



SUBMISSION BY THE
Housing Industry Association

to the
Senate Inquiry
on the
**Australia's Mandatory Last Resort Home Warranty Insurance
Scheme**

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Introduction

HIA is the premier industry organisation in the home building sector of the Australian economy, and represents some 44, 000 members throughout Australia. It employs a professional staff of some 350 persons and forms its policies through an internal democratic system of committees made up of its members serving in a voluntary capacity.

In respect to the specific terms of reference, HIA provides the following information, part of which has been recently submitted to the Productivity Commission which sought information in respect to consumer protection within the building industry.

Item 2(a) of the terms of reference relates specifically to the appropriateness and effectiveness of the current arrangements in providing appropriate consumer protection and industry management. This to HIA's mind is the key issue. If Home Warranty Insurance (HWI) is worthless, as some witnesses have alleged, then consumers should not be made to buy it. If on the other hand it does have value, then the issues for consideration are how much value, at what cost, and can the same benefits be achieved in a better way.

In order to answer these questions, it is necessary to understand what HWI is and what it is not.

The nature of statutory Home Warranty Insurance

Statutory warranties and warranty insurance should not be confused as being the same thing. The first is the legal responsibility of the builder (statutory warranties) and the second (HWI) is a safety net set up to protect consumers against losses where the builder is unable to meet their legal responsibilities due to death, disappearance or insolvency.

Statutory warranties are implied in legislation in each State and are the responsibility and obligation of the builder to the consumer. They generally relate to workmanlike quality and fitness for purpose. HWI is the safety net for consumers where the builder is unable to meet these and other contractual obligations and responsibilities in the three defined circumstances.

It is important that the HWI scheme not be mistaken for a dispute resolution vehicle. It is not appropriate or desirable for insurers to resolve disputes between builders and consumers as they have a conflict of interest - this task must be the responsibility of the State regulator/licensing body. When the two are fused in the same body there is moral hazard, since a finding in favour of one party or the other will have direct financial implications for the regulator/insurer. One of the major reasons for the decline and ultimate demise of the Housing Guarantee Fund in Victoria and the New South Wales Building Services Corporation was exactly this confusion of roles.

History of HWI

In the early 1980s statutory housing indemnity was introduced in South Australia and was underwritten by a panel of private sector underwriters. By the end of the 1980s mandated private sector warranty schemes were operating in South Australia, Tasmania and the ACT, and government underwritten schemes in Queensland, New South Wales and Victoria. A voluntary, privately run insurance scheme was also operating in Western Australia.



During the 1990s government-run enterprises came under scrutiny, particularly where there was capacity for similar functions to be performed by the private sector. By the mid 1990s both New South Wales and Victoria decided to cease offering government HWI and open their markets to private competition within a detailed regulatory framework. In Queensland the government owned insurer, the Building Services Authority (BSA), continued to operate with an exclusive franchise.¹

HIH collapse

March 2001 saw the collapse of HIH Insurances Limited (which of course had no association with HIA). HIA and some insurers had warned in advance of this collapse that the home warranty insurance cover being offered by HIH was unsustainable at those prices, which proved to be the case.

The collapse of HIH Insurances (virtually overnight) destroyed that market for a wide variety of Australian risks. The effects are still being felt in many other areas as well as home warranty, such as professional indemnity insurance and insurance for community groups and their events.

As a result of the HIH collapse and the reluctance of insurers to remain in or enter this market, the Victorian and New South Wales Governments reviewed the operation of their schemes through the mechanism of the Standing Committee of Consumer Affairs Ministers, in an effort to ensure that the scheme remained relevant and viable.

This involved a significant public review process including a Report from Professor Percy Allen commissioned by the Standing Committee of Consumer Affairs Ministers, a response to the Allen Report by the Standing Committee of Officials of Consumer Affairs, and a review for the New South Wales Government by Mr Richard Grellman. These reviews gave very detailed consideration to the issues concerned and formulated a consistent theory of how consumer protection was advanced by such legislation.

All these reviews talked about improvements to the system of dispute resolution in the home building industry and the role of the regulator; however this aspect of the reforms as yet has not been fully delivered.

After the HIH collapse, there was one major insurer to underwrite an additional 45 per cent of the builder market. As a result, further competition was imperative from both a service delivery and affordability point of view. HIA worked with the insurance industry to encourage the entrance of new insurers to the home warranty market. The industry now enjoys strong competition with secure insurers such as Vero, QBE, CGU and Lumley operating in all relevant States².

HIA notes that the QBSA, in its evidence to the Committee, made the point on a number of occasions that they are a not for profit entity. However, what was also said was that the

¹ Housing Industry Association, *Submission on Home Warranty*, 14 Jan 2002, page 1

² Contrary to the evidence given by Mr P Dwyer to the Committee on 8 April 2008, this had no connection with his complaint to the ACCC, which alleged misleading conduct by HIA, not any competition policy issue. The ACCC found there was no misleading conduct and dismissed the complaint.



international reinsurance market take 75% of the QBSA's risk, and that market is certainly responsive to both competition and the desire for profit.

Comparison of premiums

It is the business of insurers to price risk, and the price of insuring a risk (over many years) is real, whether or not a payment is made under the policy. It is only through free and fair competition that we can be certain that consumers are receiving the best possible price for an insurance product.

Since 2003, there has been considerable greater competition in every State with the exception of Queensland, and as a consequence insurance premiums have also dropped in every State but Queensland. A comparison of premiums for the median construction price of a new home in Sydney, Melbourne and Brisbane confirms that the QBSA first resort scheme provides insurance at \$1,789 compared to \$796 for Sydney and \$661 for Melbourne. Competition and the rigour involved in the insurers' underwriting practices has led to this significant difference between premiums under private insurance and the Queensland scheme.

Home Owners Warranty Insurance as a % of new home price		2002	2003	2004	2005	2006	2007
Sydney	Median New House construction Price ¹	\$179,067	\$192,167	\$240,423	\$240,125	\$246,041	265,433
	HOWI premium inclusive of government charges ²	\$1,136	\$1,496	\$1,491	\$1,385	\$953	\$796
	HOWI % of new house price	0.634	0.778	0.620	0.577	0.387	0.300
HOWI	% increase over period		24.06	-0.34	-7.65	-45.33	-19.72
Melbourne	Median New House construction Price ¹	\$165,969	\$184,070	\$200,987	\$203,431	\$219,671	\$232,649
	HOWI premium inclusive of government charges ²	\$837	\$894	\$973	\$918	\$779	\$661
	HOWI % of new house price	0.504	0.486	0.484	0.451	0.355	0.284
HOWI	% increase over period		6	8	-6	-18	-18
Brisbane	Median New House construction Price ¹	\$146,340	\$168,435	\$199,255	\$209,931	\$222,873	\$236,365
	HOWI premium BSA ³				\$1,240	\$1,692	\$1,789
	HOWI % of new house price				0.591	0.759	0.757
HOWI	% increase over period					26.71	5.42
1. Based on unpublished ABS Building Approvals data							
2. Premiums taken from Industry Insurer							
3. Taken from warranty premiums charged by the QBSA							

It is clear from the above that the legislatively standardised product which is HWI is being provided at competitive market prices. The next issue is therefore whether that standard product is providing consumers with worthwhile protection.



Consumer Protection Issues

What is appropriate consumer protection?

The Working Party of the Standing Committee of Officials of Consumer Affairs which reported on the Percy Allen Review in November 2002 saw the appropriate measure of consumer protection in this area as follows:

“insurance cover or a guarantee or the like to complete a house that is being built or to rectify any defects which are normally the builder's responsibility as articulated in legislation or a formal contract when the system has broken down and the builder is unable or unwilling to carry out this work” (at p.25).

That is, the Officials advising Consumer Affairs Ministers advocated a last resort insurance scheme as part of a balanced approach involving contracts, licensing and insurance. This is what Ministers and Governments have accepted and, to a greater or lesser degree, acted on.

Is HWI 'Worthless'?

Critics³ of HWI have repeatedly stated that HWI is 'worthless'. This assessment by consumers is apparently based on a mistaken analogy with home or motor vehicle insurance, with an expectation that every 'accident claim' should be immediately paid by the insurer regardless of fault. Needless to say, this totally misunderstands the nature of HWI.

Last resort HWI currently performs as a safety net, where consumers are protected against losses which stem from insolvency death or disappearance of the builder. This is certainly not 'worthless'.

Consider, for example, the position of Victorian consumers who contracted for new homes from Avonwood Homes Ltd which collapsed in the late 1990s. Avonwood was insured by HIH/FAI. Avonwood went into liquidation with about 800 homes under construction, which were later completed under warranty insurance. There were also about 6000 Avonwood homes still in the warranty period for which the insurers now carried the risk of defects. Consumers who had their homes completed or fixed, at a cost of \$35m which they did not have to pay, are unlikely to have thought this insurance was 'worthless'.

Consider also Real Property Constructions Pty Ltd, a Queensland building company which collapsed in March 2008. The QBSA has publicly estimated that the cost of completing its outstanding home building contracts will exceed \$20 million, a cost which will be fully met by compulsory home warranty insurance. That is \$20m that the affected consumers will not have to pay. Again, it is hard to see how this is 'worthless'. It is the risk of meeting such costs that insurers have to factor into the price at which they offer HWI to the public.

It is noteworthy that, although the Real Property Group collapse occurred in Qld under its government-operated first resort scheme, exactly the same compensation would have been paid

³ See 'Choice' Magazine Media comments 25 Feb 2004; Booth MHA, in Hansard, Tasmania, 26 Sep 2007



by private insurance in other states under their last resort schemes. This is just the sort of catastrophic occurrence that HWI was set up to deal with, and clearly illustrates the value which consumers receive from it. It is also worth observing that, as QBSA reinsures most of its insurance risk with the private insurance industry, the risks and losses are in the long term carried by private insurers under all HWI schemes, including Queensland.

In addition, premiums for HWI have fallen dramatically since 2002, demonstrating the value to consumers of a competitive market (see Table, above). It is noteworthy that, for about the price of a single year's comprehensive motor vehicle insurance premium, consumers are covered under HWI for a much larger potential liability for all of 6 years.

Witnesses before the Committee in fact made comparisons with motor insurance, and suggested that when you have a motor insurance claim, the insurer pays out and does not seek to recover against the owner, unlike warranty insurance where the insurer will seek recovery against the builder. This is simply wrong - in a motor claim the insurer will most certainly seek to recover against the party at fault, and this is no different to recovering against the builder if the builder is at fault. This is certainly what happens with all warranty insurers including the QBSA. The point needs to be clearly made that this insurance is to protect the home owner against the builder's default, and is not designed to protect the builder against his or her own negligence.

Does HWI provide effective 'industry management'?

One aspect of private sector management of HWI is that, except in Queensland, the number of occurrences of such home builder collapses, and their cost, has on anecdotal evidence apparently declined in the last 7 years in States with private insurance.

The Queensland system, while providing insurance cover to all who are licensed, does not cull out poor and failed builders through refusal of insurance. Rather, this culling is (in theory, at least) done through builder licensing, which is also operated by QBSA. This system does not prevent the bad builder from building but seeks to fix the problem after the bad building work has been done and the consumer adversely affected. The insurance in Queensland offers the same premium to all builders irrespective of the builder's past record for poor work. There is no price incentive to maintain a good building record.

As the QBSA does not discriminate for insurance, the QBSA has introduced complex reform after complex reform in recent years to allow it to ban builders from holding a licence for, among other things, financial failure or defective work. All Directors of building companies are personally liable under the QBSA Act to pay for insurance debts, costs of doing work and fines, without signing any guarantee such as may be required in some cases by private insurers on other States. The high degree of regulation has associated administration costs for both Government and business, which is ultimately borne by consumers.

The system in other States achieves the same effect, not through licensing, but through curtailing builders' access to insurance on commercial grounds. In those States, the decision on whether particular builders were good insurance risks, or needed to put up some assets as a guarantee, is a commercial decision for the insurer having regard to the circumstances of the individual.



Strong industry criticisms of HWI have in the past been made by builders who were accustomed (pre-HIH collapse) to obtaining a cheap annual insurance policy without proper underwriting assessments.

Since the insurance industry returned to stability, such problems as delays in builder assessments have largely disappeared. Again, HIA played a role in persuading insurers to streamline their assessment practices by using a 'light touch' assessment model.

Apart from administrative delays, a large part of the reasons for builder complaints was again the false perception that HWI was insurance against workmanship defects, and should recognise the good workmanship standards of the very many builders who had never had a consumer claim against them. From the insurer's point of view this was irrelevant, because it was the builder's responsibility to rectify workmanship faults; what counted was the risk that the financial stability and capital resources of the builder were insufficient to ensure they could meet these responsibilities. That was the risk that was being insured, and builders which had insufficient capital as a proportion of work outstanding, or uncertain financial and management information systems, were not seen by insurers as good risks. Such builders were therefore limited in the risk coverage which insurers were prepared to extend to them.

The results have been that, as compared with the industry pre-2001, home builders as a group are much better capitalised and also have better financial management structures. This in HIA's experience has led to far fewer financial collapses by home builders since 2002 as compared with the past. It has effectively ensured one of the objectives identified by Consumer Affairs Officers in 2002, that of consumer confidence.

Does HWI Reduce Housing Affordability?

HWI premiums are a minuscule part of a new house price, and have been falling as a proportion of that price for the last 7 years. HWI premiums have actually improved housing affordability over the last 7 years, by contrast with increases in government taxes, charges and levies on housing, which have significantly reduced affordability over the years

Corporations Regulation 7.1.12(2).

HIA notes that this Regulation removes HWI from the scrutiny by APRA of insurance products and their sale. However, HIA in 2001-2 lobbied strongly in favour of APRA regulation, meeting with the then Treasurer, APRA and the Insurance Council of Australia on this point. HIA is not aware of the reasons why its submissions were rejected and this Regulation made. HIA continues to advocate APRA regulation of HWI.

Other related issues

HIA notes that there has been a campaign on the part of the Builders Collective of Australia Inc and some individuals to paint the current HWI regime and HIA's role in it as 'misleading and deceptive conduct'. These claims have been made in complaints to the ACCC, VCAT, NSW CTT, and the Victorian Small Business Commissioner, among others. In every case the complaints were investigated but not upheld.



This has not stopped the flow of intemperate and sometimes scurrilous accusations, including some made under Parliamentary Privilege. Over the years, HIA has offered to meet with more responsible critics such as ACA / Choice Magazine in order to more fully inform them about the matters complained of, but invariably these offers have not been taken up. After criticism by a representative of the Tasmanian Greens, HIA also wrote to Senator Bob Brown with a similar offer, but disappointingly has received no reply.

Why Government Schemes Are Not The Best Option

Queensland is the only jurisdiction that maintains a government run HWI scheme.

Government-run schemes fail because their inherent conflicts of interest ultimately make the scheme expensive and unmanageable. Queensland's scheme is more expensive than any other state. It will get even more expensive given the recent collapse of the Real Property Group.

The factors contributing to Queensland's higher costs are as follows:

Insurance Offered Without Analysis of Risk:

Under the Queensland system all builders are entitled to as much insurance as they desire and all builder's are charged the same premium. Professional builders pay for those who could be classified as less professional.

Licensing Relied On To Regulate Solvency:

In theory, the licensing system culls bad builders. But this doesn't manage the risk of bankruptcy. It penalises builders for non-compliance and weeds out those who cannot build. It does not ensure financial viability. It manages workmanship, not risk of collapse.

Inefficient risk management:

The QBSA has introduced complex reforms to attempt to manage the risk in other, less effective ways. For example, all directors of building companies are personally liable under the QBSA Act to pay for insurance debts, costs of doing work and fines, without signing any guarantee such as may be required in some cases by private insurers on other States.

Conflicting Roles in Resolving Disputes:

QBSA not only provides insurance and regulates licences it also represents consumers in disputes with builders. This is neither appropriate nor desirable because of the inherent conflicts of interest. State regulator/licensing bodies must be responsible for resolving disputes. When the role of regulator and insurer are fused there is moral hazard, since a finding in favour of one party or the other will have direct financial implications for the regulator/insurer. One of the major reasons for the decline and ultimate demise of the Housing Guarantee Fund in Victoria and the New South Wales Building Services Corporation was exactly this conflict of roles.

All of these problems are highlighted in QBSA's evidence to this inquiry in relation to its management of the Real Property collapse, the largest builder collapse in Australia in recent years. On the QBSA's evidence it was aware of Real Property's difficulties and had been monitoring them



for 18 months. It had access to financial data, was receiving advice from insolvency experts, and even claimed to know the date on which the company would go into liquidation. The QBSA even became involved in real property's day-to-day management. It suggested measures for improving the company's financial performance, including closing sales offices sacking sales staff and reducing overheads. It recommended these steps under threat of cancellation of licence.

Can HWI be improved?

The complaint against HWI is that it is triggered too late. That is, the consumer must exhaust all other legal avenues for forcing the builder to rectify faulty work before the insurer will accept a claim.

While the cover is effective in cases of bankruptcy or insolvency, it is of little assistance where the builder refuses to rectify faulty work. The cost of enforcement can exceed the cost of the defect, neutering the perceived benefit of the insurance.

The key to reforming HWI therefore is to provide an earlier trigger. However, any form of first resort insurance will be expensive, potentially prohibitively so.

First resort HWI is expensive because it insures the consumer against an additional and entirely unmanageable risk: the risk of obtaining and enforcing a court order that work is defective.

HWI is not legal fees insurance. It is designed to insure a consumer against the risk of their builder going bankrupt or otherwise failing to complete work, including rectifying defective work. It is priced accordingly. HWI cannot rectify the deficiencies of the justice system. The risk of obtaining and enforcing a court order is not one the insurer can realistically insure.

HIA discussions with insurers about ways to improve HWI without increasing costs indicate that HWI insurers are not willing to provide insurance that is triggered simply because a builder has been ordered to rectify faulty work and failed to do so. This is because of the moral hazard involved. However, insurers would be willing to provide insurance that is triggered upon cancellation of licenses. This creates new challenges, since cancellation of licence is a serious issue that needs to exhibit high standards of natural justice.

'Revamping' HWI, therefore, means implementing a fair dispute resolution process that, while being speedy and low cost, nevertheless provides a reasonable basis for removing from the industry those who simply refuse to comply.

The principles of a better dispute resolution process

Alternative Dispute Resolution (ADR) means different things to different people. In technical terms it means anything other than a court. It includes mediation, conciliation, and arbitration. But just recommending that disputes be determined in some other way than a through a court is not the answer.

As noted above, the building industry needs a dispute process that provides a reasonable basis for removing from the industry those who fail to comply. Mediation, while a useful part of any process,



does not provide a basis for revamping HWI. You can hardly cancel someone's licence and trigger warranty insurance just because they have failed to agree.

An appropriate dispute resolution mechanism would demonstrate the following three principles and their related sub-principles.

Principle 1: Segmentation of Disputes

It would separate contractual disputes from factual disputes about defects. Contractual disputes are arguments about the terms of the contract rather than the quality of the work. It includes disputes about agreed variations and alleged misrepresentations. Factual disputes are disputes about whether work is defective or not.

It is a mistake to treat both types of disputes in the same manner through some kind of quasi-court arbitration process. These processes are either rigorous (and so become as delayed and unwieldy as traditional courts), or they become so quick and dirty that there is little confidence in their ability to deal appropriately with legal issues (and over time lose all consumer and industry support).

This problem can be solved by applying different processes to different types of disputes.

Deal With Contractual Disputes Through The Courts

Contractual disputes should be heard by courts because they deal with issues of contractual rights, equity rights such as *quantum merit* claims, and breaches of the Trade Practices Act, such as claims of misleading and deceptive conduct.

Deal With Defect Disputes Through Expert on-Site Arbitration

On the other hand, factual disputes about whether work is defective can and should be determined through on-site expert arbitration. A person with appropriate qualifications and training should be empowered to make binding determinations about whether work is defective and how long it should take for that defect to be rectified. Such a process would take days and not weeks or months.

Principle 2: Ensure the System Is Independent and Fair

It is crucial that all parties – builders, consumers, and insurers - have faith in the independence and integrity of the dispute resolution process and its outcomes. This implies several sub-principles.

Not Overseen By Consumer Affairs

The process must be independent of consumer affairs agencies. Such agencies may be advocates for consumers within the dispute process but they should not be the arbitrator or the regulator. The process needs to be overseen by the justice or the building regulation machinery within the relevant government.

Agreed Definition Of Defect

To underpin the integrity of the system, what is a 'defect' needs to be defined and clearly understood. Imperfect work is not necessarily defective work. Disputes often arise because working in open environments with living materials inevitably means work can be perceived as imperfect.



The appropriate way to define 'defect' is through a standard guide of tolerances. This guide would prevent the expert arbitrator from substituting their own view of workmanship standards for the acceptable standard.

Open To Builder's To Initiate

Finally, the process needs to be equally a mechanism for builders to resolve disputes with consumers, and not just a consumer initiated process. This can avoid later misunderstandings and intractable disputation between the parties.

It is simply not true to say that the builder always has power in the relationship. Laws that limit the amount a builder can charge for deposit and the timing and quantum of progress payments mean builders are always working at a loss.

Small builders in particular rely on the final payment to cover expenses and make profit. Consumers have the power to award themselves a discount simply by withholding the final payment because of alleged defects and trusting that it will never be worth the builder's while to pursue them.

Builders need protection against this form of economic hold-up. They need a process for challenging bogus claims of defective work, and for enforceable orders that money owing should be promptly paid.

Principle 3: Rights of Appeal As Speedy As Initial Decision

Any dispute process that potentially results a person losing their livelihood will need a right of appeal.

The tendency here is for appeals to be handled by some form of Tribunal. It makes the appeal process as unwieldy as the court process it was designed to replace, and undermines the purpose and intent of having a speedy, expert arbitration.

Instead, the appeal process for factual disputes about defects should involve a review of the site by further experts, either a panel or a more senior expert designated for that purpose.

Assuming the above criteria are met, it would be reasonable and practical to tie the dispute resolution process to HWI.

If through a fair and independent process a builder's work has been declared defective and that work has not been rectified - despite appeal rights being exhausted or not activated - then it would be fair and reasonable to cancel the practitioner's licence and trigger warranty insurance.

Such an outcome would deliver better consumer protection, protect the integrity of the licence system, and insure premiums are kept low by excluding demonstrably shoddy practitioners from the market.



However, reaching this point relies on a willingness to comprehensively review the way the risk of defective work is managed together with the costs and benefits of different regulatory mechanisms. It is a lot more involved than simply revamping HWI.

Conclusion

It is HIA's position that a dispute resolution process is logically separate from the insurance process and that dispute resolution should be the responsibility of the appropriate government regulatory body. It is also HIA's position that insurance is best provided by free and fair competition in the private marketplace.

At present, the private insurance market is working very effectively to provide the required level of statutory cover, which provides real and important protection for consumers, at an affordable price. The market is informed as to the prices and the product is a standard one so that comparisons and choices can easily be made. Price competition in the private market is providing consumers with significant savings on their home purchases compared with the position in Queensland.

Recommendation

HIA considers that there is no justification in State Governments taking home warranty insurance back under their control, and HIA believes that the Governments concerned share that view. Disputes are essentially juridical in nature and are best handled by governments, while insurance is basically commercial in nature and best handled by commercial organisations operating within a fair competitive marketplace.

However, we consider that State Governments could take a more pro-active position in regard to the introduction of a more robust and accessible dispute resolution process for home buyers and home builders. Such a dispute resolution process could be expressly linked to trigger HWI if failure to comply with the process leads to licence cancellation. This would have the effect of transferring the burden of pursuing a defaulting builder from consumers to the government licensing agency. In HIA's view this would address the main area of current consumer complaint about HWI without losing the advantages of the current system.