CO-OPERATIVE LIMITED
Wesbuilders
TOGETHER EVERYONE ACHIEVES MORE

Suite 1, Peer House
2 Canning Highway, South Perth WA 6151
Phone: 9367 6430
Fax: 9368 5680
Email: admin@wesbuilders.com.au
www.wesbuilders.com.au
ABN 80 285 451 976

13 May 2013 Email: publicsubmissions@erawa.com.au

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

Dear Sirs

Wesbuilders notes with interest the Authority's comprehensive Draft Report - Inquiry into Western Australia's Home Indemnity Insurance 4 April 2013 and in particular Chapter 7 Evaluation Framework.

The ERA's research is detailed and informative. Of particular interest are the following statements with which we have no issue:

> "**9.3 Consumer Protection**
>
> As established in earlier chapters of this report, the principle objective of the existing home indemnity insurance regulations (and any possible future home indemnity insurance scheme) is to protect consumers. The case for Government intervention to achieve the consumer protection objective was made using the Authority's consumer protection framework (detailed in Chapter 5)." (Draft Report p87).
>
> "**The Case for Mandatory Home Indemnity Insurance**
>
> The Authority considers that there is a case for some form of Government intervention to protect consumers against potential losses arising from the death, disappearance or insolvency of their builder. This intervention may be best provided through the regulated requirement for mandatory insurance. The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because the losses incurred due to non-completion are potentially much greater than they are for defective work." (Draft Report pix)
>
> "The status quo model is not considered stable and the potential costs that would arise should there be a failure in the model, particularly to Government, would be significant. For this reason, the status quo model is assessed as not passing the hurdle criterion on stability." (Draft Report p76)

We accept that Government consumer protection policy has a place in the residential building sector. We support the proposition that the status quo is not stable, and would add that it has been found wanting in a number of other respects.

However, we note with interest that the ERA recommendation would effectively remove the safety net for consumers for defects identified post-completion.

It is the considered opinion of the board, as practicing builders and owners of SME building companies, that in arriving at its recommended model the ERA has not given adequate weight to important issues around implementation, stability and costs of their Model 9 recommendation. It would appear the recommendation is based on free market economics despite the ERA's own finding that home indemnity insurance in WA is a case of market failure.

We are also of the view the ERA's report is pre-occupied with consumer, insurer and Government issues with little apparent consideration given to the considerable negative impact reliance on private cover for HII has on SME builders.

The attached paper sets out a number of observations in respect to the Draft Report and advances the proposition that the interests of WA taxpayers and the residential building industry generally would be much better served by the adoption of **Model 6 Government Limited Coverage**. If as a matter of public policy, the Government was inclined to maintain consumer protection at comparable levels to the current HII arrangements, then Model 5 is preferred, albeit more onerous on builders and likely to give rise to added costs to the consumer.

Yours faithfully

Glyn Denison
Chairman

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2 Canning Highway, South Perth WA 6151
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Wesbuilders Co-operative Ltd response to Economic Regulation Authority's Draft Report - Inquiry into Western Australia's Home Indemnity Insurance Arrangements

REPORT DISTILLATION

From the perspective of practicing builders the ERA's Draft Report into Western Australia's Home Indemnity Insurance (HII) Arrangements has been distilled into the following points:

- Home indemnity insurance exists as a State Government consumer protection policy.
- Home indemnity insurance arrangements are of a market failure character.
- The ERA considers there is a case for Government intervention.
- The status quo is not stable.
- Aggregate premiums for home indemnity insurance into the future (for the mandated construction period and if available for the warranty period) are likely to increase above current levels.
- Premiums are unlikely to be unaffordable.
- Divorcing the Non-Completion Risk and the Defect Risk components to allow more accurate assessment and pricing of the discrete risks has appeal.
- The ERA considers fidelity fund models as not inherently suited to delivery of home indemnity insurance (non-completion or defect risks).
- PWC found the risk of fidelity fund failure was high.

Against these distilled points the ERA is recommending the existing HII model be replaced by a model referred to as the *private with industry supplement model*, where:

- private sector insurers provide insurance (with government reinsurance) to cover non-completion risks and that this portion of the insurance be mandatory such that builders are required to hold the appropriate insurance before commencing work; and
- the building industry (through the building industry associations) becomes the provider of warranty period insurance.

The proposition that the status quo is not stable is supported. We would add that from a SME builder's perspective the status quo has been found wanting in a number of other respects and needs fixing. However, it is of note that the ERA's recommendation would in our view remove totally, the consumer's current safety net in the event of the death, disappearance or insolvency of their builder during the post-completion defects warranty period.

It is the considered opinion of the Wesbuilders board however, that in arriving at its recommended model the ERA has not given adequate weight to primary issues around implementation, stability and compliance costs. It would appear the recommendation is based on free market economics despite the ERA's own assessment that HII in WA is a case of market failure.

WESBUILDERS' RECOMMENDED MODEL

Having given due consideration to the ERA's position and the balanced needs of all stakeholders in the Western Australian residential building market, this paper recommends:

> **"the existing Home Indemnity Insurance model being transitioned to *Model 6: Government Limited Coverage* as set out in the ERA's Draft Report - Inquiry into Western Australia's Home Indemnity Insurance Arrangements dated 4 April 2013."**

ERA DRAFT REPORT

Consumer Protection

From an industry perspective we expect there to be ready acceptance of the following Draft Report statements:

> ***"9.3 Consumer Protection***
> *As established in earlier chapters of this report, the principle objective of the existing home indemnity insurance regulations (and any possible future scheme) is to protect consumers. The case for Government intervention to achieve the consumer protection objective was made using the Authority's consumer protection framework (detailed in Chapter 5)."* (Draft Report p87)
>
> ***"The Case for Mandatory Home Indemnity Insurance***
> *The Authority considers that there is a case for some form of Government intervention to protect consumers against potential losses arising from the death, disappearance or insolvency of their builder. This intervention may be best provided through the regulated requirement for mandatory insurance. The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because the losses incurred due to non-completion are potentially much greater than they are for defective work."* (Draft Report pix)
>
> *"The status quo model is not considered stable and the potential costs that would arise should there be a failure in the model, particularly to Government, would be significant. For this reason, the status quo model is assessed as not passing the hurdle criterion on stability."* (Draft Report p76)

Wesbuilders accepts that Government consumer protection policy has a place in the residential building sector. However, we note with interest that the ERA recommendation would effectively remove the safety net for consumers for defects identified post-completion.

Entering into a contract to have a house built is likely to be one of, if not the largest single financial decisions in a person's life. It is therefore important for the residential building industry as a significant sector of the State's economy that consumer confidence exists.

Implementation of a Replacement Model

The Draft Report found that Home Indemnity Insurance was a public policy issue, with a case for Government intervention to achieve the consumer protection objective made by the ERA, using the Authority's consumer protection framework.

In regard to implementation of the ERA's recommended replacement model it is reliant on a) securing a private insurer, and b) the building industry being able to offer a cost effective scheme for warranty protection using some type of fidelity fund arrangement.

Neither of these points are assured.

The Draft Report puts forward a number of overly ambitiously/optimistic comments. It also warns that Home Indemnity Insurance is complex and that insurers have had difficulty in dealing with the "long tail" associated with defect insurance.

On the issue of securing a private insurer the Draft Report states, somewhat ambitiously given the history of insurance company performance to date, that:

> *"The Authority considers that the privately provided, non-completion component of the model could be implemented given that some private sector insurers (including QBE and Calliden) have expressed a willingness to consider such a model (that is, providing insurance for non-completion risk only).[26]"* (Draft Report p83)

The Draft Report put forward the following proposition that the "long tail" made defect cover unattractive/untenable to private insurers:

> *"Consultation with private sector insurers and the Authority's own review of insurance principles has indicated that one of the key factors of the current model that deters insurers is the existence of the six year defect period. The six year defect period makes the pricing of premiums difficult and prevents insurers from being able to ascertain the true cost of any particular underwriting year until many years after that underwriting year."* (Draft Report p59)

Yet PriceWaterhouseCoopers (PWC) reported:

> *"Commenting on the concept of the provision of defect risk insurance, PWC stated that "warranty exposure is small and easily manageable."[228]"* (Draft Report p83)
>
> *"There is some appeal in divorcing the two risk components to allow more accurate assessment and pricing of the risk and reduce the cumulative exposure to an individual builder.[225]"* (Draft Report p83)

The Draft Report appears therefore to leave unanswered a critical question that goes to the heart of HII issues. If, as PWC comments, "warranty exposure is small and manageable", then the expert private insurance sector should be a ready source of cost effective cover.

Based on the following extract from *Table 5.1 Summary Assessment of Builder Failure against the Principles of Insurable Risk*, it would appear the ERA supports the PWC proposition.

Principle	First Category of Risk (Non-Completion Risk)	Second Category of Risk (Defect Risk)
Affordable premium	*Satisfied* – Evidence from existing home indemnity insurance markets indicates that premiums charged are unlikely to be unaffordable particularly when considered in the context of the costs involved in a purchasing a new home.	*Satisfied* – Evidence from existing home indemnity insurance markets indicates that premiums charged are unlikely to be unaffordable particularly when considered in the context of the costs involved in a purchasing a new home.

However the following extracts have been lifted from page 48 the Draft Report:

> *"In summary, the main limiting factors on the insurability of defect risks are:*
> - *the small size of the market and the heterogeneity of builders; and*
> - *the absence of definite losses (incorporating issues surrounding the six year tail)."*
>
> *"There exists both empirical and theoretical evidence that indicates that, in the absence of Government intervention, the private sector would be unlikely to provide consumers with a reasonably accessible product that could provide protection against loss due to the risks of death, disappearance or insolvency of a builder with whom they have entered into a contract. The absence of private sector supply of insurance is something that has been observed in other insurance markets (see box below)."*

If the expert private insurance sector is unwilling to provide defect risk cover it is unreasonable/unrealistic to expect that the building industry, with no expertise in such matters, could correct what would constitute market failure.

In terms of the recommended model, i.e. Model 9: Private with Industry Supplement, the Draft Report states:

> *"For the purposes of evaluation, it is assumed that [the] building industry acts as the provider of insurance against defect risks and that it does so using some type of fidelity fund arrangement. The Authority considers that such an outcome would be preferable to the Government being the provider of the warranty insurance though notes that the Government as a provider is considered to be a workable alternative if industry was unwilling to perform the role."* (Draft Report p83)

At page 71 of the Draft Report under the heading Practical Implementation in Western Australia, it is stated:

> *"The ability of a model to be practically implemented requires that the assessment process take into account factors specific to Western Australia. These factors can include:*
> - *the size and structure of the building industry – for example, the size of the building industry may have implications for economies of scale in the provision of home indemnity insurance. The high level of concentration of the building industry in Western Australia, may mean that some models are not practical because of the high costs of a significant builder failing; and*
> - *the structure of housing and builder industry associations – this will be of particular relevance for the assessment of industry based models.[196]"*
>
> *"196 Implicit in the use of the criterion is an acknowledgment that some models may be appealing from a theoretical standpoint but may not suit the existing dynamics of the Western Australian building industry."*

In our considered opinion the second part of the ERA's recommendation will not be achievable, in which case a HII safety net would only exist until practical completion. The current 6 year run-off period for defects identified during the warranty period would come to an end.

In advocating Model 9 on the assumption *“that building industry acts as the provider of insurance against defect risks and that it does so using some type of fidelity fund arrangement”* the ERA appears to be a odds with the following damning statement:

> *“As noted above, the Authority considers that the fidelity fund model is not inherently suited to the provision of home indemnity insurance (including non-completion and defect risks) in Western Australia. Ultimately, this lack of suitability translates into a relatively high risk of failure. In its review of a fidelity fund model, PWC found that the risk of fund failure was high and ultimately this risk would be transferred to Government as it would be forced to either bail out the fund or become a provider of home indemnity insurance.[216]”* (Draft Report p79)

Furthermore conflicting/mixed messages appear in the Draft Report where it is stated:

> *“It is less certain whether the building industry would be willing to provide insurance for the defect risk component of the model. However, the Authority considers that it is in the best interests of the industry for this product to be available to consumers and hence there is an incentive for the industry to provide the product. The Authority also holds the view that the building industry is capable of providing this product.”* (Draft Report p83)
>
> *“It has been indicated throughout this chapter [Chapter 8] that the provision of home indemnity insurance in Western Australia is a complex task and one that requires a large amount of expertise and access to a large amount of capital. The Authority does not consider that the two building associations to have the resources needed to provide a stable vehicle for consumer protection, particularly given the potential for very large financial losses to be incurred.”* (Draft Report p80)

Given the statements on pages 71, 79, 80 and 83 it is unclear how the Industry Supplement component of Model 9 could be seen as deliverable. It is the view of the Wesbuilders directors that there would be widespread and strong opposition from builders to being forced into any scheme involving industry associations. Industry associations are lobby groups with vested interests as evidence by the following:

> *“Its [MBA WA] primary role is to promote the views and interests of the building and construction industry. It also provides services to members in a broad range of areas including contracts, training, legal services, industrial relations, building codes and standards, industry economics and safety advice.”* Source: MBA website.
>
> ***“****HIA Benefits at a glance*
> ***Government Lobbying***
> *Support the future of the housing industry and ensure your voice is heard ‘at the table’ by all levels of government – a stronger voice, greater lobbying power and better outcomes for your business.”*
> Source: HIA website

Industry associations, even if interested, would clearly be in a conflict of interest position.

In terms of the WA marketplace consumer confidence in a defect protection scheme that was aligned with a builders’ association would be understandably low. The industry associations’ business model would put them in conflict with consumers, members and non-member builders if they were involved in delivering an industry-wide defects protection scheme.

On the matter of assessing models the Draft Report states:

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

The simplest, most stable, readily explainable/understood, controllable and accountable model is a tie between Model 5: Government Full Coverage and Model 6: Government Limited Coverage.

As noted at subparagraph 8.1.6 “The only significant difference from the *government full coverage model* is that the *government limited coverage model* offers a shorter defect period (two years rather than six years).”

The “*simpler the model, the better”* statement is fully supported.

A simple model will directly transfer into simpler implementation.

Stability

On the issue of stability the report details the history of Home Indemnity Insurance in Western Australia. That history is checked and characterised by insurance company failures and recurring and ongoing industry instability with no insurer demonstrating a commitment to the provision of the insurance required under the Home Building Contracts Act 1991. The reports states (underlining added):

> *"The Authority considers that the private with limited coverage model has the potential to generate a competitive supply response from insurers because the insurable risk[212] is more appealing to private insurers (non-completion) is retained, while the insurable risk that is less attractive (defect risk) is minimised."* (Draft Report p76)

Whilst the ERA might see "potential" it is our considered view that the ERA has given insufficient weight to its own acknowledgement of the inherent instability of private insurance companies providing HII. The Draft Report warns:

> *"Lines of insurance that carry a greater level of uncertainty are the first lines of insurance that will cease to be offered particularly in times when capacity is constrained. In such times, insurers will opt to use their limited financial capacity to offer safer lines of insurance. Thus, even if a particular line of insurance is deemed to be profitable it may not be supplied by insurance companies, particularly in times when financial capacity is constrained."* (Draft Report p49)

Furthermore, there is a clear warning that insurance company decisions can be driven by non-financial considerations:

> *"[46] Vero's decision to exit the market was based in part on bad publicity that had been encountered in the eastern states of Australia and a perception that such publicity was tarnishing the company's brand. See" Insurance News Net, Vero's withdrawal from home indemnity Market raises concerns in Australia, February 2010."* (Draft Report p11)

Consumers and builders need, amongst other things, stability in respect to the State's HII.

Stability would also be a high priority for Government in terms of managing and delivering on public policy in the important area of consumer protection.

As noted earlier, the ERA's recommendation is reliant on a) securing a private insurer and b) the building industry being able to offer a cost effective scheme for warranty protection. Even if secured, neither can be assured into the future.

The need for stability in its various constructions is immediate. There is at present considerable uncertainty around HII both for consumers and builders.

The ERA's Model 9 will not deliver the stability needed. It has been the reliance on private insurers that goes to the core of the HII problems since its inception. Only a decision to migrate HII to either Model 5: Government Full Coverage or Model 6: Government Limited Coverage will deliver the stability required by all stakeholders.

Costs

The report has adopted a multi-faceted approach to costs, touching on a high level cost benefit assessment; the cost and risk to Government of providing re-insurance protection, and red tape burdens on the insurance and building industries.

On the requirement for a regulatory impact assessment before the implementation of new or amended regulatory proposals, the Draft Report defers to State Treasury. The ERA has also stepped back from comparing the cost of Model 5 and Model 9 as explained on page 88:

> *"The Authority considers that there is no ability to clearly distinguish the government full coverage model and the private with industry supplement model on the basis of compliance costs. This is because there are opposing factors that drive compliance costs in each of the two models.*
>
> *In the context of compliance costs, the government full coverage model:*
>
> - *has the relative advantage that it is a "one stop" solution - builders only need purchase insurance once for each building project undertaken and this purchased insurance provides cover for non-completion and defect risks; and*
> - *has the relative disadvantage of being a government model in which incentives to deliver efficiencies are not as strong as would be expected in a model run by the private sector.*
>
> *Put another way, the private with industry supplement model:*

- *has the relative advantage of being considered able to extract greater efficiencies over time due to the implicit incentives in the model; and*
- *has the relative disadvantage in that insurance for each building project will be split into two separate products: one product for the non-completion risks and one product for the defect risks.*

> *Given the reasons outlined above, the Authority considers that there is no clear basis to distinguish the government full coverage model and the private with industry supplement model on the basis of compliance costs."*

The following appears as a footnote on page 95:

> *"The ability for the size of the premium to provide a signal to consumers about the perceived riskiness of a builder is, in the Authority's view, a small benefit that arises through the operation of a mandatory home indemnity insurance scheme because it helps consumers to make a more informed decision when engaging a builder."*

However, the Government's re-insurance arrangements with QBE artificially distorts the premiums paid by high volume builders rendering premium based comparisons flawed and incorrect.

The Draft Report states that *"compliance costs – (all else equal) the lower the indirect costs (such as time costs) incurred by parties such as builders and consumers in complying with the requirements of the model the better"*. This applies equally to an insurer's costs.

Significant compliance costs can be removed from HII by adopting a premium scale based on a simple ad valorem matrix of a) contract value bands; b) type of construction, and c) locale of the build. Such an approach would also make premium revenue estimates easier to project. Furthermore it provides cost certainty for builders and consumers in line with the *Home Building Contracts Act 1991* fixed price contract regime.

An approach to premiums, akin to 3rd Party Motor Vehicle cover, will also address a current inequity where preferential premiums afforded to a few large builders is highly detrimental to other builders.

Applying a 3rd Party Motor Vehicle Insurance model to the delivery of HII would also establish an entity which, over time, could become less reliant on Government underwriting. In the case of Model 6, reducing the defect period from 6 years to 2 years would decrease the Government's risk exposure with immediate effect. Under Model 6 the Government would receive 100% of premium collections, removing the concern that the current premium sharing agreement does not truly reflect the apportionment of risk.

A topic not addressed in the Draft Report is the contentious issue of the validity of HII as a policy of insurance. Whilst consumers receive the benefits of a policy of insurance the same can't be said for many builders. More often than should be the case compliance costs for builders includes the cost of having to provide personal security to the insurance company. The builder is effectively providing the first line of cover with the insurance company essentially fulfilling a first resort finance role, only coming "on risk" for a loss once their security is exhausted.

Returning to the foundations on which HII is based, i.e.:

> *"………….the principle objective of the existing home indemnity insurance regulations (and any possible future scheme) is to protect consumers. The case for Government intervention to achieve the consumer protection objective was made using the Authority's consumer protection framework (detailed in Chapter 5)."* (Draft Report p87), and
>
> *"………….there is a case for some form of Government intervention to protect consumers against potential losses arising from the death, disappearance or insolvency of their builder. This intervention may be best provided through the regulated requirement for mandatory insurance. The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because the losses incurred due to non-completion are potentially much greater than they are for defective work."* (Draft Report pix),

there is an obligation to ensure that in any HII scheme there is fairness, an absence of misuse of market (near monopoly) power and no artificial barriers to entry.

Adopting Model 6 Government Limited Coverage would not only lessen the cost to builders in the same way reducing the defect cover period from 6 years to 2 years would deliver benefits to the Government, it would open the way for the HII provider to adopt innovative solutions free of the constraint of the private sector investor driven business model for insurance companies set out on page 43 of the Draft Report.

The report addressed the functional aspects of Government involvement in the following terms:

> *The Authority considers that the Insurance Commission of Western Australia is most likely the organisation best-placed to administer a Government-run home indemnity insurance scheme. The Commission is already a provider of workers' compensation insurance and third party motor vehicle insurance and hence has knowledge and expertise in the functioning of insurance and reinsurance markets.*[179] *The Authority does recognise however that the Commission would require sufficient time and resources to build up the skills and capacity to be able to effectively provide home indemnity insurance services.*[180] (Draft Report p63)

Summary

Whilst the ERA has put forward one recommendation for consideration its Draft Report does not rule out either Model 5 or Model 6.

The Draft Report leaves it open to the Government to adopt Model 5 or Model 6 and still deliver a very sound public policy outcome in the area of consumer protection.

The ERA states (page ix), and we concur, that:

> "*The case for Government intervention is stronger on the matter of protecting consumers against losses caused by non-completion than it is on the matter of protecting consumers against losses caused by defect. This is because the losses incurred due to non-completion are potentially much greater than they are for defective work*".

There will be ongoing inherent instability in the delivery and oversight of HII if it continues to be reliant on private insurance companies. With HII effectively a barrier to entry into the residential housing market it must be reliable, transparent, fair and accountable.

In proposing the following alternative to the ERA recommendation the building industry is indebted to the ERA and its research staff for their contribution to finding a solution to the shortcomings of the current HII arrangements.

We believe the following recommended balanced approach to HII will:

- deliver the best outcome for all stakeholders;
- deliver the best outcome quickly;
- end uncertainty;
- improve community and builder understanding of HII;
- provide consumer protection for a short post-construction (make good) period;
- allow HII provider to be progressive and innovative;
- remove the HII conflict between private insurers and the Government; and
- receive widespread consumer and builder support.

WESBUILDERS RECOMMENDED MODEL

Having given due consideration to the ERA's position and the balanced interests of all stakeholders in the Western Australian residential building market, it is recommended to Government that:

> **"the existing Home Indemnity Insurance model be transitioned to *Model 6: Government Limited Coverage* as set out in the ERA's Draft Report - Inquiry into Western Australia's Home Indemnity Insurance Arrangements dated 4 April 2013."**

This is a Public Document.
Discussion on the content of this paper is encouraged.
Follow-up enquires are welcome, and can be directed to:
Mike Waddell, General Manager, Wesbuilders Co-operative Ltd
Landline 9367 6430 Mobile 0409 996 369 Email mikew@wesbuilders.com.au
Issued 13 May 2013