

17 May 2013

Mr Bill Scanlon
Economic Regulation Authority
Inquiry into Western Australian Home Indemnity
Insurance Arrangements
PO Box 8469
PERTH BC WA 6849

Dear Bill,

Inquiry into Home Indemnity Insurance (HII)

This letter is a response by Master Builders to the Draft Report on the Inquiry by the Economic Regulation Authority (ERA) into Western Australia's Home Indemnity Insurance Arrangements (HII) released on 4 April 2013.

Master Builders is Western Australia's oldest industry body representing the views of builders in the residential, commercial and civil engineering sectors of the building and construction industry in Western Australia. Established in 1898 we have around 1800 members, of whom the largest group are builders in the residential sector. Around 90 per cent of large "project builders" operating in WA are members of our organisation. In addition our membership includes a large number of smaller, "niche builders" in metropolitan and regional areas. Views expressed in this submission can therefore be viewed as representative of builders involved in the residential building sector in Western Australia. We should also state that the Association is a shareholder in the national company MBA Insurance Services Pty Ltd, which provides a range of insurance products including HII in Western Australia.

In preparing this response to the Draft Report our organisation draws on its experience of HII since its introduction in 1996, together with recent input from individual builders who responded to our invitation to make comment on the issue. In addition a subcommittee of the Association's Housing Council provided more detailed comments and recommendations which form the basis of this submission.

In general terms it is noted that the ERA's approach can be summarized as follows:-

1. The provision of an indemnity insurance scheme is desirable in the interests of consumer protection in Western Australia.
2. This scheme should be operated by private insurers.

3. Recommended changes to indemnity insurance arrangements aim to provide a more attractive “product” or environment to entice additional insurers into the market. By changing the insurance scheme to cover “construction risk” only, it is assumed that more insurers will enter the market and create a competitive environment. Furthermore by eliminating or reducing the “tail” of exposure to insurers or limiting the warranty period to 2 years only insurers will find it more attractive to offer the product.

Master Builders does not agree with this rationale nor the conclusions of the ERA in its approach. In our view the ERA’s contention that proposed changes to the indemnity scheme will attract additional insurance providers is highly questionable, given the gradual but long-term withdrawal of insurers from this market Australia-wide due to the apparent low returns to insurers from the product. More importantly, the Authority’s recommended model, even if implemented, does not address any of the building industry’s concerns with the scheme that were outlined in our initial response of 31 August 2012 to the Issues Paper prepared for the Inquiry. In particular, the ERA’s proposed model:-

- (i) Will not reduce the level of instability and uncertainty caused by fluctuation in the number of insurers who have offered HII in Western Australia. Over the last 16 years builders have on several occasions experienced “crisis” levels of interruption to their business activity and cash flow caused by the sudden exit of an insurer from the market resulting in an inability to obtain this mandatory insurance. Under the ERA’s preferred model there is no certainty of any greater stability in the provision of this insurance which will be “at the whim of insurers”.
- (ii) Will see no change in levels of resentment among builders over the ability of insurers to act as a “defacto” licensing body and determine the type and volume of work that a builder can take on. Building contractors licensed by the Building Commission are effectively regulated by another private sector agency which can dictate the volume, type, timing and amount of building a registered builder can undertake.

Builders will continue to have little or no choice but to accept any restrictions imposed by insurers, including large increases in insurance premiums, the provision of bank guarantees or changing the structures of their businesses. In many cases, builders are effectively being asked to underwrite the risk of the insurer which is completely unsatisfactory and unacceptable.

- (iii) Will not reduce the level of cynicism from builders and others that insurers take little or no risk with this product which delivers limited benefit to consumers. We note that the ERA made no comment about the adequacy of the \$100k maximum cover provided under the policy.

Consumers are probably largely unaware of this maximum payout. In the event of a liquidation much of this could be used to cover liquidator or legal costs. Many consumers

will be left largely out of pocket and will probably have to contribute additional funds to see their home completed by another builder.

Under the ERA's recommended model, consumers would be left with even less protection as the warranty period of insurance would not be mandatory. Our Association has no appetite to offer insurance for this period as suggested by the ERA. We do not believe that there would be sufficient demand for the product by consumers who are already covered by the six year statutory warranty period under the Building Services (Registration) Act. Moreover if the Association was to offer this type of insurance, a potential source of conflict with members could occur which we would be anxious to avoid. The financial risks to the Association and its members are deemed insufficient to offset the risk to Association finances and members' funds.

Although a fidelity fund has been operating very effectively in the Australian Capital Territory for over 10 years, now, it should be noted that the demographics of the WA housing industry are very different. The fact that 20% of the residential builders provide 80% of our dwelling units makes the establishment of a fidelity fund in WA much less feasible.

Should one industry association be given the opportunity to run such a fund it has the potential to create issues with freedom of association and prejudice amongst non-member builders. This would be an undesirable outcome. A better practice would be to eliminate warranty protection for more than 2 years.

- (iv) Will see the current practice of price discrimination in premiums charged by insurers and paid by large and small builders likely to continue. Having a regime where premiums are based on financial turnover and capacity alone rather than other factors such as industry longevity, building quality etc is not the best outcome from our perspective. This adds a competitive disadvantage to pricing in the building industry for smaller builders whom, it could be argued, pose a lower risk to insurers than the collapse of a large corporate builder.

Premium Pricing and Transparency

It could also be argued that the inequality of premium pricing discriminates against new entrants and may, as premiums continue to increase exorbitantly, even discourage new entrants from entering the industry.

The continuance of a state government subsidy for large builders accentuates this market advantage to large builders. In order to create a more level playing field it would appear that the State government should obtain a more market based financial return for the provision of this underwriting facility. We note that even under the ERA's recommended model it regards the continuation of government underwriting to be essential. We believe that any system of

insurance which relies on state government support to attract and retain the presence of private insurers is an undesirable situation, and will continue to lead to instability and inequity in the market. In any event, information published on an annual basis about premium bands, premium pools, assessment criteria and payouts should be more readily available to interested stakeholders. Builders should clearly be aware of what criteria is being adopted to differentiate premiums amongst their peers.

Preferred Remedies

Master Builders is particularly concerned that HII has become a fragile product with an uncertain future, based on the decision of two insurers. For a multi-billion dollar industry with a work force exceeding 120,000 and building more than 21,000 dwelling units per annum this is completely unacceptable. As the ERA is aware, there is a huge discrepancy in premiums being charged for HII policies, largely based on a builders' turnover. Master Builders recommends that the pricing structure for HII should become more transparent and accountable.

All builders (and their clients) should know what the premiums are and what is required to move from one band of premiums to another.

There should also be more information disclosed on the premium pool and claims history including the various bank and other guarantees already provided by the builders. This would enable a fairer and more objective assessment to be made of whether insurers are treating the builders fairly.

Providers of HII insurance should be required to disclose their premium pool and claims record to the State government on an annual basis.

Master Builders' preferred option is that the provision of HII becomes voluntary for both construction risk and warranty insurance. This will lead to lower construction costs and improved housing affordability. With some consumers now paying \$3,000 for a \$300,000 - \$400,000 new home under construction, with higher premiums forecast, we are extremely concerned about the impact of HII on housing affordability.

The fact that there are only two insurers in the HII market, with only one providing policies for builders with turnovers exceeding \$3million, highlights the lack of competition and little if any prospect for improvement.

Home buyers should not be exposed to significantly increasing premiums for a product less than 1% of them are ever likely to use.

The experience in Tasmania which abolished mandatory HII from July 2008 suggests that a voluntary regime is clearly viable even though private insurers have withdrawn from this market altogether. Home buyers have saved accordingly.

Should this option of voluntary HII not be palatable to government, the operation of the scheme could be limited to homes built under the Home Building Contracts Act (up to \$500k). While it is recognized that this restriction would limit the premium pool (and hence the attractiveness of the scheme to potential insurers) clients building homes above \$500k may be more “market savvy” and able to minimize risks themselves, rather than rely on an expensive and inadequate insurance product.

Given the extent of market failure that has occurred in the past in providing this product, and our view that the underlying causes of market failure, instability and industry uncertainty are unlikely to be removed under the ERA’s recommended model, a preferred outcome may be Model 6 – Government Limited Coverage. Whether this be administered by the Building Commission or Insurance Commission of Western Australia is a choice for government. We have noted concerns expressed in Queensland about possible conflicts of interest in the dual role as insurer and registrar preformed by the Building Services Authority (BSA) in that state. Insurers could assist in the administration of a government scheme in the short-term, and could be encouraged to offer 2 year warranty insurance due to the limited risks involved in provision of this insurance. Implementation of a Government Scheme (any option) would provide industry with greater confidence and stability, as well as providing more transparent pricing structures and assessment criteria.

If the State government is committed to retaining some form of statutory housing indemnity scheme, there would be considerable advantages in linking it with the statutory authority responsible for builders’ registration – currently the Building Commission. This body has the power and capacity to assess builders’ financials and monitor changes to their financial well being.

Should the Building Commission become responsible for housing indemnity insurance, Master Builders recommends that home owners be given the option of declining this form of insurance. Many home buyers enter into building contracts with the utmost confidence of their builder and should not be forced to contribute to a scheme. In some cases, the escalating cost of housing indemnity insurance could alter their purchasing decision.

Off the Plan Projects

Master Builders recommends that any “off the plan” project where the owner takes possession immediately after construction is complete should be exempt from HII. At the moment this type of project is limited to 3 storeys or more.

Builders' Homes

Master Builders recommends that builders who build their own residential homes or holiday homes should be exempt from making HII payments. It is inappropriate and unnecessary.

Conclusion

Master Builders believes the current regime of HII is fundamentally flawed and requires abolition or a complete overhaul. We do not believe the current regime has any prospect of improvement as we are not confident of additional competition in the term of new insurers entering the market.

If the government believes some form of consumer protection is warranted it should either limit HII to the Home Building Contracts Act or give a suitable government agency the power to manage it. Our preference, however, is to put more onus on the Building Commission to better regulate the operation of builders, including turnover limits, and placing more responsibility on consumers to choose their builders wisely.

Whatever system is put in place should be reviewed in 2 years to ensure the housing industry has a stable and affordable system of HII which is operating in the public interest.

Master Builders would be pleased to discuss any aspect of this submission. Kindly contact the undersigned if you wish to do so. We welcome the opportunity to co-operate with the State government to improve the current system of HII in Western Australia.

Yours sincerely,
MASTER BUILDERS ASSOCIATION OF WA

Gavan Forster
Housing Director