Inquiry into Western Australia's Home Indemnity Insurance Arrangements

Issues Paper

5 July 2012

Economic Regulation Authority

WESTERN AUSTRALIA

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Foreword

The Treasurer of the State of Western Australia has requested that the Economic Regulation Authority (**Authority**) undertake an inquiry into the effectiveness of Western Australia's home indemnity insurance arrangements.

In accordance with the inquiry's Terms of Reference, the Authority will determine if there is an ongoing need for the mandatory provisions of home indemnity insurance, and whether alternative regulatory models could be applied in Western Australia to replace or improve current arrangements (which, as indicated in the Terms of Reference may include the establishment of a fidelity fund).

In addition, the Authority is to determine if ground subsidence due to underlying geological causes should be included in the scope of home indemnity insurance arrangements.

The purpose of this Issues Paper is to provide background information and outline the issues to be considered. It is intended to assist stakeholders to understand the nature of the issues under review and to facilitate public comment and debate. Throughout this Issues Paper, questions that may be of particular interest to stakeholders are raised and highlighted in boxes.

Submissions on any matter, including those raised in this Issues Paper, should be submitted by 4:00 pm (WST) on Thursday, 16 August 2012, preferably in electronic form, and addressed to:

Economic Regulation Authority

Inquiry into Western Australia's Home Indemnity Insurance Arrangements

Email address:	publicsubmissions@erawa.com.au
Postal address:	PO Box 8469, PERTH BC WA 6849
Facsimile:	(08) 6557 7999

Section 1.3 of this Issues Paper provides further information regarding the process for making a submission. Interested parties and stakeholders will have a further opportunity to make submissions following the release of the Authority's Draft Report.

The Final Report for this inquiry is scheduled to be delivered to Government on 30 April 2013, following which the Government will have 28 days to table the report in Parliament.

I encourage interested parties to consider the Terms of Reference and matters raised in the Issues Paper and prepare a submission for the inquiry.

STEVE EDWELL
MEMBER

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1 Introduction

The Treasurer of Western Australia has given written notice to the Authority to undertake an inquiry into the effectiveness of Western Australia's home indemnity insurance arrangements.

1.1 Terms of Reference

The Terms of Reference require the Authority to consider and develop findings on:

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

The Terms of Reference also require the Authority to consider:

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

1.2 Review Process

The Issues Paper is intended to give sufficient background information to assist stakeholders understand the nature of the issues under review and to facilitate debate for this inquiry. The Authority invites submissions from interested parties on matters of relevance to the Terms of Reference and the issues paper. Submissions are due by 4:00 pm (WST) on Thursday, 16 August 2012. All submissions received from stakeholders will be considered by the Authority.

As part of the inquiry process, the Authority will produce a Draft Report that will be published on the Authority's website. Public submissions on the Draft Report will be sought following its publication. A Final Report will be presented to the Treasurer by 30 April 2013 and the Treasurer will then have 28 days to table the report in Parliament.

In accordance with section 45 of the *Economic Regulation Authority Act 2003*, the Authority will act through the Chairman and members in conducting this inquiry.

1.3 How to Make a Submission

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

Inquiry into Western Australia's Home Indemnity Insurance Arrangements
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849
Email: publicsubmissions@erawa.com.au
Fax: (08) 6557 7999

Submissions must be received by 4:00 pm (WST) on Thursday, 16 August 2012.

Submissions will be placed on the Authority's website unless confidentiality is claimed. The submission, or parts of the submission in relation to which confidentiality is claimed, should be clearly marked. Any claim of confidentiality will be dealt with in accordance of Section 55 of the *Economic Regulation Authority Act (2003)*.

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

2 Home Indemnity Insurance in Western Australia

In Western Australia, the provisions of the *Home Building Contracts Act 1991* (**the Act**) make it mandatory for all home builders who build for another person (the consumer) to hold home indemnity insurance.[1] This mandatory obligation is given effect through Part 3A Section 25C of the Act, which dictates that:

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

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

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

The insurance is also required to cover new home purchasers against loss resulting from faulty workmanship in instances where the builder cannot be found. This element of the insurance cover is required to stand for a period of six years from the day of practical completion of a new home. In other words, the home indemnity insurance provisions of the Act offer consumers with 'last resort' cover. This means that if a builder is still trading, statutory protection is afforded under provisions of the building contract that is held between the consumer and the home builder. In the event of a dispute, consumers must first pursue claims with their builder if their builder is available.

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

> *(i) at least $100,000 or such other amount as is prescribed; or*
>
> *(ii) the cost of the building work,*

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

- the risk of losing a deposit (up to $13,000) paid under a building contract;

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

- the risk of loss resulting from non-completion of residential building work; and
- the risk of incurring building remedy costs during a six year period following completion of the house.

The Act is currently administered by the Building Commission[2] and prior to that it was administered by the Department of Employment and Consumer Protection. Enforcement of the Act is provided by relevant local government authorities as they have the responsibility of approving building applications, and in the process ensuring that builders hold appropriate insurance.

To obtain home indemnity insurance cover, a builder will contact an insurance company seeking cover for a certain period of time (usually one year). Eligible builders are then granted a 'pre-qualified' status from their insurer and the cost of the premiums are determined, usually on the basis of a certain percentage of the value of construction. Premiums charged differ among builders depending on the risk profile that is determined by the insurance company. Following the establishment of pre-qualification, a builder is able to obtain an insurance certificate from the insurance company for each house, or construction project valued in excess of $20,000, that is commenced during the year.[3]

Western Australia's home indemnity insurance arrangements are broadly similar to those in New South Wales, Victoria and South Australia. In these states, home indemnity insurance is mandatory, 'last resort' and characterised by some level of support from government. The Queensland scheme is unique in Australia in that it is a 'first resort' scheme.[4] The Tasmanian approach is also unique in that home indemnity insurance is no longer mandatory.

Table 2.1 on page 4 provides a summary of other key elements of home indemnity insurance arrangements in Australia, including the minimum value of work for which insurance is required; the maximum valuable payable; and the coverage period.

Again, arrangements in Western Australia are broadly similar to those in other jurisdictions when assessed in the context of these parameters. The Queensland scheme stands out as one in which the need for insurance is triggered even for relatively low values of work, and one in which the maximum payable value from an insurance policy is relatively high.

Further details of interstate home indemnity insurance schemes are provided in Appendix 2.

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

[3] Section 2 of the *Home Building Contracts (Home Indemnity Insurance Exemptions) Regulations 2002,* states: "The *Home Building Contracts Act 1991* requires that the builder take out home indemnity insurance for residential building work costing over $20,000, unless there is an exemption."

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

Table 2.1 Home Indemnity Insurance Arrangements in Australia[5]

Jurisdiction	Type of scheme	Minimum value of work	Maximum value payable	Coverage period
New South Wales	Last resort	$20,000	$340,000 or 20% of the contract value	Up to 7 years from completion of structural work
Victoria	Last resort	$12,000	$200,000 or 20% of the contract value	Up to 6 years from completion of structural work
Queensland	First resort	$3,300	$400,000	Up to 6 years and 6 months from completion of structural work
South Australia	Last resort	$12,000	$80,000	Up to 5 years from completion of work
Western Australia	Last resort	$20,000	$100,000	Up to 6 years from completion of work
Northern Territory	Last resort	$12,000	$80,000	Up to 6 years from completion of work
Australian Capital Territory	Last resort	$12,000	$85,000	Up to 6 years from completion of work

2.1 The Nature of the Home Indemnity Insurance

Under the existing home indemnity insurance arrangements in Western Australia, the builder is responsible for ensuring that an insurance policy is in place, yet it is the consumer who is protected by the cover afforded by the insurance policy.

It is compulsory for builders to take out home indemnity insurance. In many other insurance markets the decision of whether to take out protective insurance cover is made by the consumer (for example, in cases of home, contents and car insurance).

In the case of home indemnity insurance, the consumer is not given this choice of accepting or refusing the insurance cover. The compulsory nature of home indemnity insurance is similar to some other insurance products such as third party motor vehicle insurance.

[5] All home indemnity insurance schemes listed in Table 2.1 are mandatory schemes. Tasmania is the only Australian jurisdiction where home indemnity insurance is voluntary. Further details about the Tasmanian approach to home indemnity insurance are provided in Appendix 2.

While it is the builder that must hold, and in the first instance, pay for the insurance, it is nearly always the case that the insurance costs are passed directly on to the consumer. Preliminary research undertaken by the Authority indicates that typical premiums in Western Australia range from $500 to $1,500 per home.[6]

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

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

(ii) the event where a builder dies, becomes insolvent or disappears *and* that the work of that particular builder is found to be faulty during a period covering six years from completion of the building work.

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

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

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

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

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

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

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

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

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6 Premiums are usually calculated by the insurance providers as a percentage of the value of the home to which the insurance policy applies.

- *the cost of materials* – an increase in the cost of materials can affect both costs to the builder and costs to insurers in paying out claims.[7]

Providers of home indemnity insurance must consider the risks over a period spanning six years beyond the completion of construction but they must price this risk prior to the commencement of construction.

Insurers must also contend with problems of information asymmetry in that the builders will always have more information about their financial position, technical expertise and business intentions than will the insurers.[8] The problems of information asymmetry exist to varying degrees in other markets for insurance.

2.2 A Brief History of Home Indemnity Insurance in Western Australia

The first housing indemnity insurance scheme to operate in Western Australia commenced in the 1980s. The first scheme was a voluntary scheme meaning that the ultimate choice of whether to take on housing indemnity insurance was left to the consumer.

Western Australia's current mandatory HII scheme was established by amendments to the *Home Building Contracts Act* in 1996. The shift came about following pressure from consumer advocates who argued for increased consumer protection. It is likely that the introduction of mandatory requirements would have increased the demand for home indemnity insurance. Despite this, there is evidence to suggest that many insurance companies suffered financial losses as a result of offering home indemnity insurance in the late 1990s.

In March 2001, two major insurers operating in the Australian housing indemnity insurance market (HIH and its subsidiary company, FAI) were placed into liquidation. The global economic environment at the time was characterised by an abnormally high level of insurance claims and a large degree of financial market uncertainty. HIH and FAI serviced up to 40 per cent of the national market at the time that they were placed into liquidation. Following the collapse of these insurers, there was a shortage of providers that were willing to either (i) provide housing indemnity insurance, or (ii) provide reinsurance cover to those insurers that were willing to provide housing indemnity insurance.

In July 2001, the State Government announced that it would provide a 'rescue package' to assist homeowners and builders following the collapse of HIH and FAI. The package provided consumers with replacement cover, to the value of $100,000 per homeowner, for consumers who had previously held housing indemnity insurance cover provided by HIH or FAI. The State Government estimated that the rescue package would cost $6 million.

The rescue package was put in place to protect consumers and to enable builders to continue to operate.

In the context of developments at the time, a national review of housing indemnity insurance hosted by the Ministerial Council on Consumer Affairs in early 2002 put forward a recommendation to 'put less emphasis on insurance and give more attention to strengthening the regulatory framework'.

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7 Based on analysis by the Essential Services Commission, 2012, *Performance of Victoria's Domestic Building Insurance Scheme 2010-2011*, p. 9.

8 Section 3.1 contains a fuller explanation of information asymmetry.

By April 2002, the Western Australian Minister for Consumer Protection announced legislative change that had the effect of lessening the reliance on housing indemnity insurance. Mandatory housing indemnity insurance requirements were removed for major developers. Other amendments allowed builders who were members of approved mutual funds to use the financial cover of the fund in place of housing indemnity insurance.

Also in 2002, the State Government introduced a Deed of Agreement with providers of housing indemnity insurance effectively providing the insurers with protection for claims between $10 million and $90 million resulting from the collapse of any one home builder. This essentially formalised the transfer of underwriting some portion of the risks held by private insurers to the State Government.

In the late 2000s, there were a number of insurers providing home indemnity insurance in the Western Australian market. However, CGU Insurance and Lumley Insurance withdrew from the market in 2009 and Vero Insurance Group exited from the market in 2010.

QBE Insurance and the Calliden Group are currently the only two insurers offering housing indemnity insurance in Western Australia.[9] A Deed of Agreement that obligates the State Government to underwrite some of the risks faced by QBE was agreed to by both parties in 2010. This Deed expires in mid-2013. The Calliden Group holds an agreement with the State Government to provide housing indemnity insurance until mid-2013. However, unlike QBE, the Calliden Group does not qualify for a risk transfer Deed of Agreement with the State Government because the company has chosen to limit its exposure to less than $10 million per builder.

In providing home indemnity insurance, the focus of the Calliden Group is small to medium builders with turnover that is less than $20 million per year.[10] QBE, is a much larger company,[11] and appears to operate across the market.

2.3 The Western Australian Home Building Industry

The Western Australian home building industry consists of approximately 5,800 registered builders. The construction industry as a whole (including residential and non-residential construction) employs about 119,000 people, which is equivalent to about 9.2 per cent of total employment in Western Australia.[12]

Despite being populated by a large number of builders, the housing industry in Western Australia is highly concentrated. A smaller number of large builders account for a large majority of the market and a large number of smaller players build relatively few houses per year. The ten largest builders in the State account for almost 80 per cent of the market (measured by number of houses constructed) and the top three builders account for about 40 per cent of the market.[13] The typical business model adopted by the large builders is to secure customers and then contract out the building work to subcontractors.

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[9] QBE and the Calliden Group also provide housing indemnity insurance in other Australian jurisdictions.

[10] The Calliden Group website, http://www.calliden.com.au/ourproducts/licensedbuilderconstruction.cfm, accessed 19 June 2012.

[11] In 2011, the Calliden Group reported gross premium revenue of $A224 million, while QBE's Australian operations earned gross premium revenue of about $US4.4 billion. See, the Calliden Group and QBE Insurance Group, Annual Reports 2011.

[12] Australian Bureau of Statistics, *Labour Force Australia*, cat. no. 6291.0.55.033.

[13] Source: Housing Industry Association, various media releases.

On average, Western Australian builders construct about 18,000 houses per year. The swings in activity between peak and trough in the housing construction sectors are significant. In years of strong activity, the number of houses constructed might reach almost 22,000 and in quieter years there can be as few as 16,000 houses constructed.[14]

The underlying driver for new home construction is demographic change but the observed volatility is a product of changes in factors such as affordability (both perceived and actual), interest rates and consumer confidence[15] and conditions in the rental market.

Questions for Interested Parties

1) Do you have additional information that could strengthen the Authority's understanding of the operation of the home indemnity insurance market?

2) Are there elements of interstate home indemnity insurance schemes that are superior to existing arrangements in Western Australia and if so, why?

3) What is preventing other insurance companies from providing home indemnity insurance?

4) Are home indemnity insurance premiums set at a reasonable level?

   a) Are premiums priced appropriately to fully reflect the risks being borne?

   b) Does the current level of premiums add an unnecessary cost to the price of building a home?

   c) Do home indemnity insurance providers have adequate financial capacity to withstand major claims without recourse to government intervention?

[14] Australian Bureau of Statistics, *Building Approvals, Australia*, cat. no. 8731.0.

[15] In turn, consumer confidence is influenced by a myriad of factors including levels of employment, incomes and inflation.

3 The State Government as a Bearer of Risk

The first task of the terms of reference is to consider the position of State Government as an underwriter of the private provision of home indemnity insurance since 2002. Issues surrounding this matter are presented in this chapter. A detailed explanation of the role of the State Government as underwriter of private insurance providers is contained in Section 2.2 of this report.

3.1 The Case for Government Intervention in a Market

The Western Australian Government is an active participant in the home indemnity insurance market as it underwrites some of the risk that is borne by QBE Insurance. State government intervention in the home indemnity insurance market is not uncommon in Australia. Home indemnity insurance schemes in New South Wales, Victoria and Queensland operate with some degree of state government involvement in the underwriting of risks (see Appendix 2).

Typically, a government may justifiably intervene in a market if there is a case of market failure. In certain cases, private sector markets do not deliver outcomes that are efficient or optimal. Put another way, a case of market failure occurs when the individual pursuit of self interest leads to results that are sub-optimal from a whole of society perspective. For example, the government is a provider of basic infrastructure (for example, roads, footpaths and parks) because such infrastructure would be unlikely to be provided at an appropriate level and efficient price if left to the private sector.

A market failure is most often the outcome in situations where there are:

- *information asymmetries* – where some parties have access to a greater level of information than other parties to the extent that the parties without access to information are unable to make informed decisions;

- *non-competitive markets* – typically occurring where there is a natural monopoly in the provision of a good or service. A natural monopoly occurs when it is most efficient for production of a good or service to be provided by a single firm with the result that the single firm has an overriding cost advantage over actual and potential competitors;

- *externalities* – refer to the cost or consequences that a party must bear due to the actions of another, unrelated, party. For example, a poorly maintained property in the neighbourhood may lead to a decrease in the property value of a neighbouring property; and

- *public goods* – are goods (or services) that are (i) non-rival in consumption and (ii) non-excludable. A good is non-rival if once provided to one person the cost of providing it to another person is zero. A good is non-excludable if it is very difficult to exclude people from benefitting from consumption of the good. Generally the private sector may be reluctant to supply public goods because it can be difficult to exclude people from benefitting from the good and this creates problems of people being unwilling to pay for consumption of the good.

In the case of the home indemnity insurance market, there may be elements of some of the above factors that are at play and can justify the intervention of government in the market. It may well be the case that home indemnity insurance would not be provided at all, or offered at a price perceived by a significant number of consumers as unaffordable, if it were left entirely to the private sector to provide the service.

As indicated in Chapter 2, information asymmetries feature in many insurance markets, and it is probably the case that they exist to some degree in the home indemnity insurance market also. In insurance markets, it is typically the case that the party seeking insurance (in the case of home indemnity insurance this party is the builder) has access to a greater level of information than the insurance company. This imbalance in the knowledge of information can make it difficult for insurance companies to set premiums at an appropriate level.

Further, a builder may have an incentive to hide or provide only selective information to an insurance company in an effort to cast him or herself in a favourable light. By doing this the builder may be able to negotiate premiums that are lower than they realistically should be. While the builder will ultimately pass on insurance premium costs to the consumer, he or she still benefits from a low premium as the lower the insurance premium, the more competitive will be the total product offering of that particular builder.

If it can clearly be demonstrated that a market failure exists then it could reasonably be argued that it is in the interest of society to have the government intervene to provide (some element of) home indemnity insurance services.

3.2 The Impacts of Government Intervention in the Home Indemnity Insurance Market

By acting as an underwriter in the home indemnity insurance market the State Government carries a liability that could be triggered in the event of a collapse of a major builder. At the end of 2011, the size of the State Government's liability was estimated to be approximately $250 million.

Questions for Interested Parties

5) What are the risks to the State Government arising from its intervention in the home indemnity insurance market? Is the State Government managing these risks appropriately?

6) Is the State Government being adequately compensated for the risks being held?

7) Should the State Government continue to play a role in the home indemnity insurance market?

4 Housing Indemnity Insurance as a Mandatory Requirement

The second task in the terms of reference requires the Authority to determine whether there is an ongoing need for the mandatory provisions of home indemnity insurance in Western Australia. Matters surrounding this issue are contained in this chapter.

4.1 Mandatory Requirements and Consumer Choice

As discussed in Chapter 2, the Act stipulates that builders of residential homes in Western Australia must hold a valid home indemnity insurance policy before being able to commence work. While the provisions of the Act are directed towards builders, the intent of the mandatory provisions of the Act is to protect consumers. It is ultimately the consumers who pay for, and benefit from, the cover that is afforded to them by home indemnity insurance.[16]

By making home indemnity insurance mandatory, the provisions of the Act take away the ability of consumers to choose whether or not they purchase home indemnity insurance.

In principle there will always be a compelling argument to give consumers the freedom to control their own purchase decisions. Doing so enables consumers to weigh up the costs and benefits of any purchase decision and act appropriately. Such decisions are best left to consumers because different consumers will have different perceptions of the benefits that can be earned in purchasing a particular good or service.

However, there are instances where it can be argued that consumers may have a tendency to make purchase decisions that are either not in their own interests, or not in the interests of society. In these situations, government regulation may be required.

An example of such situation is the case for mandatory building inspections prior to handover. Regulations such as mandatory building inspections are implemented to counter the clear information asymmetries that exist between the parties involved in a building transaction.

A builder will invariably have more information about the quality of workmanship and materials that have gone into the construction of a house. The average consumer may be able to make a cursory judgement about the quality of the house but will not be able to make a fully informed judgement because most consumers are not expert in the techniques surrounding the construction of a house. In the absence of regulatory protective mechanisms such as mandatory building inspections, there may be a tendency for unscrupulous builders to take advantage of this information asymmetry and provide consumers with substandard housing.

[16] It is most likely the case that the reason the onus of holding home indemnity insurance is placed on the builder is for administrative simplicity, and the fact that the risk that is being insured is not specific to each home being built, but relates to the quality and financial strength of the builder. Home buyers are less likely to be able to efficiently manage the process of obtaining insurance as they are generally not in a position to obtain the appropriate information from builders and pass this information on to the insurance company so that the insurance company can effectively assess an insurance application. Rather than dealing with each home buyer on an individual basis, the insurance companies can deal with builders by obtaining the required information as part of a 'pre-approval' process. The insurance company can then issue individual insurance cover on each new home without having to re-assess the risk each time a new home is built.

In summary, to demonstrate that mandatory provisions are required in the case of home indemnity insurance, it should be established that:

(i) it is in the interests of either the individual consumer or society as a whole for purchasers of new houses to be covered by the provisions of home indemnity insurance;

(ii) it would be unlikely that consumers would purchase home indemnity insurance if it were not a mandatory requirement to do so; and

(iii) there exists a real risk that home indemnity insurance would not be offered by insurance companies if mandatory provisions were removed even though there might be some demand for home indemnity insurance from consumers.

Questions for Interested Parties

8) Does home indemnity insurance meet the intended level of protection for consumers?

9) Is there an ongoing need for the mandatory provisions of home indemnity insurance? This issue can include but is not limited to:

   a) the impacts on consumers if housing indemnity insurance became voluntary;

   b) the impacts on the building industry;

   c) the impacts on home indemnity insurance providers;

   d) the impacts on the real estate industry, particularly with respect to any potential liability a real estate agent may incur if a home is sold within its defect rectification period; and

   e) the impacts on government.

10) Do current arrangements impose a heavy ‘red tape’ burden on residential home builders or consumers?

5 Alternative Regulatory Approaches

The third task of the terms of reference requires the Authority to consider alternative regulatory models that could be applied in Western Australia to replace or improve current arrangements. This chapter presents a range of alternative approaches that may warrant consideration. The alternative approaches that are presented in this chapter do not constitute an exhaustive collection of possible options.

5.1 A Voluntary Home Indemnity Insurance Scheme

Tasmania introduced a voluntary home indemnity insurance scheme in 2008 (see Appendix 2 for more detail). If such a model were adopted in Western Australia, the mandatory provisions in the Act that dictate that builders must hold home indemnity insurance would be repealed. The decision as to whether home indemnity insurance is purchased would then fall to either builders or consumers (assuming the product continued to be available).[17] Coinciding with a voluntary scheme may be a tightening of licensing, monitoring and dispute resolution mechanisms so that an element of consumer protection can be maintained in the absence of insurance cover.

The benefits of a voluntary scheme are that builders and consumers would be free to make their own decisions depending on the perceived value of home indemnity insurance. As discussed in Chapter 4, there is always a strong case for leaving decisions in the hand of consumers and industry players unless it can be demonstrated that doing so is not in the public interest.

It is almost certain that the removal of mandatory requirements would lead to a decrease in demand for home indemnity insurance in Western Australia. If the decrease in demand is significant enough, insurers may be tempted to exit the market, as has been the case in Tasmania.

There is a risk that a voluntary scheme will result in a situation where those consumers who choose not to purchase home indemnity insurance may be the same consumers who would be left most vulnerable in the event of a builder disappearing. This is because consumers with relatively low incomes might have greater tendencies to opt out of voluntary insurance.

There could also be a range of adverse implications for the State Government and society in having a proportion of the new home building population not covered by home indemnity insurance. For example, in cases where a builder disappears and insurance is not held, the State Government may ultimately end up financially assisting consumers.

5.2 A First Resort Scheme

A ‘first resort’ insurance scheme, as in place in Queensland (see Appendix 2 for more detail), enables a consumer to trigger an insurance claim against a builder while the builder is still trading and available. This contrasts to the existing ‘last resort’ scheme where home indemnity insurance can only be triggered if the builder is dead, insolvent or

[17] It is not clear how such a scheme would play out. Some builders may choose to continue to purchase home indemnity insurance (provided that it was available) and promote the insurance as part of a product offering to consumers. Equally, builders may choose not to purchase home indemnity insurance so that the total building costs borne by the consumers can be kept to a minimum. Equally as well, some consumers may demand that some form of home indemnity insurance is in place while others might not.

has disappeared. All else being equal, first resort schemes offer a greater level of consumer certainty (and protection) than do last resort schemes.

The premiums associated with a first resort scheme will inevitably be greater than the premiums associated with a last resort scheme. This is because a first resort scheme offers a greater degree of protection and will result in more claims being made (relative to a last resort scheme).

Depending on how it is structured, a first resort scheme may be compromised by the creation of moral hazard. If all faulty workmanship is covered by insurance then it may be the case that builders will have less incentive to uphold high standards because any problems with work quality could be dealt with by the insurance process.

5.3 A Fidelity Fund

A fidelity fund is a funding and investment structure that can be used to financially reimburse consumers in the event that a legitimate claim for compensation is made. Under a fidelity fund model, contributions to the fund would likely be made by consumers through some form of building levy. These contributions would need to be assessed regularly and be set at a level commensurate with the expected volume and size of payouts from the fund over the long term. In effect, the contributions to such a fund would serve the same purpose as do insurance premiums in the current model, and similar to the current model, the burden of payment would most likely fall to the consumer. If designed and managed properly, a fidelity fund should hold sufficient funds to cover claims.

A fidelity fund model could be completely run by government thus generating a greater degree of government control in the offering of home indemnity insurance. The simplicity of having a single party responsible for the provision of home indemnity insurance is an attractive feature of the model.

In an optimal fidelity fund model, levy payments would be structured to avoid problems of adverse selection. This would require levy payments to the fund be calculated after a risk assessment on home builders is undertaken by the fidelity fund. Under such an approach, consumers using high risk builders would have to pay a greater contribution than consumers using low risk builders. However, a model that worked on a flat rate of contribution would offer relative simplicity.

5.4 National Housing Indemnity Insurance Scheme

A national housing indemnity insurance scheme would provide builders and insurers with surety and consistency on regulations and this may help the market to operate effectively. It may also offer greater economies of scale to insurers thus making the market more attractive for them to operate in; and ultimately have the effect of lowering premiums due to the achievement of greater efficiencies.

5.5 Separation of the Insurance Product

Under the regulations of the existing home indemnity insurance scheme, insurers are required, in one product offering, to provide insurance cover for two different events:

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

(ii) the risk that a builder dies, becomes insolvent or disappears *and* that the work of that particular builder is found to be faulty during a period covering six years from completion of the building work.

Having to cover two different events under the one product offering may unnecessarily complicate matters and create difficulties in the appropriate pricing of risk. The existing scheme may also lead to confusion amongst consumers about the types of situations for which they are covered under a home indemnity insurance product. Separating the current home indemnity insurance cover into two separate product categories may result in greater clarity about the insurance product offering from the perspective of both insurers and consumers.

Questions for Interested Parties

11) Is an alternative regulatory model needed to replace the existing regulatory framework for home indemnity insurance?

12) What alternative regulatory models could be applied to replace or improve current arrangements?

13) Are there examples of regulatory frameworks used in other jurisdictions that are superior to the existing Western Australian regulatory framework?

6 Subsidence Insurance

The fourth task in the terms of reference is to determine whether there is scope for the State's home indemnity insurance arrangements to provide consumers with protection against damage caused by ground subsidence due to geological causes rather than builder fault. Issues on this matter are presented in this chapter.

6.1 Ground Subsidence

Ground subsidence is the gradual sinking of ground. In the context of this inquiry, subsidence is a concern because downward movement in the earth can cause damage to built structures such as houses.

Subsidence can occur due to a range of reasons, including:

- flood activity;
- water extraction from underground;
- gas extraction and other underground mining activities;
- changing climatic conditions, most commonly a drying of a ground area; and
- underlying and natural geological causes such as movements in the structure of the earth.

6.2 Subsidence Insurance

In Western Australia, the risks of damage caused by subsidence are currently borne by homeowners. As a general rule, insurance companies do not cover damage to homes caused by ground subsidence. Furthermore, builders are not liable for damage caused by subsidence if the builder has acted in accordance with relevant regulations regarding ground testing and site preparation. Queensland is the only Australian jurisdiction that has regulatory provisions requiring that homeowners be covered against subsidence damage as part of the State's home indemnity insurance arrangements.

The risks covered by subsidence insurance (and the nature of the insurance itself) are different to the risks covered home indemnity insurance.

First, as explained in Section 2.1, the risks that are being insured against in home indemnity insurance have to do with some combination of (i) a builder becoming insolvent, dying or disappearing, and (ii) that builder also being responsible for poor quality workmanship that becomes apparent during a specified time period following completion of the house. In the case of ground subsidence, the risks that are being insured against are entirely unrelated to the builder and instead completely related to geological conditions and surrounding activity of the area in which insurance is being provided.

Second, the existing home indemnity insurance arrangements in Western Australia offer consumers 'last resort' protection whereas subsidence cover as is being proposed in the terms of reference offers consumers 'first resort' protection. In other words, the existing home indemnity insurance arrangements cover consumers only in the event that a builder disappears (regardless of the reason for the disappearance). Subsidence insurance is unrelated to the builder so irrespective of whether the builder is contactable, the insurance would be triggered in the event that subsidence damage occurs.

It is clear that the inclusion of subsidence insurance in the existing home indemnity insurance arrangements would provide consumers with an extra degree of cover. However, this element of protection would undoubtedly come at an additional cost for consumers.

As part of this review, the Authority will investigate whether the benefits of the inclusion of subsidence insurance in some form of the State's home indemnity insurance arrangements exceed the costs of inclusion.

Questions for Interested Parties

14) Why is subsidence insurance not available in Western Australia?

15) Are problems due to ground subsidence significant in Western Australia?

16) Are some areas of the State more prone than others to damage caused by ground subsidence?

17) Should 'no fault' ground subsidence be included in the scope of home indemnity insurance arrangements?

18) Would insurance companies be willing to provide insurance against the damage caused by ground subsidence?

19) Can the problems caused by ground subsidence be managed in a more effective way than through insurance?

APPENDICES

Appendix 1 Terms of Reference

INQUIRY INTO WESTERN AUSTRALIA'S HOME INDEMNITY INSURANCE ARRANGEMENTS

TERMS OF REFERENCE

I, CHARLES CHRISTIAN PORTER, Treasurer and pursuant to section 38(1)(a) of the *Economic Regulation Authority Act 2003* request that the Economic Regulation Authority (the Authority) undertake an inquiry into the effectiveness of Western Australia's Home Indemnity Insurance (HII) arrangements, which are established by the *Home Building Contracts Act 1991*.

In conducting the Inquiry, the Authority is to consider and have regard to:

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

In its assessment of the options, the Authority must give consideration, but need not be limited, to the:

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

The Authority will release an issues paper as soon as possible after receiving the terms of reference. The paper is to facilitate public consultation on the basis of invitations for written submissions from industry, government, consumer groups and other relevant stakeholders.

A draft report is to be made available for further public consultation on the basis of invitations for written submissions. A final report is to be completed by no later than the close of business on 30 April 2013. Note that to accommodate the timing necessary to implement new arrangements, no extension of time is possible beyond this date.

HON C. CHRISTIAN PORTER MLA
TREASURER; ATTORNEY GENERAL

Appendix 2 Home Indemnity Insurance in Other Jurisdictions

Western Australian home indemnity arrangements are similar to those in New South Wales, Victoria and South Australia. Queensland takes a unique approach to home indemnity insurance in that its scheme is a 'first resort' scheme. The Tasmanian approach is also unique in that home indemnity insurance is no longer mandatory. Further details are provided in this chapter.

New South Wales

Home indemnity insurance arrangements commenced in New South Wales in 1972 and were administered by the State Government until mid-1997 at which time home indemnity insurance obligations were shifted to private sector insurance providers.

Up until 2002, the New South Wales scheme was a 'first resort' scheme, meaning that consumers could make claims for financial cover in instances where a builder was still trading. A 'last resort' scheme was adopted in July 2002 in response to the turmoil in insurance markets that was being experienced at the time.

In July 2010, the New South Wales Treasury became the sole provider of home indemnity insurance and risks were managed by the State's Self Insurance Corporation. Two private companies currently operate as agents for the State Government and in doing so undertake much of the administrative work.

Arrangements in New South Wales are similar to those in Western Australia in that home indemnity insurance in New South Wales:

- is mandatory;
- offers 'last resort' protection; and
- is administered by private companies yet underwritten by the State Government.

The State Government underwrites 100 per cent of the risk incurred in the provision of home indemnity insurance in New South Wales.

Victoria

Prior to legislative formalisation in 1987, home indemnity insurance in Victoria was provided by both the Housing Industry Association and the Master Builders Association. In 1984, the two schemes were merged to become the Housing Guarantee Fund and the State Government took control of key staff appointments at the Fund.

The legislative formalisation of the scheme in 1987 effectively brought into play a legislated and compulsory 'first resort' scheme.

In 1996, the State Government replaced the Housing Guarantee Fund with a privatised builders warranty insurance scheme, which was managed by private insurance companies. Like the case in New South Wales, the traditional 'first resort' scheme became a 'last resort' scheme in the early 2000s.

In 2010, the Victorian Government announced it would replace the privately-run scheme with a government-run scheme. Today, private insurers have an agreement with the

Victorian Government to issue the insurance certificates and the Victorian Government underwrites the risk.

Arrangements in Victoria are similar to those in Western Australia in that home indemnity insurance in New South Wales:

- is mandatory;
- offers 'last resort' protection; and
- is administered by private companies yet underwritten by the State Government.

The State Government underwrites 100 per cent of the risk incurred in the provision of home indemnity insurance in Victoria.

Queensland

The Queensland home indemnity insurance scheme differs to that in Western Australia (and New South Wales, Victoria and South Australia) in that the scheme provides consumers with 'first resort' protection. Other unique elements of the Queensland scheme are that it includes no fault subsidence cover and is entirely administered and underwritten by the State Government. The Queensland scheme is mandatory.

South Australia

In June 2010, the South Australian Government announced an agreement with QBE and the Calliden Group enabling the two companies to provide home indemnity insurance. The South Australian scheme is similar to that operating in Western Australia in that it is mandatory and offers 'last resort' protection.

Tasmania

Tasmania is the only jurisdiction in Australia that has a voluntary home indemnity insurance scheme. Market information indicates that the switch to a voluntary scheme resulted in the exit of insurance providers from the home indemnity insurance market to the extent that home indemnity insurance is no longer available in Tasmania.

Legislation is currently being drafted for the purpose of amending the home warranty and building disputes process. The intent of the new legislation is to improve consumer protection by strengthening contract protection and dispute resolution mechanisms such that these provisions will negate the need for home indemnity insurance.