Actuaries Institute.

22 November 2024

Home Buildings Compensation Fund Review Team
NSW Government

Email: HBCF.Review@sira.nsw.gov.au

Dear Review Team,

Consultation: Review into Home Building Compensation Scheme

The Actuaries Institute ('the Institute') welcomes the opportunity to make a submission to this consultation.

The Institute is the peak professional body for actuaries in Australia. Our members work in a wide range of fields including insurance, superannuation and retirement incomes, enterprise risk management, data analytics and AI, climate change and sustainability, and government services. The Institute has a longstanding commitment to contribute to public policy discussions where our members have relevant expertise. The comments made in this submission are guided by the Institute's 'Public Policy Principles' that any policy measures or changes should promote public wellbeing, consider potential impacts on equity, be evidenced-based and support effectively regulated systems.

In relation to Home Building Compensation (HBC) schemes, Actuaries advise on a range of functions, including: policy development, reform costings, premium setting, liability valuations, capital management, reinsurance arrangements, risk management and business planning.

The NSW HBC Scheme plays a key role in protecting homeowners in the event of incomplete or defective work. Given the significant financial risk involved in home building – it is the often the single largest financial commitment undertaken by an individual or household – it is critical for societal resilience that these schemes remain efficient and effective.

Drawing on our knowledge of the NSW scheme and other schemes we address six key areas in this submission. Those, and our key points, are:

1. Functions outside of the HBC Scheme have a direct impact on HBC claims experience; builder supervision is a key example. Where possible, we encourage the review to consider and discuss the broader functions impacting HBC Scheme performance to ensure the Scheme can fulfil its objectives as efficiently as possible. (Refer Section 1 of the attachment.)
2. The Institute supports increasing the maximum cover amount and suggests setting the maximum compensation amount to target a percentage of claims fully compensated. An increased maximum cover amount would more accurately reflect contemporary building costs incurred by most homeowners thereby providing a reasonable safety net. (Refer Section 2 of the attachment.)
3. The Institute supports reviewing the maximum cover for incomplete work and notes further considerations should be given if the 20% limit is increased or removed to reflect good practice use of progress payments. (Refer Section 3 of the attachment.)

4. Homeowners in particular generally have a low awareness of the Scheme. The last resort nature of the scheme, cover limited to dwellings 3 storeys and below, and restrictions on the time limits required to lodge a claim are not well understood. We suggest the Review considers how this could be overcome. (Refer Section 4 of the attachment.)
5. The Institute supports providing cover to homeowners where there is no valid HBC policy in place through no fault of the homeowner so that the Scheme can be effective in protecting all impacted homeowners. There is precedent for similar schemes in workers compensation and compulsory third party. (Refer Section 5 of the attachment.)
6. Historic losses for private insurers, the significant expertise and capital support required, and the limited premium pool relative to other classes makes the HBC Scheme less attractive to APRA licenced insurers than alternatives lines of business. (Refer section 6 of the attachment.)

The Institute would be willing to discuss this submission with the Review team. If you would like to do so, please contact the Institute via (02) 9239 6100 or public_policy@actuaries.asn.au

Yours sincerely

(Signed) Elayne Grace
CEO

Attachment

1. Functions outside the HBC impacting HBC claims experience

The NSW Home Building Compensation (HBC) Scheme plays a key role in protecting homeowners in the event of incomplete or defective work. There are many functions and processes that impact HBC Scheme performance. In NSW, many of these functions are currently performed outside the HBC Scheme.

An effective and efficient HBC scheme relies on:

- Effective licencing requirements to ensure builders have the required skills and qualifications to undertake the work
- Clear eligibility requirements to ensure the volume and type of work builders undertake is matched by their financial resources
- Effective regulation of building standards and build quality
- Effective supervision and inspections of builder compliance with standards
- A fair, efficient and cost-effective dispute resolution system
- Appropriate mechanisms and incentives in place for builders to rectify defective work to reduce the number of defect claims to the Scheme
- The efficient flow of information between the licencing, eligibility, dispute resolution and insurance functions to support making timely decisions and improve regulation, supervision and training.

This interconnection means performance in one area will impact performance in another area. For example, weaknesses in supervision will impact the number of disputes and the number of claims falling to the HBC Scheme. Where possible, we encourage the review to consider and discuss the broader functions that impact HBC Scheme performance to ensure the Scheme can fulfil its objectives as efficiently as possible.

2. Maximum cover amount

The Institute supports increasing the cover amount from the current $340,000 which was set in 2012. We suggest:

- Setting the cover amount to target a percentage of claims fully compensated. This is consistent with the approach taken by other HBC schemes. For example, the threshold may be set at a level to target full compensation for 95% of claims.
- Considering the time between issuing a policy and paying a claim. HBC payments can occur up to ten years after the policy is issued. Future inflation will impact the cost of claims and should be considered when selecting the maximum cover amount.
- Including an automatic review period and/or triggers to ensure the claim cap continues to support the HBC Scheme's full claim compensation target. For example, reviewing the cap every 5 years or if contract values increase by 15% above levels at the time the limit was set.
- Basing the analysis on the past HBC claims experience, adjusted for inflation. This will ensure the analysis reflects the types of policies covered by the Scheme, the cost of materials and the cost of labour.

An increased maximum cover amount would more accurately reflect contemporary building costs incurred by most homeowners thereby providing a reasonable safety net.

We note the premium impact will not be spread equally across all policies. Premiums on policies with lower contract values are expected to be unimpacted by the increase in cover. For example, swimming pool policies will be largely unimpacted as few claims would exceed the current $340,000 cap.

3. Maximum cover for incomplete work – 20% of the contract price

The Institute supports reviewing the 20% threshold and suggests:

- Reviewing progress payment schedules to ensure progress payments cover the cost of work performed and do not expose the Scheme to unexpected financial risk.
- Considering any limitations on cover if the homeowner pays ahead of schedule.
- Considering whether reductions in payouts should be applied in the event of under pricing/under quoting. We recognise factors to consider include consumer awareness of what would be a reasonable contract price, and materiality. For the scheme to be on a sustainable and equitable footing, there should be a policy around underinsurance.

4. Awareness and understanding

Homeowners

The Institute's engagement with the NSW Scheme and other HBC schemes suggests homeowners generally have a low awareness of the HBC Scheme. In particular, areas that are not well understood are:

- Product design:
  - The last resort nature of the Scheme which means the homeowner must pursue the builder if the triggers are not satisfied. This approach differs from most other general insurance products.
  - There is a poor understanding that units in a complex of 4 storeys and above are not subject to the same protections as low-rise residential construction.
- Terms of cover:
  - The distinction between structural and non-structural defects and the timeframes required to lodge a claim are not well understood.

Builders

Builders tend to have a reasonable awareness of the Scheme although there is some confusion over the types of work requiring cover. Areas that are not well understood include:

- Low value work, near the $20,000 threshold
- High rise (4 storeys or more), particularly when the build includes car parks or is mixed residential/commercial.

We suggest the Review considers how these levels of awareness could be improved and/or changes to simplify the operation of the Scheme.

5. Compliance

The Institute supports providing cover to homeowners where there is no valid HBC policy in place through no fault of the homeowner so that the Scheme can be effective in protecting all impacted homeowners. There is precedent for similar schemes in workers compensation and compulsory third party in motor. In these schemes, there is no difference in the benefits provided to injured workers/road users relative to the benefits available where there is a valid insurance policy.

We suggest the review highlights the importance of educating, monitoring and enforcing builder compliance with HBC Scheme requirements alongside the Scheme covering uninsured homeowners.

6. Multi-insurer market considerations

History of private insurer participation

- Prior to 1997, NSW operated a government underwritten first resort scheme.
- Private insurers commenced underwriting HBC insurance in 1997.
- Large losses led to progressive reforms including the removal of coverage for buildings greater than three storeys and transition from a first resort to last resort model.
- Due to continued large insurer losses following these reforms, private insurers progressively withdrew from the market.
- From 1 July 2010, the NSW Government passed legislation to create a government underwritten HBC Scheme.
- In 2018, the government introduced a series of reforms that included opening the Scheme to private insurers and alternative indemnity product providers to enter alongside icare HBCF.

Although the market is open to competition, icare HBCF currently remains the sole HBC provider.

Alternative Indemnity Providers (AIPs)

The Australian Prudential Regulation Authority (APRA) is the prudential regulator and is focused on ensuring the safety and soundness of financial institutions. APRA's prudential requirements cover a range of systems and processes including risk management, capital management, reinsurance management, outsourcing and information security. Licenced insurers must meet APRA's prudential requirements at all times.

The HBC product is particularly challenging for insurers due to:

- The delay between issuing a policy and paying a claim which means it takes a long time for actual experience to emerge. Premiums and reported financial performance rely heavily on estimates of future claim payments.
- The impact of economic and construction cycles on building activity, insolvencies and claims experience means claims experience varies greatly year-on-year.

This uncertainty points to a need to maintain sufficient capital and expertise to be able to continue to meet obligations to policyholders in a variety of operating environments.

If AIPs are not subject to the same requirements as APRA licenced insurers, they are unlikely to provide the same level of security as APRA licenced insurers. The distinction between an APRA licenced insurer and AIP and the level of security provided is likely to be poorly understood by homeowners.

The Institute suggests the Review considers the advantages and disadvantages of a scheme open to AIP participation.

Insurer considerations

In assessing whether to enter the HBC market, insurers will consider a combination of factors, including, but not limited to:

- Historic losses for private insurers. Insurers will be reluctant to re-enter the market without a history which shows premiums are set at sustainable levels to cover the cost of claims, expenses and provide a suitable profit margin.
- Complexities of the HBC product which require expertise and significant capital support. The long-tailed nature of HBC covers means that experience takes many years to emerge, particularly for defect claims. The links to the construction industry conditions means that experience is cyclical. The resulting uncertainty and volatility in claims cost means that a significant amount of capital support and expertise is required to enter the market. Private insurers must consider whether the opportunities available from entering the market are worth the costs associated with developing the required expertise and the additional capital support.
- The government backing of icare HBCF. Although the State Insurance Regulatory Authority (SIRA) requires that icare HBCF operates under the principle of competitive neutrality, private insurers may be hesitant to enter the HBC market if they perceive icare HBCF has an advantage in the market. In addition, insurers will need to assess whether icare's 10-15% profit margin on the basis of competitive neutrality, is sufficient to meet their requirements.
- The limited premium pool relative to other classes of insurance. The relatively small premium pool means that private insurers are likely to pursue other initiatives where the risks are lower and the potential payoff from the investment may be higher.
- Current and expected future conditions impacting the construction sector. If insurers expect challenging conditions to continue, and therefore an increase in claims, they will be less likely to enter the market in the short-term.
- Level of capital required and reinsurer support. APRA's prudential capital standards and SIRA's Guidelines require insurers to hold capital sufficient to cover losses arising from a 1-in-200 year event, after allowing for reinsurance recoveries. Insurers typically manage their exposure to a 1-in-200 year event by purchasing excess of loss reinsurance. Reinsurer appetite to provide excess of loss reinsurance covering HBC risks is likely to be limited. This is more of an issue for mono-line insurers and AIPs where their 1-in-200 year event estimate is driven by HBC risks. For a large, diversified insurer, it is unlikely HBC will materially impact their whole of portfolio 1-in-200 year loss estimate.
- The effectiveness of processes that currently sit outside the HBC Scheme. For example, dispute resolution and regulations and which we note in area 1.