



Institute of Actuaries of Australia

Builders' Warranty

First resort or last resort or does it really matter?

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Abstract

The builders' warranty market has come under intense scrutiny in most jurisdictions in recent years and particularly after the collapse of HIH. The debate has typically been emotive with various stakeholders vehement in defending their point of view. Interestingly, one stakeholder that has not been widely heard from is the consumer.

This paper provides:

- Details of what and who builders' warranty insurance covers
- A summary of the various builders' warranty schemes and their recent history
- The key similarities and differences in the operations of the various jurisdictions
- A discussion about the pro's and con's of first resort and last resort builders' warranty schemes
- Details of the requirements for successful first resort and last resort builders' warranty schemes
- A discussion about the role of actuaries in guiding the debate and their obligation to consumers (if indeed, there is an obligation).

The views expressed in this paper are my own and do not necessarily reflect those of any other living person (not that I am implying a conspiracy whereby all others with my view have been eliminated).

Keywords: builders' warranty insurance, first resort, last resort, insurer, monopoly, consumer

1. Executive Summary

This paper covers issues relating to builders' warranty insurance. The various sections are:

- What is Builders' Warranty Insurance
- Builders' Warranty Around Australia
- Review of the Reviews
- Builders' Warranty Scheme Design
- What About the Consumer?
- Conclusions
- Disclaimer and Recognition
- References.

That's it! There's too much summarisation in this world and too little recognition of the detail. If you're really struggling for time then read the conclusions. If you don't like them then read the detail. If you don't like that then join the queue – at least you will have confronted the broad range of issues faced!

2. What is Builders' Warranty Insurance?

2.1 Nature of insurance

Builders' warranty insurance (BWI) is designed to protect consumers against any sub-standard work by a contracted builder. It is compulsory in all Australian states and territories (although not compulsory in the Northern Territory until 1 January 2006) for any residential building works worth more than the state/territory's minimum threshold (this threshold varies between jurisdictions and is discussed in Section 3). Essentially, once a builder is contracted to a job, the builder will take out a policy with an insurer and indirectly charge this premium to the homeowner. A builder cannot legally undertake works valued above the jurisdiction's minimum threshold without a BWI policy and cannot commence works before providing the homeowner with details of the insurer who is underwriting the risk.

Owner builder insurance is a similar cover provided to owners who use sub-contractors or undertake the building works themselves and provides cover to subsequent owners. The availability and restrictions on owner builder insurance are policy decisions and need to consider the interaction between builder and owner-builder cover (i.e. strict restrictions in one insurance could see a switch to the other insurance). The proportion of builders' warranty policies that relate to owner builders can be substantial meaning that owner builder cover is a necessity if all domestic buildings are to be covered for builders' warranty. Owner builder insurance is not considered further in this paper.

2.2 Who is covered?

Builders' warranty insurance protects homeowners against financial loss arising from defective or incomplete works by their builder. As such, a BWI policy exhibits similar characteristics to a compulsory third party personal injury insurance policy, whereby the recipient of the benefits is not the person who takes out the insurance policy and the insurance is compulsory. This contrasts with typical insurance policies where the purchaser of the insurance is the recipient of any insurance payout and the insurance is not compulsory.

In summary:

- standard insurance policies are triggered following an accident or specified event
- builders' warranty basically provides cover for repair costs incurred by a homeowner arising from faulty workmanship by a builder. It has similar aspects to a standard product warranty (such as a motor vehicle warranty or a white goods warranty) where cover is provided for repair costs arising from faulty workmanship in a vehicle or product.
- builders' warranty could cover all claims where the owner proves defective work (first resort), or could cover only claims where the builder is unable to complete the work because they are dead, disappeared or insolvent (DDI) (last resort), or a level of cover somewhere in between the two. In Australia, several States have changed from first resort to last resort following difficulties arising from the lack of availability of cover from insurers.
- the first resort system is more like a warranty product since claims are paid when defects are identified; the last resort system is more like an insurance product since claims are only paid upon a defined event (e.g. a defect is identified and the builder is DDI)
- in order to be sustainable, warranty style covers require the manufacturer (or, in this case, builder) to be held accountable for poor quality products thus providing an incentive for builders to maintain the quality of their work. This could also be achieved by an adequate licensing process

- insurance style covers must revolve around a defined event (such as a builder being DDI). An event that is not clearly defined will result in debates regarding the liability of the insurer to pay for various events.

While the nature of builders' warranty creates differences to "standard" insurance policies, potentially the major impact results from its compulsory nature. By being compulsory, there are implications on the availability and price of the insurance that are not relevant in non-compulsory schemes. If the insurance is not available then builders cannot undertake building works. If the cost of the insurance is prohibitive then there is incentive for builders to find alternative ways of providing the service (e.g. as a contractor to an "owner builder").

2.3 What is covered and when?

There are three causes of financial loss that a BWI policy will generally protect a homeowner against –

1. *Incomplete Works*: In the event that a builder cannot complete a job as a result of insolvency or simply refuses to complete the building (in a first resort scheme), the warranty policy provides financial assistance to the homeowner to have the work completed by another builder.
2. *Structural Defects*: Any structural defects to the property arising from sub-standard building work are covered for a period of around six years (this term varies between states) under a warranty policy. Throughout this period, a builder is required, where possible, to return to the insured property and repair such defects. What constitutes a structural defects can be difficult to precisely define (e.g. the Victorian definition includes "results in, or is likely to result in physical damage to the building or any part of the building", which is arguably a very broad coverage)
3. *Non-Structural Defects*: Refers to problems arising as a result of sub-standard building work that does not relate directly to the structure or frame of the house. Plastering and painting are examples of non-structural works. In some states, the period of cover is only two years, as opposed to the six years of cover for structural defects.

When or whether the above items are covered varies depending on the legislation of the jurisdiction. As a general rule, each item is covered as long as the builder is dead, has disappeared or is insolvent (known as DDI). In some cases, coverage extends to all defects of incomplete work regardless of whether the builder is still operating or not. In addition to the above, there are typically dollar limits on claim amounts and time limits within which a claim can be made. Details of the various schemes around Australia are provided in Section 3.

It is worth noting that a BWI policy does not cover the consumer for poor finishing where the issue is within the tolerance of building standards (e.g. small gaps between the skirting boards and floorboards). The coverage relates purely to the soundness of the building works. To some extent it doesn't matter how bad it looks, as long as it won't fall down!

2.4 First Resort versus Last Resort – in theory

Builders' warranty schemes are typically classified as being either a first resort or a last resort system. In theory, the coverage of first resort and last resort systems are quite different with a last resort system being a subset of a first resort system.

A last resort system refers to the situation where the insurance coverage exists only once all other avenues of recovery or rectification have been sought. Thus, under a last resort system, claims are only covered once the builder is DDI. If the builder is not DDI then the owner must deal with the builder to get the problem fixed.

Under a first resort system, the owner reports claims to the insuring body. The insurer then deals with the claim and either ensures that the builder completes or repairs the building works or pays for the required work to be completed and then seeks recovery from the offending builder.

Put simply, a first resort system is where claimant's first port of call is the insurer and it is the insurer's "responsibility" to solve the dispute. Under a last resort system the insurer is only involved where the builder is DDI.

Why "in theory"?

The theoretical models of first resort and last resort are clearly different. This difference can become less clear when the systems are actually put into place. It is often claimed that first resort systems introduce claim management techniques to reduce the number of complaints that are dealt with as claims. Errors in the assessment of complaints can then lead to claims being denied that appear to be legitimate first resort claims. Small claims may also be denied and claimants instructed to resolve the issue directly with the builder.

Jurisdictions with last resort schemes will generally provide a dispute resolution mechanism to assist consumers and builders to resolve disputes. Thus, while the insurance coverage does not apply, the jurisdictions provide a means for claims to be resolved.

The two examples above could end up producing quite similar results, although coming from either side of the spectrum.

Given the ability for a range of coverage within first and last resort systems, whether a scheme is first resort or last resort is not prescriptive enough to determine the adequacy of the scheme. The scheme needs to be considered as a whole, taking into account the full range of claim notification, dispute management and claim payment as well as the builder licensing and registration. These issues are considered in more detail in Section 5.

2.5 Long-tail nature and link to building cycle

Important aspects to understand in relation to BWI are its long-tail nature and strong link to the building cycle.

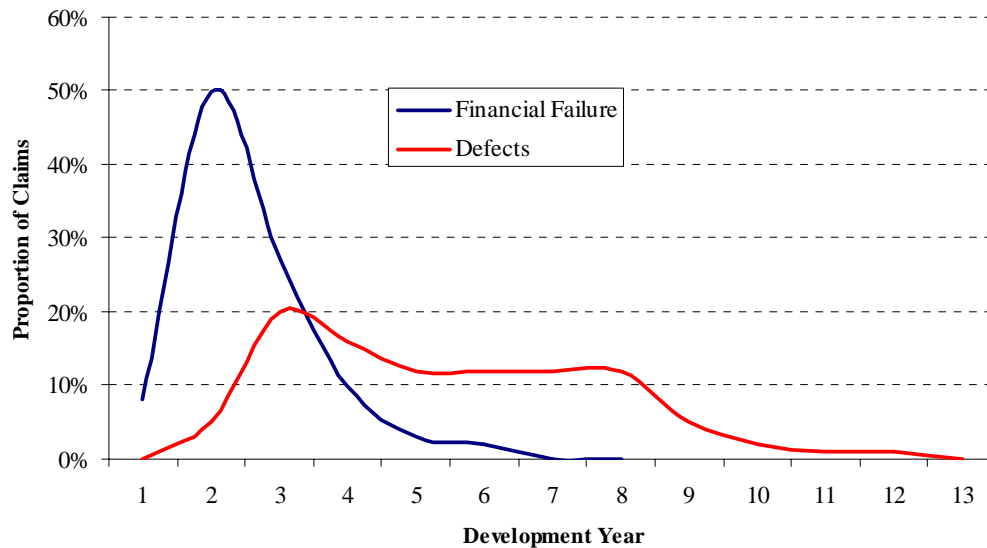
Long-tail nature

BWI covers claims for around 6 years following the completion of building. Delays in building and settling claims can mean that payments in relation to a particular year are still being made 10 years after the policy was issued. This in turn means that it takes several years before the ultimate cost of an underwriting or generation year can be known with any certainty.

One of the main consequences of long tail lines of business is that deteriorations in claims experience can take some years to materialise and, if they are not properly monitored, can have a sizeable impact on the feasibility of the scheme. For example, if reserves were built up at a 60% loss ratio for 4 years and it was then discovered that the underlying loss ratio was 85%, then the best part of a full year's premium would be required to be added to the reserves. This could have a devastating impact on the capital base supporting the business.

To highlight the delay in settlement of claims, Figure 2.1 shows the payment pattern experienced under the HGF scheme.

Figure 2.1 – HGF Payment Pattern



From Figure 2.1:

- Financial failure claims are predominantly paid in the first couple of years from the commencement of the policy with some payments (typically relating to disputed claims) taking around 4 years to settle over 95% of claims
- Defects claims take considerably longer than financial failure claims to be paid reflecting the delayed nature in the recognition of defects. After a build up over the first 3 years, payments are relatively consistent for development years 4 to 8 and decline reflecting the end of the warranty period.

The patterns observed in Figure 2.1 relate to the HGF which was a first resort scheme. Payment patterns could differ under a last resort scheme but the underlying difference between financial failure and defect claims will remain.

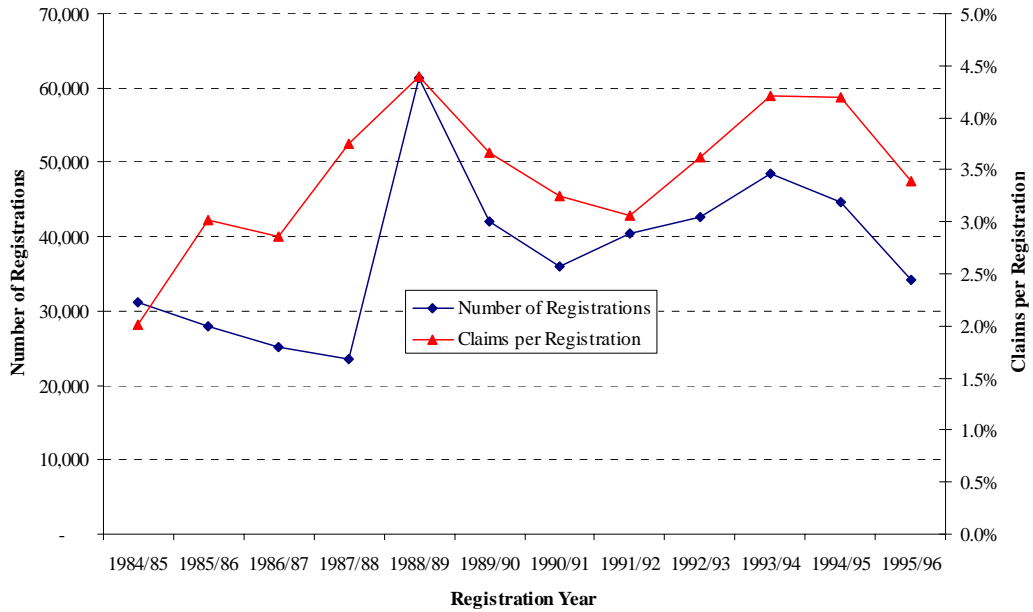
Link to building cycle

Links to the building cycle are inevitable. When there is plenty of work available, builders have access to income that can enable them to remain solvent. In the case of some builders, the high demand leads them to “cut corners” so that they can move onto the next job. When a slow down in the building industry occurs, builders surviving on cash flow are hit the hardest and history shows that significant numbers of builders become insolvent. On top of the insolvencies, the short-cuts taken during the good times are being identified as defects. Both of these factors lead to high builders’ warranty claims costs.

In general, the cycle would be expected to be greater for last resort systems than for first resort systems since many of the defect claims associated with an insolvency would be reported prior to the insolvency under a first resort scheme. There is some potential that the earlier reporting of the defect claims would lead to a poor builder having restrictions placed on building activity and financial capacity.

Figure 2.1 shows the number of building registrations and the claims per building registration for the life of the Housing Guarantee Fund in Victoria.

Figure 2.1 – Registrations and Claim Frequency for the Housing Guarantee Fund Limited



From Figure 2.1 it can be clearly seen that there is a strong correlation between building registrations and claim frequency. Not only do high building registrations result in more claims but the number of claims per permit tends to be around 50% higher than during periods with a lower level of building activity. This correlation supports the theory that the quality of building reduces in times of high demand.

3. Builders' Warranty Around Australia

The details provided in this section are based on publicly available information. In some cases the word “available” is technically correct, the collection of the data, however, was more akin to extracting hens’ teeth. The comparisons describe some of the broad characteristics of the schemes - there are characteristics that are unique to each scheme that are not covered.

There have been numerous government inquiries into builders’ warranty over the last few years and these are discussed in Section 4. Much of the content of this section has been sourced from those reviews.

3.1 Current State of Play

The size of the building markets around Australia vary considerably in size. Figure 3.1 shows the number and value of residential building approvals from March 2004 to February 2005 as reported by the Australian Bureau of Statistics (ABS).

Figure 3.1 – Number and Value of Residential Building Approvals (3/04-2/05)

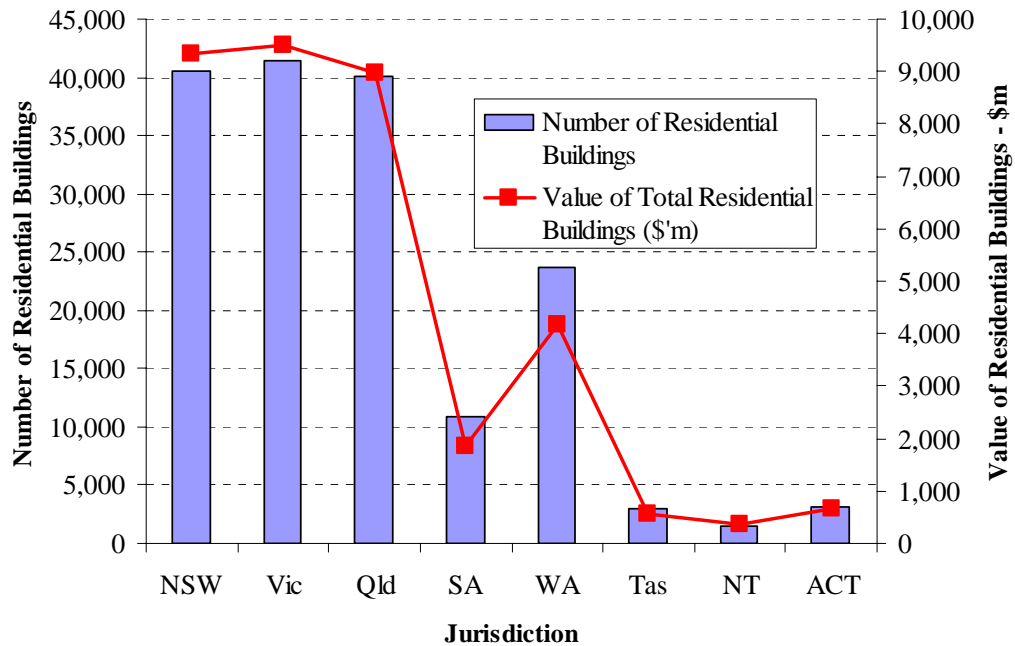


Figure 3.1 clearly shows that NSW, Victoria and Queensland dominate the building market in Australia, each having around 25% of the market. Of the remaining 25%, WA make up around 13%, SA approximately 6% and Tasmania, NT and ACT around 2% each. The Queensland market has grown appreciably in recent years and has approximately doubled since 2000 when Victoria and NSW made up around 75% of the Australian market.

Table 3.1 summarises the key characteristics of the builders’ warranty schemes around Australia.

Table 3.1 – Builders' Warranty Around Australia

	Underwriter	Cover Type	Mandatory Level	Minimum Insurance Cover	Max. Pay-out for Non-Completion	Duration of Cover
NSW	Private	Last Resort	\$12,000	\$200,000	20% of contract	6 years from completion for Structural, 2 years non-structural or 12 months for incomplete work
Victoria	Private	Last Resort	\$12,000	\$200,000	20% of contract	3 months from handover until 6 years from completion for Structural, 2 years non-structural
Queensland	Government	First Resort	\$3,300	\$200,000	\$200,000	6 months from handover until 6.5 years from completion
South Australia	Private	Last Resort	\$12,000	\$80,000	\$80,000	3 months from handover until 5 years from completion
Western Australia	Private	Last Resort	\$12,000	\$100,000	\$100,000	6 years from completion for Structural, minimum 4 months for maintenance
Tasmania	Private	Last Resort	\$12,000	\$200,000	\$200,000	6 years from completion
ACT	Private	Last Resort	\$12,000	\$85,000	\$85,000	6 years from completion for Structural, 2 years non-structural
Northern Territory ¹	Government	Last Resort	\$12,000	n/a	n/a	6 years from completion for Structural

Note: 1. The Northern Territory structure reflects the regulations due to commence from 1 January 2006. The structure up to 31 December 2005 is described in Section 3.2.

The key observations from Table 3.1 are:

- the NSW, Victorian and Tasmanian schemes are almost identical
- SA, WA and ACT are similar to NSW but have different policy limits and durations
- NT is similar to the other states with the key exception that the insurance is provided by the government insurer (TIO)
- Queensland is similar to NSW in terms of policy limits but has a lower mandatory cover level, is first resort and the underwriter is the government.

In broad terms, jurisdictions other than Queensland are similar in that they are last resort systems that have private insurers as the underwriters. Queensland, on the other hand, has a first resort system underwritten by the government.

While Queensland appears to be the odd one out, Section 3.2 shows that this has not always been the case. Recent years have seen a general move away from first resort systems and the privatisation of all markets other than Queensland and the Northern Territory.

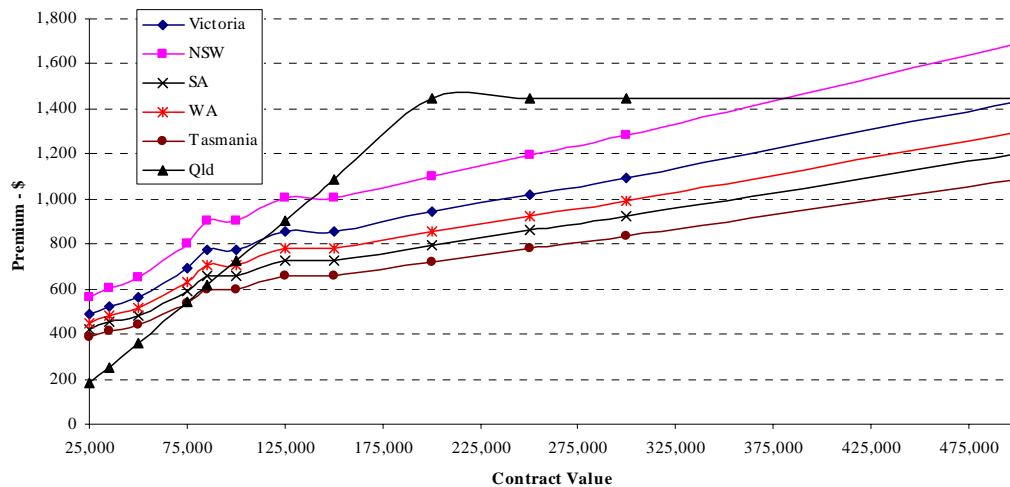
The details in Table 3.1 also only tell part of the story. Items also requiring consideration include:

- The price and rating structure of the insurance policies
- Builder registration/licensing requirements
- Dispute resolution processes and systems
- Allowance for owner builders
- Inclusion or exclusion of multi-storey dwellings.

Comparisons of price and rating structures are quite difficult where private insurers are involved. Naturally the insurers regard their rating structures and pricing as commercially sensitive information. Fortunately for me, one broker makes their standard rates across Australia publicly available.

Figure 3.2 has been derived from the publicly available information noting that the premiums for jurisdictions other than Queensland are likely to represent the base premiums to which loadings are added for builders that pose a relatively greater risk.

Figure 3.2 – Premium Comparisons by Jurisdiction



From Figure 3.2:

- The general shape of the premium curves is the same across all jurisdictions except Queensland (this reflects the fact that the premiums for jurisdictions other than Queensland are from the same source and Queensland premiums are those of the monopoly insurer Building Services Authority, “BSA”)
- The Queensland premiums start lower and rise faster than those of the other jurisdictions. Given that Queensland has monopoly pricing and the premiums for other jurisdictions relate to a single broker, the comparison does not provide any insight into the relative levels of the costs underlying the various schemes
- The kinks in the non-Queensland rates reflect the fact that the same premiums are charged for particular bands of contract value. Queensland premiums are constant for contracts above \$200,000.

One of the key differences in the “shape” of the premiums by contract value is that the Queensland rates level off from around \$175,000 while the premiums for other jurisdictions continue to increase with contract value. Given that there are caps on the maximum payout there is an argument that increasing premiums above a certain contract value is not warranted. The counter to this only holds if the probability and/or cost of claims continue to increase with contract value.

I note that the availability of monopoly pricing in Queensland provides the capability for premiums to include cross-subsidies (between contracts of different value and builders of differing quality/financial soundness) that cannot be accommodated in a privately underwritten scheme (without limitations on rating structures). There are strong arguments for and against cross-subsidies and they exist across most workers’ compensation and compulsory third party schemes. Their existence does not necessarily render the scheme as undesirable. The key is ensuring that the cross-subsidies are deliberate and well understood.

Interestingly, the premiums for the non-Queensland jurisdictions can be more readily compared. Figure 3.3 shows the premiums relative to NSW after removing fixed costs of \$112.

Figure 3.3 – Premiums Relative to NSW (less \$112 fixed costs)

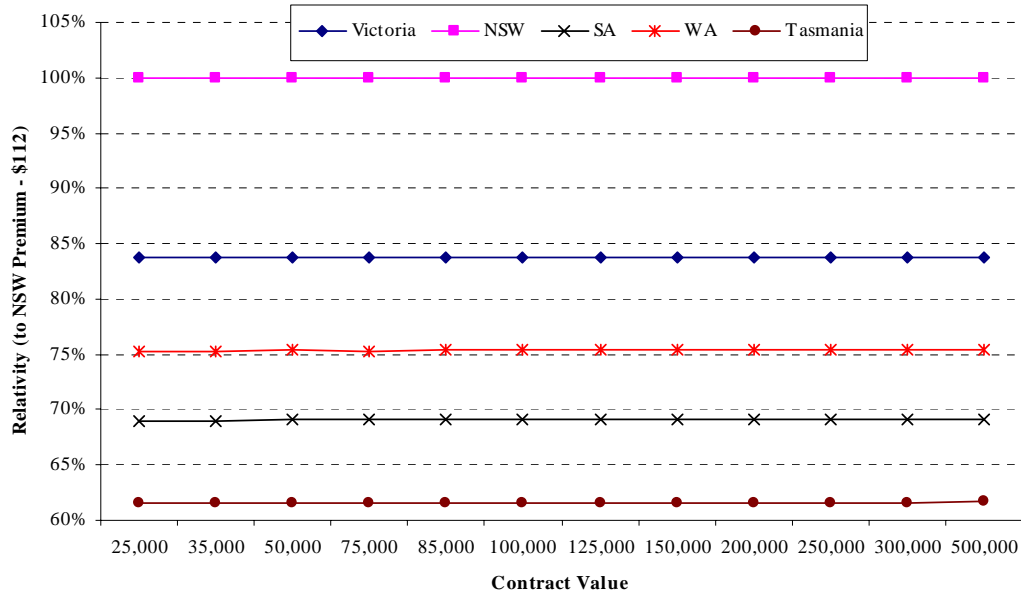


Figure 3.3 shows:

- After the removal of fixed costs the premiums across all jurisdictions are the same relative to NSW
- Victorian premiums are around 85% of NSW premiums
- WA premiums are around 75% of NSW premiums
- SA premiums are around 70% of NSW premiums
- Tasmanian premiums are around 62% of NSW premiums.

Without detailed claims history from each jurisdiction it is not possible to comment on the reasonableness of the relativities shown above. Figure 3.4 compares the premium relativities to the relativities of the December 2004 capital city median house prices. There are numerous reasons why the premium relativities should not be the same as house price relativities. The comparison does, however, provide some context for the premium relativities.

Figure 3.4 – Premium Relativities versus Median House Price Relativities

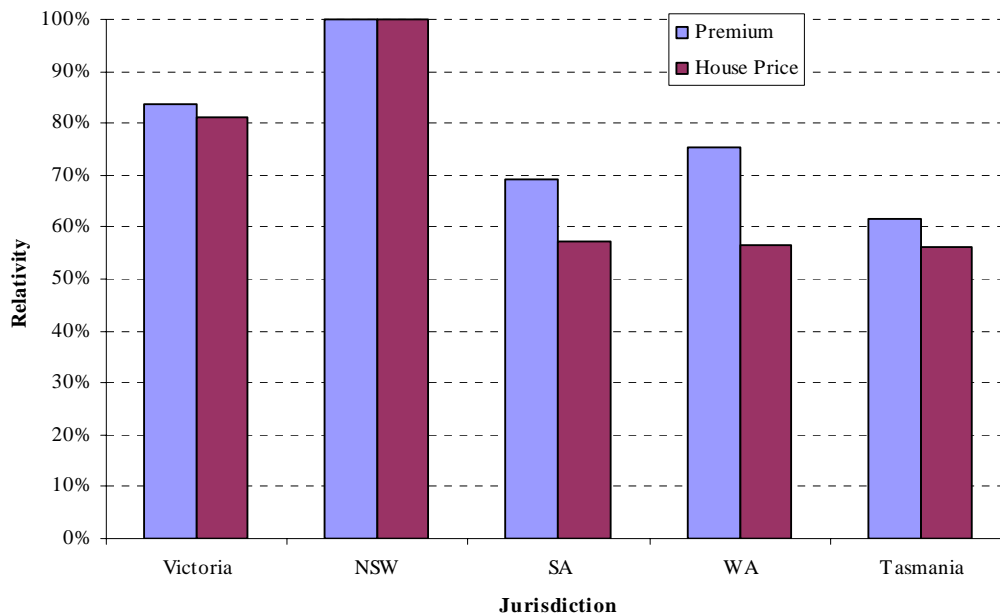


Figure 3.4 shows that the premium relativities are higher than the median house price relativities. This would be expected to reflect the fact that materials and labour costs across Australia are not as variable as house prices, which include a significant land value. The lack of publicly available information means that it is not possible to determine if the relativities across Australia are the same for other insurers.

The premium comparisons above do not take into account the underwriting policies applied by the various insurers. For example, I understand that Vero categorise builders into several categories with the low risk categories offered cover immediately while high risk categories are either rejected, have increased premiums or are required to provide some form of security.

In addition to the problems in obtaining premium data, there is no publicly available information that provides details of the underlying costs of the insurance provided. The schemes in most jurisdictions are relatively new and do not have sufficient history to understand the development pattern of claims with any certainty.

With the HGF and Building Services Commission (BSC – the government monopoly insurer of the pre-1996 NSW scheme) data fading into irrelevance and the BSA keeping tight control over any data, it seems unlikely that there will be any improvement in the ability for the general public to be able to obtain sufficient information to be able to determine whether the price and coverage of builders' warranty insurance is fair and reasonable.

Apart from the cost aspect of BWI, the builder registration requirements and dispute resolution procedures area also key areas of each scheme.

Without observing claims as they pass through a dispute resolution system, it is difficult to comment on the systems efficiency. The dispute resolution systems around Australia vary but have come more into line in recent years. The larger jurisdictions have dedicated tribunals or boards that have the ultimate say in the outcome of each claim. Some, including South Australia, do not have a specific tribunal and the consumer is required to go through the normal court system.

Each jurisdiction has a government department that receives disputes from consumers, however the level of dispute management appears to differ considerably. For example, South Australia appears to provide a service to assist consumers progress their dispute through the various stages, while Queensland provides a service to directly assist consumers resolve any dispute.

In terms of builder registration, there appears to be a key difference between registration and licensing. The privately insured jurisdictions apply a registration approach whereby a builder is required to have particular skills and/or qualifications. Upon doing so, the builder can be registered.

This is quite different to the case in Queensland where builders are required to be licensed. Builders must not only meet knowledge and qualification criteria but must also meet defined financial criteria.

As a general rule, licensing would be expected to be required to be undertaken on a more regular basis than registration.

It is my view that the much of the problem with builders being unable to obtain insurance cover in the privately underwritten jurisdictions reflects the fact that builders are registered and not licensed – thus the insurer is required to make the assessment about the financial viability of the builder (with no minimum standard applied to those registered).

3.2 History of schemes in each State/Territory

The history of schemes throughout Australia has not been as varied as other types of compulsory insurance such as workers' compensation and compulsory third party. That said, there have still been considerable changes over time. Each of the jurisdictions is described below.

Victoria

Compulsory builders' warranty insurance began in Victoria in the early 1970's run by two privately run organisations and was taken over by the government-owned Housing Guarantee Fund (HGF) in 1983. The HGF provided first resort cover up to a maximum of \$40,000 and provided dispute resolution and builder registration services. This effectively meant that the HGF had the power to refuse future registration of a builder unless defects were repaired or the cost of repair reimbursed. Coverage was for seven years from the earlier of the issuance of a building permit or the signing of a building contract.

In 1996 as part of the "Kennett/Stockdale privatisation party" the HGF was moved into run-off and the underwriting of builders' warranty was placed in the hands of private insurers. The general nature of cover was the same as under the HGF (i.e first resort) although the limits of cover were increased.

Following the collapse of HIH (a dominant underwriter in Victorian builders' warranty and the straw that broke the camel's back) the first resort scheme was altered to be an insurance of last resort, whereby the insurance was only required to pay for claims where the builder was DDI. At the same time, the maximum payment for any claim was increased though the terms for lodging claims were altered (largely to reduce the time permissible to lodge structural defect claims) and buildings with more than 3 stories were excluded from compulsory cover. These changes came into force from 1 July 2002 and are those currently in place.

New South Wales

Builders' warranty insurance was first introduced in NSW in 1972 as a government-run scheme. In 1987 the Building Services Corporation (BSC) was established to run the government-backed scheme, which was a first resort scheme. Coverage was for seven years from for major structural defects, three years for general defects and based on the commencement date of the building works.

In 1995, the BSC was integrated into the Department of Fair Trading and in May 1997 a privately insured builders' warranty scheme commenced, which was similar to the government-backed scheme and still first resort. Following the collapse of HIH and the withdrawal of some insurers from the builders' warranty market, the privately underwritten scheme was changed with the key changes being:

- the scheme became last resort rather than first resort with claims limited to DDI
- the period of cover was reduced from 7 years for all major events to 6 years for structural defects and 2 years for non-structural defects
- cover for default was limited to 20% of the contract value (up to \$200,000) rather than the \$200,000 limit overall
- buildings with more than 3 storeys were excluded from the requirement of compulsory cover.

Queensland

In brief, the Queensland builders' warranty system is a monopoly scheme managed by the Building Services Authority (BSA). The Authority licences builders, manages the insurance scheme (collecting premiums and paying claims) and manages disputes between consumers and builders. As such, the BSA has complete management of all aspects of the Queensland builders' warranty system.

Builders' warranty commenced in Queensland in 1977 being introduced by the Builders' Registration Board. The BSA was established under the Queensland Building Services Authority Act 1991 and has underwritten builders' warranty since that time.

The Queensland builders' warranty system provides insurance coverage on a first resort basis whereby a claim is paid if the consumer cannot otherwise get the builder to rectify the problem (and a legitimate claim is made). Payment of the claim is independent of the solvency of the builder and the BSA may seek recovery of costs from the builder. The BSA provides a dispute management service which aims to resolve the dispute prior to a claim being paid.

Apart from some technical differences in the level of cover and the requirements for cover, the Queensland model is similar to the Victorian scheme, as managed by the Housing Guarantee Fund (HGF), prior to the 1996 changes.

South Australia

Statutory builders' warranty insurance was introduced in South Australia in the early 1980's and was underwritten by a panel of private underwriters. As far as I can discern, South Australian builders' warranty has remained last resort privately underwritten scheme throughout its existence with relatively minor (compared to the other jurisdictions) changes made along the way.

From 1 September 2002, builders are no longer required to take out a BWI policy for buildings that are over three storeys and contain 2 or more separate dwellings or units. This is in line with the changes made in NSW and Victoria.

Western Australia, Tasmania, ACT

Very limited information was obtainable about the history of the Western Australian, Tasmanian and ACT schemes.

The current BWI system in Western Australia came into effect from 1 February 1997 and hence has been running for over 8 years.

The current system in Tasmania commenced on 20 November 2003. Prior to that time, Tasmanian builders warranty was first resort with a minimum threshold of \$5,000 and insurance coverage up to \$50,000.

No historical information regarding the ACT scheme was readily available.

Northern Territory

From 1 January 2006, a compulsory last resort scheme similar to that operating in NSW and Victoria will commence. Prior to then, the system is a last resort scheme underwritten by the government insurer TIO and is not compulsory. While the current Northern Territory system is underwritten by the government, it is not due to legislation but rather lack of interest from private insurers.

3.3 Comparison of various schemes

The various builders' warranty schemes around Australia have come very much into line over the last few years, which makes this section far easier to complete. The alignment of the schemes is quite different to other compulsory forms of insurance such as workers' compensation and compulsory third party insurance. With the exception of Queensland, each jurisdiction provides last resort cover that is privately underwritten – there are differences in the cover limits, exclusions and duration of cover, although these are relatively minor. The Queensland system remains a government-backed, first resort scheme.

There is currently some debate as to the level of first resort payments being made by the BSA with several observers highlighting situations where the BSA has tended to deny claims rather than paying the consumer and seeking reimbursement from the builder. In particular, recent news articles in *The Courier-Mail* have suggested that several consumers have not received payment for what appear to be legitimate claims and that this represented a change in procedures by BSA. Possibly, BSA may claim these are simply irregularities in the insurance arrangements and do not represent a change. In any event, this highlights the need for a claim resolution service.

The limited publicly available information in relation to the BSA means that the extent of these procedural changes by BSA is unclear as is their impact, if any, on recent financial performance.

The fact that most schemes are privately underwritten makes the comparison of claim rates, average premiums, financial performance, etc. impossible.

As mentioned in Section 3.1, one of the key differences between the various jurisdictions is the requirement placed on builders for registration or licensing. The more onerous licensing approach (as used in Queensland) provides a greater assurance that builders will not become insolvent. From the information available, it appears that all other jurisdictions apply a registration approach.

In terms of dispute resolution, NSW, Victoria, Queensland, Western Australia and Tasmania have dedicated building disputed tribunals or boards. The remaining jurisdictions legal redress is only available through the civil courts.

Builders' Warranty – First resort or last resort or does it really matter?

Unfortunately for me, the convergence of the builders warranty schemes over recent years means that views about the merits of the variety of types of builders' warranty schemes are largely irrelevant because governments across the country have locked themselves into the schemes that they have "created" and it would take either a change of government or another insurance company failure to change the way builders' warranty insurance is provided.

4. Review of the reviews

4.1 Government Reviews

There have been a number of government (state and federal) reviews of the domestic building market and builders' warranty in particular. At the risk of over-simplifying the situation, to the extent that the reviews have looked into builders' warranty, they have largely had the same sorts of limitation – largely based on the scope of the review in the first place. A complete review of the reviews would be a paper in itself. The assessment of government-backed first resort schemes is considered as part of this paper.

The main reviews into builders' warranty in recent years are:

- National Review of Home Builders Warranty Insurance and Consumer Protection prepared for the Ministerial Council on Consumer Affairs by Professor Percy Allan, June 2002 (the Allan report)
- NSW Home Warranty Insurance Inquiry by Richard Grellman, September 2003 (the Grellman report)
- Reform of Building Regulation by the Productivity Commission Research Report, November 2004 (the Productivity Commission report)
- Housing Regulation in Victoria: Building Better Outcomes (a draft report for further consultation and input) by the Victorian Competition and Efficiency Commission, July 2005 (the VCEC report).

In addition, there is a report in response to the Allan report by a Working Party of the Standing Committee of Officials of Consumer Affairs in November 2002.

Tasmania has recently commenced a review into builders' warranty requesting submissions in an issues paper prepared by the Tasmanian Justice Department, Consumer Affairs and Fair Trading in April 2005. The results of that review are timetabled to be provided to the Attorney-General in October 2005. It will be very interesting to see the outcome of the Tasmanian review. The issues paper appears to address the real issues facing builders' warranty and the questions asked give the impression that all options are on the table for consideration. Having said that, I would be extremely surprised if a government-backed first resort scheme was recommended, given that the Tasmanian scheme is currently in line with most of the schemes around Australia.

The various reviews have broadly similar recommendations and have a tendency to utilise the observations of preceding reviews. To some extent, this means that the Allan report carries a great deal of weight.

Many of the observations and conclusions of the Allan report are, in my opinion, sound. This includes one of the core conclusions being "...that reducing building faults, disputes and claims has more to do with the regulation of the building process than with the ownership and market franchise of the HBWI insurer". There is, however, one element of the review that I consider requires further comment.

For the reason stated in the sentence quoted above, the Allan report goes on to state that "...this report focuses on what can be done within the existing (mainly private) ownership and (mainly competitive) market structures to achieve better insurance outcomes. This is also consistent with the National Inquiry's terms of reference which require it to:

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

In effect, the report did not give consideration to a government-backed monopoly scheme as its terms of reference did not provide the scope to do so. This in turn has implications for the view of a first resort scheme.

The report comments on first resort schemes on several occasions:

- “If the builder is still trading the homebuyer may lodge a HBWI claim in states with “first resort” insurance schemes, but as we shall see later the chances of being paid out are slim unless they have exhausted other avenues of dispute resolution.”
- “In practice, however, insurers expect a homebuyer to exhaust all other avenues of appeal before claiming on their insurance policy. Effectively “first resort” is little different to “last resort” except that it results in homebuyers having false expectations about their insurance rights.”
- “Should governments try to enforce “first resort” legislation, private insurers would quickly withdraw from the market. As mentioned later the sooner some governments end the cruel hoax of “first resort” insurance the sooner consumers will come to accept that homebuilding is not insured in the same way as motor vehicle, house and contents or medical and hospital treatment.”

These statements need to be considered in context. They are largely based on first resort schemes that operated at the time of the review where the insurance was provided by private sector insurance companies. The issuance of first resort cover by a government-backed monopoly scheme was not, as mentioned above, considered as an option.

In general terms, I agree with the Allan report quotes above. I do not, however, consider that first resort insurance cannot be viable. With a suitable link between builder registration and builders' warranty insurance a first resort scheme would be viable – this is most likely to be able to be achieved via a government-backed monopoly, particularly given the experience of first resort schemes with private insurers in NSW and Victoria.

Why harp on this point when it is clear that the Allan report did not consider the option of a government-backed monopoly scheme? Only because of the points made earlier – that the various reviews have tended to rely on the observations of the reviews preceding them and/or the scope of the inquiry limits the ability of the review to fully consider a government-backed scheme.

The Grellman review dismissed first resort and government-backed monopolies with statements such as:

- “As a government scheme in New South Wales would be unlikely to deliver either a “first resort” product or insurance for all builders, then this option cannot be regarded as panacea.”
- “... the creation of a government monopoly appears insupportable when private sector insurers are willing to provide an equivalent service.”
- “...lack of consistency with Victoria and time to implement with instability and uncertainty in the meantime.”

Based on the above, there was no chance of the NSW Government adopting a government scheme. Hence, the review was constrained in its assessment of whether a government scheme should be considered. Issues with the arguments above include:

- no reason is given as to why a first resort scheme would not be considered by the government. In fact, the whole idea of a first resort scheme is barely considered
- the report indicates that private insurers would not be willing to provide first resort cover and other reports have stated this explicitly. Hence, if first resort cover was offered then a government monopoly is not insupportable

- the current (at the time of the report) instability and uncertainty was the reason the review was undertaken in the first place and it therefore seems an interesting choice for a reason for not adopting a new model
- consistency with Victoria is an amusing reason given that Victoria was looking to the outcome of the Grellman report to assist in its decision on how to fix the builders' warranty "crisis". If each jurisdiction is not willing to change because it wants to be consistent with another then there will never be any change. A classic chicken and egg scenario (or is that egg and chicken?).

The Productivity Commission report avoided making any direct comment about the relative merits of the manner in which the insurance is provided. It does state, however that "...interdependencies across the regulatory system for building mean that improvements in one area flow across to other areas. In this case, improvements to compliance mechanisms (such as strengthened inspection regimes) generally may have positive impacts on insurance in the building sector". This concurs with the general view of the Allan report, "...that reducing building faults, disputes and claims has more to do with the regulation of the building process than with the ownership and market franchise of the HBWI insurer".

The VCEC review considered the issues of first resort versus last resort and private versus government monopoly as independent issues. This separation of issues ensures that the case for first resort or a government monopoly are easily argued against.

The argument mounted against first resort cover was that the "...Commission is not convinced that the move to 'last resort' insurance has resulted in a material loss of consumer protection for events formerly covered under so-called 'first resort' cover". This argument was based on the consideration of first resort and last resort covers provided by private insurers. Whether a government-backed scheme could or would provide additional cover to consumers was not considered.

Further evidence that a government-backed first resort scheme was not considered is comment that "This debate is almost academic, because private insurers are unwilling to offer such 'first resort' cover. Were providers compelled to do so, they would likely retire from the market. Vero, for example, has stated:

- So-called 'first resort' [builders warranty insurance] does not and cannot work because it fails, on several counts, to meet two of the primary tests of insurance, i.e. those of insurable/financial interest and insurable event.
- Vero will not participate in the market if the insurance system reverts to a so called 'first resort' scheme. This is insurance based on unsound principles."

The government-backed versus private insurer question was resolved by arguing:

- Monopoly schemes have a lack of risk rating and cross-subsidies (e.g. Queensland)
- Moving to a government scheme would remove the consistency between Victoria and NSW and substantially reduce the market for private insurers – thus reducing incentive for them to be involved
- Under a monopoly the managing body is not subject to competition which then leads to complacency and inefficiencies.

It would seem reasonably easy to mount opposing arguments to these points. In particular, the ability for a government-backed scheme to provide greater coverage (i.e a first resort scheme) was not mentioned – probably because the merits of a first resort scheme had already been assassinated.

The VCEC report appears to have followed the Napoleonic approach of divide and conquer.

The comments above are not intended to be an endorsement for a first resort government backed scheme but rather to highlight that the reviews into builders' warranty do not necessarily start with a clean sheet of paper.

In addition to the comments above, the question of “what drove the move away from first resort” needs to be asked.

In effect it was because the insurers could not, or would not, provide the cover at an affordable price. The changes did not, in my opinion, adequately address the issues facing consumers in relation to dispute resolution systems and claims management.

To some extent there is a difference of views between those who have been more exposed to the NSW system versus those exposed to the Victorian system. The HGF ran quite smoothly throughout its term and appears likely to ultimately close its books having never made a call on the government for funding – i.e. it was a fully self-sufficient organisation. The BSC on the other hand has been at the opposite end of the spectrum. It is, therefore, understandable why those from NSW would view a government-based scheme with extreme scepticism. It is unfortunate, however, that this same degree of scepticism has run across the Victorian system.

Without trying to be controversial, it appears that the recollection of the Victorian and NSW schemes appear to have been heavily influenced by the inadequacies of the NSW scheme rather than the strengths of the Victorian scheme. As one (biased) observer noted, the Queensland scheme has copied the best bits of the Victorian scheme as managed by the HGF. Given that the initial reviews into builders' warranty emanated from NSW, it could be argued that they are biased against government-backed first resort systems.

In Victoria's case, it is evident that insurers were not able to provide a first resort scheme that operated as efficiently as the HGF (and arguably were unable to provide a sustainable first resort system). This drove the change to a last resort system in 2002. In the case of NSW, it would appear that insurers were unable to perform any better than the BSC in terms of the provision of a first resort system again resulting in a change to a last resort system.

The insurer argument is that a first resort system is not workable. The BSC provides one example of failure but the HGF and BSA (in Queensland) provide two examples that such schemes can work. This leaves 2 options:

- First resort schemes can not be operated by private insurers; or
- The management by insurers of first resort schemes to date has been sub-standard.

In the case of HIH, the second point is definitely true. It is debatable whether it is true of other insurers.

What is certain to me (at least) is that the various reviews into builders' warranty insurance have not fully considered the government-backed first resort scheme as a realistic option.

Inertia, insurer power and government risk averseness all led to inquiries that could not be considered truly open and unconstrained. That is not to say that the recommendations considering the scope are wrong but just that a public backed first resort system cannot be concluded to be inappropriate or inefficient.

So what? The observations above mean that a government-backed first resort scheme has not been given full consideration by any of the major reviews completed to date. Given the current aversion of governments to take on such types of business it would be reasonable to argue that detailed consideration of the government monopoly option would simply have been a waste of time. The problem with what has been done, however, is that there is a general misconception that the reviews have given full consideration to first resort cover and concluded that such cover is not viable. As the success of the Housing Guarantee Fund in Victoria fades in peoples' memories (or has already done so), the viability of first resort schemes will only be measured against Queensland – and as a general rule people are happy to accept that Queensland is different! The myth that a first resort scheme is not viable has been created.

4.2 Industry Data

One of the major weaknesses in any analysis of builders' warranty around Australia is the lack of industry-wide data available. The key pieces of information that are required for a decent assessment are:

- number of building works in each year (potentially split by value range, type, owner builder, domestic/commercial)
- number of builders registered (owner builder, number operating, split by value of works)
- value of building works per annum
- average premiums charged (by value range, by type of work) – also total premiums
- number of notifications
- number of claims
- amounts paid/recovered
- time to payment/authorisation of claims.

In general terms, the access to information is very poor. It is difficult to obtain details of the characteristics of cover in each jurisdiction.

The lack of information makes informed debate about builders' warranty impossible. The various stakeholders have, in many cases, opposing interests and views. Without full information it has proven to be impossible to move away from the cycle of argument and counter-argument based on limited information or hearsay.

This is not dissimilar to the situation with public liability. Limited publicly available information; a long tail liability class; stakeholders with varying interests; an uninformed debate about the cost of cover; the need to consider tort reform and the required premiums. Issues like this are unlikely to be confronted in short-tail lines of business due to the relatively fast recognition of claims costs and the ability for niche insurers to target profitable markets without facing the risk of a blow-out in the cost of the tail.

5. Builders' Warranty Scheme Design

It is my view the various analyses of builders' warranty reviews have failed to take into account that a scheme needs to be considered as a whole. Arguments against each element of a scheme can be raised which, when considered in isolation, appear reasonable. However, the same arguments would be disputed when considered as part of a broader scenario. This has generally occurred as a result of the terms of reference for the review being constrained in some way.

Consideration of the scheme as a whole is a must. Each component of the scheme is correlated in some way to the others. Thus, an analysis of scheme design must consider not only the coverage and delivery of the insurance but also the builder licensing and registration, dispute resolution processes and the claim payment and recovery processes. Clearly the consideration of each of these items makes any analysis and/or comparison quite difficult. This, however, is the nature of compulsory insurance schemes. This problem has been encountered and not solved across both the workers' compensation and compulsory third party schemes for as long as they have been in existence. Each jurisdiction is able to find reasons why they are a better scheme than the other jurisdictions – whether it be through cheaper premiums, “better” benefits, faster payment, better return to work etc.

The following sub-sections discuss my view of the required components of builders' warranty scheme design.

5.1 What are the requirements for a builders' warranty scheme?

As mentioned above, a builders' warranty scheme needs to consider builder licensing and registration, the insurance coverage, dispute resolution processes and the claim payment and recovery process. The path followed in developing a scheme design depends largely on the philosophy of the cover being provided. To provide a more realistic example, I will assume that the cover is required to be compulsory and that competition policy dictates that the private market should be used where there are companies willing and able to provide the same product as would be offered under a monopoly scheme.

Warranty Scheme Philosophy

The philosophy behind the warranty scheme is a key driver of the type of scheme that should be implemented. Builders, consumers, insurers and governments are all key stakeholders in a builders' warranty scheme. What are the relative weightings placed on the needs of each of the stakeholders? The conflicting issues that need to be ranked include:

- Builders
 - Availability of insurance
 - Cost of insurance
 - When insurance is required
 - Impact on builder registration/licensing
 - Dispute resolution process
- Consumers
 - Consumer protection
 - Insurance coverage (what is covered, when and for how much)
 - Cost of insurance
 - Quality of builders

- Dispute resolution process
- Cost of dispute resolution
- Insurers
 - Level of cover provided
 - Ability to assess insurance risks
 - Ability to control builder quality
 - Dispute resolution processes
 - Claim payment and recovery processes
- Governments
 - Financial risk
 - Political risk
 - Private versus public
 - Market efficiency.

There is no magic formula to derive these weightings. They will be based on the relative risk averseness of each of the stakeholders and their views of equity and economic profitability. It is also not clear whether the views of each stakeholder should be given equal weight or whether some stakeholders should have more say than others. What is clear is that consumers have been relatively under-represented in any assessment of scheme philosophy to date.

Scheme Coverage

A key issue to consider is the extent of coverage to be provided to consumers. Should the insurance cover all disputes or only those that meet certain criteria (such as the builder being DDI)? Should the insurance cover all building works or only works above a certain value and/or on specified types of buildings. Should the insurance coverage cover all defects or only structural defects? The aim of builders warranty insurance is to protect consumers. The level of protection to be provided should be the initial focus of the scheme design.

Answering what should be covered and by how much first and then designing the scheme around the coverage required is the reverse of how scheme changes have occurred in recent times. Changes have typically been made to scheme coverage so that the existing scheme structure can be maintained or enhanced. In my view this is the tail wagging the dog.

It is in the scheme coverage component that helps answer the question of whether the coverage should be first resort or last resort. How the scheme is designed to provide that coverage should then follow.

Insurance Scheme, Builder Registration and Dispute Resolution

Insurance scheme design, builder registration or licensing requirements and the dispute resolution process are inextricably linked. Changes in any one of these areas will have implications on the other areas.

For example, a strict builder registration, licensing and monitoring regime will place less of a requirement on insurers to assess the insurance risk of each builder. Further, the greater the requirements placed on builders the less the likelihood of disputes.

To some extent, the design of each of these areas is reliant on the scheme coverage. If a first resort scheme is to be provided, then there is a requirement for the builder registration process to be reactive to any claims against the builder. If this is not done, then the insurance product becomes untenable. In a last resort system it could be argued that this requirement is largely removed because a builder with a claim against them is DDI and there is no future impact on the sustainability of the insurance.

In terms of the insurance scheme, the basic criteria for insurance are that:

- the loss must be fortuitous
- the frequency and magnitude of the expected loss must be assessable
- the circumstances of a loss must be capable of definition
- there must not be excessive exposure to loss
- the premium must be affordable
- the insurance must not threaten the public interest.

The basic criteria for insurance have been used as arguments against first resort insurance, in particular by Vero in its submissions to various inquiries.

Taking each item in turn –

The loss must be fortuitous

The general argument is that a first resort scheme leads to risks that are not necessarily fortuitous. Clearly, a last resort scheme relates to losses that are “fortuitous” working on the reasonable basis that all builders would avoid dieing, becoming disabled or becoming insolvent.

It could be argued, however, that losses from a first resort scheme could also be fortuitous. In order to be fortuitous, however, a first resort scheme needs to rely on the link between claims and builder registration. If a builder knows that they will not be able to remain registered if a claim is lodged against them then they will avoid necessitating a claim – hence making any loss fortuitous.

The frequency and magnitude of the expected loss must be assessable

Interestingly, the ability to assess losses has not been well considered in recent assessments of builders' warranty insurance. In particular, the NSW and Victorian schemes do not have sufficient historical information to judge the true underlying cost of the schemes currently in place. Further, the availability of scheme data is extremely limited, thus making the ability for new entrants to fully understand the likely costs.

Having said that, the experience of the HGF clearly indicates that the frequency and magnitude of the loss is assessable.

The circumstances of the loss must be capable of definition

This requirement is satisfied for all types of builders' warranty cover regardless of whether they are first resort or last resort. The key is to ensure that the definitions are precise enough to ensure that the coverage is limited to that intended to be covered.

There must not be excessive exposure to loss

In terms of builders' warranty insurance, the key is to ensure that three conditions mentioned above are met. As long as these conditions are met then the scheme should not be subject to excessive exposure to loss. One additional restraint on this is that insurers must be able to charge adequate premiums. The compulsory nature of builders' warranty insurance means that there is pressure on insurers if they are perceived to be charging excessive premiums. If, however, the insurer cannot charge premiums reflective of the underlying risk then it is likely that they will face excessive exposure to loss.

The premium must be affordable

The need for premiums to be affordable is obvious. The amount considered to be “affordable” is typically lower where the insurance is compulsory, as opposed to voluntary.

The insurance must not threaten the public interest

Again, this is obvious. On the basis that builders' warranty is designed to protect the interests of consumers, it is probably reasonable to conclude that as long as the other criteria for insurance are met, then the insurance will not threaten the public interest.

The criteria for insurance do not include the allocation of premiums. Under a privately insured scheme such options are limited. Insurers are either required to meet particular underwriting requirements (e.g. underwriting restrictions exist in NSW and Queensland CTP) or the insurers must be able to charge whatever premiums they consider are required (and competitive with the market). A government-backed monopoly scheme has considerably more flexibility in how premiums are charge since it is not a risk of being marginalised by a competitor.

The need for including the builder licensing and registration component may not be obvious but the level of requirements placed on builders has major implications on the ability for insurance to be provided.

5.2 What are the implications of the design requirements?

The need for insurers to have control over the risks underwritten has significant implications for the potential scheme design. If the registration of builders does not take into account the builders' building quality and financial stability then there is limited scope for insurers to offer insurance without additional underwriting requirements. Further, unless builders are punished for having claims (via fines, the requirement to pay costs or deregistration) then a first resort system is untenable.

Overall, the criteria for insurance do not, in themselves, render first resort builders' warranty insurance as untenable. Nevertheless, a first resort scheme is only tenable if the insurance criteria are met, and in particular that there are adequate registration restrictions in place to ensure that any loss is fortuitous.

To some extent first resort systems can also be viable if the insurance is provided by private insurers. However, in order for insurers to provide first resort insurance they must rely on the link between builder quality and builder registration/licensing. The required leap of faith by insurers is unlikely to be seen as a risk worth taking – thus making a first resort scheme with insurance provided by private insurers extremely unlikely. Interestingly, this fact was overlooked when the NSW and Victorian schemes were first privatised and it took the failure of HIH and the threat of Vero exiting the market to drive changes to the schemes.

First resort systems pose further problems for private insurers. There are a very large number of disputes raised. Under a last resort system, these disputes do not reach the insurer unless the builder is DDI. In a first resort system, the insurer must deal with all disputes and, in addition, seek recovery from builders. This clearly has cost implications – under a first resort system, there may be a large number of claims where the only payment is in relation to dispute resolution, and all claims will probably be increased in cost as a result of dispute resolution and recovery costs. As a general rule, insurers are not geared to handle the large volume of general enquiries of which only a small percentage develop any further. For example, Building Advice and Conciliation Victoria's 2003/04 annual report highlighted the receipt of 20,120 enquiries with 92% solved over the phone.

6. What about the consumer?

In my view, consumers are the key stakeholders in BWI. They are the ultimate payers of the insurance premiums (since builders typically pass the costs on) as well as being the beneficiary of any insurance payout. Further, consumers are typically the ones who suffer the most if a dispute cannot be settled.

6.1 Who is looking after the consumer?

The National Review noted that the inquiry "...did not receive any complaints from consumers outside NSW. This may not reflect consumer satisfaction with HBWI in other jurisdictions, but instead the absence of organised homebuyer groups in those states and territories".

The NSW consumer group referred to is BARG – the Building Action Review Group. BARG have provided submissions to a number of inquiries though appear to be a relatively small group. The reason for the words "appear to be" is that I have not been able to track down any information about BARG other than that they exist.

To my knowledge, a similar group does not exist in other states and territories. This effectively means that, unless governments stand for the rights of their constituents (who are the consumers), then consumers do not have a voice. One of the recommendations of the National Inquiry was that Government(s) "fund a national consumer advocacy group (for example, ACA or BARG) to establish a small dedicated office to help homebuyer complainants and to provide input to public policy deliberations". At this stage, this recommendation appears to have fallen on deaf ears.

One issue faced by consumer groups is that they will often be perceived as being whingers. The National Inquiry made specific mention of the fact that the inquiry "... has had to rely solely on the views of BARG and its members for a consumer perspective on HBWI. Because BARG represents homebuyers who have had bad experiences with builders, officials and insurers its views represent the dissatisfied end of the consumer spectrum. Consumers who have not got into trouble buying a home of course have no reason to be vocal".

While those groups representing consumers are likely to be biased in their view, this does not make them different to those representing builders, insurers and governments who are also biased in their views. Interestingly, the biased nature of the views of the other groups was not highlighted in the report.

Without a vocal consumer lobby there is unlikely to be significant enough political risk to prevent policy decisions being made that are not in the best interests of a majority of consumers.

6.2 What is the best system from a consumer's perspective?

The best system from a consumer's perspective has two components. One is the view of the consumer who does not have a dispute and the other is the view of the consumer who has difficulties with the builder.

For the consumers who do not have a dispute, the key components of the BWI system are:

- Cheap premiums
- Ease of access to a policy for their builder
- Cheap premiums (just in case the first one didn't work).

For consumers who have a dispute, the key components of the BWI system are:

- Timeliness of the process
- Limited legal processes (and cost)
- A repaired house.

Consumers typically do not want to get into a dispute; they just want their house fixed. To that end, the extent of coverage would be desired to be more rather than less. Clearly this is in conflict with the first and third points relating to consumers who do not have a dispute.

The key to achieving low premiums is to ensure that the quality of builders' works are high, that builders have adequate capital (so that insolvencies are minimal) and that builders are forced to repair faulty workmanship.

Forcing builders to repair faulty workmanship can be a timely process if adequate controls are not in place. To this end, the licensing and registration of builders needs to be such that, if faulty workmanship is not repaired, then the builder's ability to continue is threatened. Examples might include revocation of licence or suspension. Further, builders who become insolvent could be prevented from holding a licence for a period of time (say 5 years) with a second offence resulting in a lifetime ban.

Putting these practices in place would help remove the incentive for builders to undertake non-desirable work practises.

In addition to licensing controls, there needs to be adequate dispute resolution systems that provide timely and affordable access to consumers. These systems should not be consumer biased but, equally, should not be an impediment to consumers who are largely ignorant in relation to the legal system and processes as well as having limited resources to fund such challenges.

6.3 Do actuaries have a role to play?

Paragraph 1 of the IAAust Code of Conduct (as at 30 June 2005) states "*The Institute of Actuaries of Australia is a professional body which, through its Members, has an obligation in the public interest to provide high quality Actuarial Advice and service. In order to achieve this, it is essential that high standards of conduct are maintained by all Members of the Institute when they give advice of a professional nature*".

Paragraph 5 goes on to state that "*...All Members, in whatever field they practise, must act with honesty and in a manner to maintain the dignity and reputation of the profession and to fulfil its responsibility to the public*".

Paragraph 17 provides further clarification: "*An Actuary must not provide Actuarial Advice to any person or organisation when the Actuary has reason to believe this advice may be used to evade the law or in a manner that is contrary to the public interest or the interest of the profession*".

My reading of the Code of Conduct is that actuaries are required to consider the interest of the public prior to the provision of any advice. Advice contrary to the public interest should not be provided.

In terms of builders' warranty, it could be argued that the public interest is dominated by the interest of homeowners. Taxpayers and shareholders will also be interested parties but homeowners are probably those with most to lose. If it is accepted that the public interest is dominated but the interest of the homeowner, then it follows that any actuarial advice that is not in the best interest of homeowners should be provided with extreme care.

Does this mean that any advice that reduces homeowners' ability to make claims is against the public interest and hence a breach of the Code of Conduct?

A counter argument that could be put forward is that the policy has been set by governments and actuaries are advising on the best way of implementing that policy. It does raise questions, however, which are – to what extent do actuaries consider the public interest? and, to what extent can actuaries influence debate concerning public interest?

From my perspective the answers are limited and limited.

Actuaries are typically going to be employed by insurers or governments (either directly or on a consultancy basis). This will generally mean that the views of the consumer will not be directly relevant to the scope of the requested review i.e. the scope of the review will not provide for a detailed assessment of the “best” system for the consumer without taking a wide range of other factors into account.

Actuaries are typically placed in the position of providing a view on the likely cost of a specified set of conditions. Rarely are actuaries given the opportunity to discuss the merits of the framework in relation to issues other than cost and, to some extent, many actuaries would feel uncomfortable in doing so.

In my view, this makes the role of the actuary in promoting the public good is at best an indirect role. The code of conduct prevents the actuary from providing advice that is knowingly against the public interest but it would be drawing a long bow to suggest that this in turn should restrict actuaries from providing advice to specific questions asked by clients. The standard approach by actuaries is to clearly specify the scope of the assignment and to highlight that the results therein can only be considered in light of the project scope.

Is this good enough? Each actuary working in this area will need to consider whether they consider that their advice meets the requirements of the Code of Conduct. I do not think that there is a simple answer to the question.

7. Conclusion

The main conclusions and observations from this paper are summarised under the various section headings below.

7.1 What is Builders' Warranty Insurance

Builders' warranty insurance protects homeowners against financial loss arising from defective or incomplete works by their builder. As such, a BWI policy exhibits similar characteristics to a compulsory third party personal injury insurance policy, whereby the recipient of the benefits is not the person who takes out the insurance policy and the insurance is compulsory. This contrasts with typical insurance policies where the purchaser of the insurance is the recipient of any insurance payout and the insurance is not compulsory.

The main items to note are:

- Because BWI is compulsory, it must be both available and affordable
- The precise coverage of BWI is dependent on the legislation in each jurisdiction. DDI is the minimum coverage (referred to as last resort) though cover can extend to all defects, regardless of whether the builder is still operating (referred to as first resort). Under a first resort system, the claimant's first port of call is the insurer and it is the insurer's "responsibility" to solve the dispute. Under a last resort system the insurer is only involved where the builder is DDI
- There are typically dollar limits on when cover must be purchased and on claim amounts as well as time limits within which a claim can be made
- BWI does not cover the consumer for poor finishing where the "defect" is within the tolerance of building standards. Not looking good is not sufficient to justify a claim
- BWI has strong links to the building cycle with the highest claim numbers coinciding with peaks or just after peaks in the cycle.

7.2 Builders' Warranty Around Australia

NSW, Victoria and Queensland dominate the building market in Australia, each having around 25% of the market (by contract value). Of the remaining 25%, WA make up around 13%, SA approximately 6% and Tasmania, NT and ACT around 2% each. The Queensland market has grown appreciably in recent years and has approximately doubled since 2000 when Victoria and NSW made up around 75% of the Australian market.

In terms of BWI, the NSW, Victorian and Tasmanian schemes are almost identical being privately underwritten last resort schemes. SA, WA and ACT are similar to NSW but have different policy limits and durations. NT is similar to the other states with the key exception that the insurance is provided by the government insurer (TIO).

Queensland is the odd one out. While its policy limits are similar to NSW, it has a lower mandatory cover level, is first resort and is underwritten by the government.

Items also requiring consideration include:

- The price and rating structure of the insurance policies
- Builder registration/licensing requirements
- Dispute resolution processes and systems
- Allowance for owner builders

- Inclusion or exclusion of multi-storey dwellings.

The amount of information available to compare schemes is quite limited. In terms of premiums, the information available highlights quite different structures between the privately underwritten jurisdictions and Queensland by contract value. The Queensland rates level off from around \$175,000 while the premiums for other jurisdictions continue to increase with contract value. Given that there are caps on the maximum payout there is an argument that the rate of increase of premiums above a certain contract should reduce. The counter to this only holds if the probability and/or cost of claims continues to increase with contract value.

I note that the availability of monopoly pricing in Queensland provides the capability for premiums to include cross-subsidies (between contracts of different value and builders of differing quality/financial soundness) that cannot be accommodated in a privately underwritten scheme (without limitations on rating structures). There are strong arguments for and against cross-subsidies and they exist across most workers' compensation and compulsory third party schemes. Their existence does not necessarily render the scheme as undesirable. The key is ensuring that the cross-subsidies are deliberate and well understood.

With the HGF and Building Services Commission (BSC – the government monopoly insurer of the pre-1996 NSW scheme) data fading into irrelevance and the BSA keeping tight control over any data, it seems unlikely that there will be any improvement in the ability of the general public to obtain sufficient information to be able to determine whether the price and coverage of builders' warranty insurance is fair and reasonable.

Apart from the cost aspect of BWI, the builder registration requirements and dispute resolution procedures area also key areas of each scheme.

Without observing claims as they pass through a dispute resolution system, it is difficult to comment on any system's efficiency. The dispute resolution systems around Australia vary but have come more into line in recent years. The larger jurisdictions have dedicated tribunals or boards that have the ultimate say in the outcome of each claim. Some, including South Australia, do not have a specific tribunal and the consumer is required to go through the normal court system.

Dedicated tribunals would be expected to provide consumers with a more accessible dispute resolution path due largely to the cost and complexity of dealing with the normal court system.

In terms of builder registration, there is a key difference between registration and licensing. Registration requires builders to have certain qualifications and experience. Licensing takes the process a step further and also considers the financial status of the builder. Licensing would be expected to be required to be undertaken on a more regular basis than registration.

It is my view that much of the problem with builders being unable to obtain insurance cover in the privately underwritten jurisdictions reflects the fact that builders are registered and not licensed – thus the insurer is required to make the assessment about the financial viability of the builder (with no minimum standard applied to those registered).

7.3 Review of the Reviews

There have been a number of government (state and federal) reviews of the domestic building market and builders' warranty in particular. The main reviews are the Allan report (2002), the Grellman report (2003), the Productivity Commission report (2004) and the VCEC report (2005).

Each of these reports has effectively recommended a privately underwritten last resort BWI scheme. This is, to a certain degree, an expected outcome.

The consideration of first resort government-backed schemes was either outside the scope of the review, not considered as an option or a mixture of the two. In summary:

- The Allan report did not consider a first resort government-backed scheme as an option (it was outside the terms of reference)
- The Grellman report dismissed a first resort government-backed scheme largely because the New South Wales government was considered unlikely to entertain such an option
- The Productivity Commission report avoided making any direct comment about the relative merits of the manner in which insurance is provided
- The VCEC draft report has considered the issues of first resort versus last resort and private versus government monopoly as independent issues. It has not considered a government-backed first resort scheme.

As a result, the reports cannot be considered to provide complete commentary in relation to government-backed first resort systems.

I consider the general conclusion that a first resort systems is not viable to be incorrect. With a suitable link between builder registration and builders' warranty insurance a first resort scheme would be viable – this is most likely to be able to be achieved via a government-backed monopoly, particularly given the experience of first resort schemes with private insurers in NSW and Victoria.

The key problem with the reviews is that there is a general misconception that the reviews have given full consideration to first resort cover and concluded that such cover is not viable. As the success of the Housing Guarantee Fund in Victoria fades in peoples' memories (or has already done so), the viability of first resort schemes will only be measured against Queensland – and as a general rule people are happy to accept that Queensland is different! The myth that a first resort scheme is not viable has been created.

One of the major weaknesses in any analysis of builders' warranty around Australia is the lack of industry-wide data available. In general terms, the access to information is very poor. It is even difficult to obtain details of the characteristics of cover in each jurisdiction.

The lack of information makes informed debate about builders' warranty impossible. The various stakeholders have, in many cases, opposing interests and views. Without full information it has proven to be impossible to move away from the cycle of argument and counter-argument based on limited information or hearsay.

This is not dissimilar to the situation with public liability. Limited publicly available information; a long tail liability class; stakeholders with varying interests; an uninformed debate about the cost of cover; the debate about the need for tort reform and the required premiums.

7.4 Builders' Warranty Scheme Design

Consideration of any scheme as a whole is a must. Each component of the scheme is correlated in some way to the others. Thus, an analysis of scheme design must consider not only the coverage and delivery of the insurance but also the builder licensing and registration, dispute resolution processes and the claim payment and recovery processes. Clearly the consideration of each of these items makes any analysis and/or comparison quite difficult. This, however, is the nature of compulsory insurance schemes. This problem has been encountered and not solved across both the workers' compensation and compulsory third party schemes for as long as they have been in existence. Each jurisdiction is able to find reasons why they are a better scheme than the other jurisdictions – whether it be through cheaper premiums, “better” benefits, faster payment, better return to work etc.

The key areas of scheme design that need to be taken into consideration are:

- Warranty scheme philosophy
- Scheme coverage
- The link between the insurance scheme, builder registration and dispute resolution.

The scheme philosophy and coverage could, in theory, be considered in isolation to the insurance scheme design, builder registration and dispute resolution. However, the conclusions about the preferred scheme philosophy and coverage have major implications for the basis in which the insurance is provided, the extent to which builders are registered/licensed and the needs of the dispute resolution system.

7.5 What About the Consumer?

The best system from a consumer's perspective has two components. One is the view of the consumer who does not have a dispute and the other is the view of the consumer who has difficulties with the builder.

For the consumers who do not have a dispute, the key components of the BWI system are:

- Cheap premiums
- Ease of access to a policy for their builder
- Cheap premiums (just in case the first one didn't work).

For consumers who have a dispute, the key components of the BWI system are:

- Timeliness of the process
- Limited legal processes (and cost)
- A repaired house.

The key to achieving low premiums is to ensure that the quality of builders' works are high, that builders have adequate capital (so that insolvencies are minimal) and that builders are forced to repair faulty workmanship.

Forcing builders to repair faulty workmanship can be a timely process if adequate controls are not in place. To this end, the licensing and registration of builders needs to be such that, if faulty workmanship is not repaired, then the builder's ability to continue is threatened.

In addition to licensing controls, there needs to be adequate dispute resolution systems that provide timely and affordable access to consumers.

Unfortunately for the consumer, they have a very soft voice. There is no widespread vocal lobby group that can compete with insurers, builders and hence influence governments.

The IAAust Code of Conduct implies that actuaries are required to consider the interest of the public prior to the provision of any advice. Advice contrary to the public interest should not be provided.

In terms of builders' warranty, it could be argued that the public interest is dominated by the interest of homeowners and hence any actuarial advice that is not in the best interest of homeowners should be provided with extreme care.

Does this mean that any advice that reduces homeowners' ability to make claims is against the public interest and hence a breach of the Code of Conduct?

In my view, the role of the actuary in promoting the public good is at best an indirect role. The code of conduct prevents the actuary from providing advice that is knowingly against the public interest but it would be drawing a long bow to suggest that this in turn should restrict actuaries from providing advice to specific questions asked by clients.

The standard approach by actuaries is to clearly specify the scope of the assignment and to highlight that the results therein can only be considered in light of the project scope. Is this good enough? Each actuary working in this area will need to consider whether they consider that their advice meets the requirements of the Code of Conduct.

7.6 First resort or last resort or does it really matter?

Getting back to the question posed by the title of the paper, does it really matter if a BWI scheme is first resort or last resort?

My answer to this is an unequivocal yes!

However, the yes only relates to the manner in which the insurance, builder licensing and dispute resolution systems are provided. If the various support systems are appropriately provided then either a first resort or last resort scheme can be sustainable and can provide adequate consumer protection.

Given the experiences of the past, it would appear that a first resort system requires a monopoly insurance provider with strong controls over builder licensing. Recent experience suggests that last resort systems are sustainable but the price signals to ensure proper licensing are weak and the dispute resolution procedures are quite separate from the insurance and registration processes. As a result, the level of protection currently offered to consumers is, in my opinion, inadequate. Stricter licensing controls for builders that have disputes are desirable.

8. Disclaimer and Recognition

As with every good actuarial paper, I would like to declare that the views expressed in this paper are mine and not necessarily those of my employer, relatives, neighbours or acquaintances. Hopefully they are shared by somebody.

This paper has been reviewed by a person “agreeable to the Institute’s GI organising committee”, has been suitably altered and now presumably contains “acceptable content”.

I would like to thank the Housing Guarantee Fund for allowing me to use elements of their data in the paper.

A considerable amount of the factual information contained in this paper would not have been available without the considerable efforts of my colleague Travis Houlden – thank-you Travis, but it is still your shout!

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