepresentations or non-disclosure a serious offence with heavy penalties (for example, substantial fine on first count, loss of building licence on second and mandatory 3 months jail on third and subsequent counts).

Pro: Would reinforce integrity of insurance and thereby make it more accessible and less costly for honest builders.

Con: Would be necessary to define offences carefully to avoid penalties for minor oversights in completing insurance applications.

Priority: Medium.

Use local councils for enforcement*

Require builders to lodge insurance certificates with local government authorities when applying for building permits.

Pro: Would ensure that a builder's insurance certificate was sighted before they started building work.

Con: Entails additional uncompensated work for local councils in states where they do not accept that this is part of their work (for example, NSW). However, with a private competitive model the only alternative way to enforcing mandatory HBWI is a more cumbersome centralised system of compliance checking administered by each state and territory government.

Priority: Medium.

Integrate regional markets*

Create a national HBWI market by harmonising and stabilising the coverage of individual state schemes.

Pro: Australia's combined HBWI market is very small (annual insurance income still totals less than \$160 million even after recent steep increases in premiums) compared with European and North American markets. Anything that helped consolidate the present fragmented market, which comprises eight separate state/territory-based schemes, would improve its attractiveness to new players and overseas re-insurers.

Con: It would be difficult to completely standardise HBWI conditions given different claims patterns and consumer concerns in each jurisdiction. Moreover there has already been a convergence of schemes since NSW and Victoria adopted a last resort scheme as practiced in WA, SA and the ACT. Also WA and SA recently adopted some measures introduced in NSW and Victoria. If the eastern states could reduce their claims costs and insurance premiums to those of WA and SA there might be a stronger chance of reaching national agreement on uniform legislation.

Priority: Medium.

Lift minimum threshold***

Set minimum value of building work requiring warranty insurance at \$12,000 (for example, WA, SA and new NSW and Victorian scheme.)

Pro: Would confine HBWI claims to the more serious cases thereby reducing pressure on costs and premiums. It would also relieve kitchen, inbuilt wardrobe and air-conditioning installers of high premium rates that threaten the industry's already slim profit margins (estimated at 6 per cent).

Con: Would leave consumers exposed on smaller jobs, especially where they recruit specialist suppliers independently of the main building contractor to install facilities whose contents are largely prefabricated off-site (for example, kitchens, inbuilt wardrobes, air-conditioning systems, awnings, carports, saunas and spa baths).

Priority: Very High.

Lower maximum sum insured*

Set minimum statutory HBWI cover at \$100,000 (for example, WA).

Note: Insurers treat the minimum statutory insurance cover as the maximum policy cover they will offer. Where the value of a building contract is less than this cover insurers offer a lower premium since any insurance payout would be below the policy value.

Pro: Would reduce the cost of insurance and thereby premiums without disadvantaging the vast majority of homebuyers whose potential non-completion or defects claims are well below \$100,000. Caps on insurance payouts at present range from \$200,000 in NSW, Victoria and Queensland to \$100,000 in WA, \$85,000 in the ACT, \$80,000 in SA and \$50,000 in Tasmania. By contrast average building costs in January 2002 varied by less than 35 per cent between capital cities (other than Hobart where the average cost was abnormally high that month), from \$511 per square metre in Perth to \$686 per square metre in Melbourne (ABS data).

Con: Would disadvantage homebuyers with expensive homes. Might not be acceptable to new homebuyers in NSW, Victoria and Queensland where the maximum insurance payout under current legislation is very generous. Of course any change to present arrangements would only affect new insurance policies, not existing ones.

Priority: Medium.

Insure direct contractors*

Require not only builders, but also all tradespersons who contract directly with a consumer to have HBWI (for example, NSW, Vic, Qld and SA).

Pro: Necessary for ensuring consumer protection. Would also boost insurance premium pool.

Con: Would still not cover small jobs below the statutory minimum insurance level. Would involve extra resources to police.

Priority: Medium.

Insure consumer agents*

Require all professionals (for example, architects, engineers, accredited certifiers, etc) who either act on behalf of a homebuyer and/or perform a service for them to have professional indemnity insurance (for example, NSW and WA).

Pro: Necessary for ensuring consumer protection since this category of building practitioners is exempted from HBWI. Would treat ‘professionals’ no differently to builders in terms of building risk management.

Con: Would require extra resources for policing.

Priority: Medium.

Insure subcontractors

Require all tradespersons who work for a home builder to have HBWI to protect the subrogation recoveries of insurers in circumstances where the subcontractor has not rectified the defects (exists in no state or territory).

Pro: Would enable contractors to pursue subcontractors whose work was deficient. Also by spreading the cost of insurance over more policyholders it should reduce average premiums.

Con: Could be expensive to enforce unless contractors insisted on such insurance for their own protection. Might make prime contractor less vigilant in supervising subcontractor’s work.

Priority: Low (because of difficulty of implementation).

Exclude developers and spec builders as beneficiaries

Exclude developers and speculative builders who are required to have HBWI from being beneficiaries of such insurance (for example, NSW and Vic).

Pro: Would eliminate insurance claims from commercial intermediaries who are not the end consumer.

Con: Could encourage developers and spec builders to ignore or cover up defects rather than have them rectified.

Priority: Low (since if this is a concern it makes more sense to exclude developers and spec builders from taking out insurance until they sell their properties — see earlier proposal).

Include external constructions*

Require all works associated with, but external to a house — such as paving, fences, carports, swimming pools and spas — to have HBWI (for example, NSW, Vic and SA).

Pro: Would provide protection for all home constructions above the minimum insurable amount and boost the size of the HBWI pool.

Con: Homebuyers may avoid HBWI threshold by contracting exterior work separately from main housing construction.

Priority: Medium.

Shorten claims lodging

Limit time for lodging claims for defects and defaults to 90 days from discovery of event.

Pro: Would reduce ‘tail’ of insurance claims, thereby reducing insurance uncertainty.

Con: Could encourage homeowners to make claims when faults are noticed rather than when they are serious, thereby increasing insurance costs.

Priority: Low.

Exclude unfathomable risk*

Trim other HBWI cover whose risk is not calculable, as both NSW and Victoria have done (see next four measures).

Pro: Would increase appeal of HBWI market to insurers, thereby making it more accessible and less costly.

Con: This could eventually precipitate a consumer backlash, unless there is an improvement to dispute resolution processes for problems no longer nominally covered by insurance.

Priority: Medium (except for the next two proposals which rate high).

Adopt last resort insurance***

Make HBWI a ‘last resort’ measure by restricting claims to a builder’s death, insolvency or disappearance (for example, WA, SA, ACT and new NSW and Victorian schemes).

Pro: Recognises reality that private insurers refuse to accept HBWI as a ‘first resort’ measure anywhere in Australia. As such mandating ‘last resort’ insurance would accept what happens in practice and end the false expectations generated by ‘first resort’ legislation. Even in Queensland, where a government agency (BSA) provides HBWI, genuine ‘first resort’ insurance does not apply since a homebuyer is expected to seek restitution from their builder before claiming on insurance. Nevertheless in Queensland the BSA uses its licensing powers to discipline builders who do not rectify work ordered by the BSA. Where a builder refuses to obey such orders the BSA compensates the homebuyer.

Con: See comment in previous option. Would require better building safeguards (as canvassed under consumer justice options) to minimise those risks no longer insured, such as incomplete or defective work that a practicing builder refuses to remedy.

Priority: Very High (since private insurers refuse to underwrite ‘first resort’ insurance).

Shorten non-structural cover***

Limit minimum period of cover for non-structural matters to two years (for example, new NSW and Victorian schemes).

Pro: Would bring Australia into line with the USA, Canada and Britain thereby making its HBWI market more acceptable to international re-insurers. Would relieve builders of having to give warranties on fixtures and fittings (for example, stoves) in excess of the manufacturers’ warranties.

Con: Would require greater vigilance on the part of homebuyers to detect and remedy non-structural faults before their cover expired.

Priority: Very High.

Limit non-completion claims*

Limit insurance payouts on buildings not completed to 20 per cent of their original contract value (for example, Vic and new NSW scheme).

Pro: Would prevent insurance fraud where a builder and consumer conspire to understate the true contract value.

Con: Could penalise honest homebuyers who are tricked by dishonest builders into making progress payments in advance of the work being properly completed.

Priority: Medium.

Cap liability of insurers*

For claims against a single builder, cap the insurer's liability at \$10 million (for example, new NSW, Victorian and WA schemes).

Pro: Should attract private insurance for large builders undertaking project homes and multi-storey units that comprise the bulk of dwellings.

Con: Leaves government as the insurer of last resort without any guarantee that it will be adequately compensated for this risk. However, given the present skittishness of insurers towards large HBWI risks, governments may have no alternative but to fill this void if most large builders are to have access to insurance. Alternatively large builders could be required to join a statutory fidelity fund to cover insurance payouts in excess of \$10 million per builder.

Priority: Medium.

Disallow contract trigger

Disallow wrongful termination for default

Note: In NSW and Victoria insurance claims have been triggered by termination of home building contracts.

Pro: Would keep contract disputes out of HBWI where they do not belong.

Con: Where a builder is still trading yet refuses to obey a Dispute Tribunal's ruling the consumer may have no alternative, but to terminate the contract or default on it in order to trigger insurance. With NSW and Victoria moving to last resort insurance the termination of contracts should not impact on insurance therefore making it a non-issue.

Priority: Low.

PART 6: CONCLUSION AND RECOMMENDATIONS

The main finding of the National Inquiry is that the cost and availability of HBWI is as much a function of the regulatory framework governing the home building process as the conditions applying to the insurance market. Making the building process more reliable and less acrimonious offers the only lasting solution to HBWI for consumers, builders and insurers.

To ensure a smooth implementation of reforms and a continuing watch over the home building process an industry 'watchtower' group is proposed:

Watchtower Group***

Appoint a Watchtower Group, representing all industry interests, to monitor the building process, advise on home building reforms, issue 'red flag' warnings on faulty building materials and practices, survey consumers and use the results to issue 'Builder's Choice' awards.

Note: The NSW Building and Construction Council (BACC), if expanded to include consumer representatives, could be the model for such a group.

Pro: Would encourage disparate groups to identify common problems and solutions.

Con: May only work at a state level given the localised nature of home building activity.

Priority: Very High.

On balance most options canvassed in this report should provide a net socio-economic benefit to the community after allowing for costs of implementation. However, it has not been possible within the budget of this Inquiry to model the direct cost/benefit of each proposal let alone the indirect effects.

On the relative merits of each option a case could be made for adopting the vast majority. However, this would be difficult administratively and could result in excessive regulatory and compliance costs that a simple cost/benefit analysis would not accurately capture.

If the National Inquiry had to choose the 'Top' measures that together might best achieve the outcomes sought by all parties it would nominate the thirteen marked with a double asterisk and the fourteen given a triple asterisk. In the Inquiry's view these measures deserve the most attention in terms of their:

- Relevance to the pivotal objectives;
- Likely impact on these objectives; and
- Political and administrative feasibility.

Chart 19 summarises these core reforms.

The key actions necessary to safeguard consumers and make insurance affordable, accessible and sustainable are:

- **Adopt realistic insurance requirements.**
 - **Proposal:** Recognise that insurers and re-insurers at present have the upper hand and won't accept regulatory imposts that force them to lose money. This means adopting 'last resort' insurance as already exists everywhere except in name. It also means excluding building risks that are not fathomable and therefore not insurable. Where this is not politically acceptable (for example, single events that could generate \$10 million in claims) or would deprive a large class of homebuyers of insurance (for example, owners of high-rise apartments) governments may have to underwrite the risk or require developers/builders to contribute to a fidelity fund that would cover the cost.
 - **Observation:** Modifying the state-based regulatory regimes for HBWI is the fastest way of restoring insurer/re-insurer confidence in the Australian market. NSW and Victoria have already recognised this by switching from 'first resort' to 'last resort' status. WA and SA, which have been 'last resort' states, have adopted some of the measures already taken by NSW and Victoria. This is seeing a convergence of insurance schemes, but it is doubtful that complete uniformity will be achieved as long as some states have bigger insurance claims' problems than others. Queensland would be wise to stick with its current arrangements until the private competitive model practiced elsewhere stabilises and proves its worth. Reforming the regulatory framework of the building industry itself will be critical to the success of HBWI whether a private or public model is used. This is a medium to longer-term exercise so the sooner it is begun the sooner its benefits will be felt.
- **Eject 'cowboys' from the building industry.**
 - **Proposal:** Develop a centralised home builders' rating system based on each builder's building achievements, business history, financial soundness, disputes record and clients' feedback to help both consumers and insurers distinguish 'good' from 'bad' builders. If this is not acceptable, at least introduce 'Builder's Choice' awards, as exist in Alberta, to help consumers identify low risk builders.
 - **Observation:** Until consumers can make an informed and rational choice, market forces cannot operate properly to reward 'good' builders with extra work and punish 'bad' ones by denying them customers. Likewise as long as insurers only have access to a builder's records rather than his customers' feedback, insurance criteria is likely to remain finance-centric.
- **Set clear building standards and enforce them.**
 - **Proposal:** Adopt a single standard contract and set of specifications for all dwelling work costing between \$25,000 and \$200,000, require on-site inspections by an accredited surveyor of each critical stage of construction (basically structural matters) and regularly audit the performance of both private and local council certifiers.

- **Observation:** For ordinary dwellings, inspections cannot be objective without building codes and standards setting minimum measurable outcomes. Also for consumer interests to be properly served, the BCA needs to cover all basic facets of a building, not just human health and safety elements as it does at present. In the absence of a complete rewrite of the BCA and its associated standards, the next best thing is for governments to agree on a single standard contract, with clear specifications on structural and non-structural matters, that could serve as a benchmark for resolving building and insurance disputes.
- **Intervene and resolve disputes early.**
 - **Proposal:** Set timelines for each stage of dispute resolution (that is, mutual negotiation, mediation, arbitration, litigation, and insurance claims). In addition broaden the responsibility and authority of official builder licence investigators to inspect and validate alleged building defects on-site and order remedies where the builder is at fault.
 - **Observation:** Disputes become acrimonious, broaden in content and end up as insurance claims if they are not resolved quickly. Complaints resolution should start with both parties being asked to mutually resolve their differences within a given timeframe. If this is not successful formal conciliation and arbitration should immediately follow. The person performing this intermediary role should have the interpersonal skills of a mediator and the technical skills of a surveyor. This would enable them to make an assessment of building faults, try to facilitate an agreed outcome or if this is not possible make a determination on what should be fixed by the builder on pain of having their licence qualified or suspended. Of course both builders and consumers should have the right of appeal to a civil court or dedicated building disputes tribunal.

Fixing HBWI will not be easy. But unless the underlying causes are tackled, consumers will remain exposed to inferior building work, builders will remain hostage to insurance companies and insurers will be fickle about their long-term commitment to this market.

The Ministerial Council on Consumer Affairs has an opportunity to start a process of stakeholder consultations at both a state/territory and national level with a view to agreeing on a package of measures that would stabilise and eventually reduce building complaints and claims and thereby make insurance affordable and accessible.

Hopefully the common problems, shared objectives and possible options identified in this report may serve as a catalyst for furthering this process.

