

Dear Senators, The Treasury, Mr McCarthy, and Mr Griffin

**RE: Inquiry into the Australia's Mandatory Last Resort Home Warranty Insurance Scheme**

It is with great disappointment we find we have to continue to correct presentations, however it is essential that all are informed accurately, and we invite Mr McCarthy or Mr Griffin to respond immediately if we have inadvertently presented any aspect incorrectly.

*Mr McCarthy opens with: Much of the criticism of the scheme operating in New South Wales in recent weeks has been ill-informed and unhelpful. The New South Wales scheme is vastly different to the private home warranty insurance schemes that operate in other states and territories. He also states New South Wales scheme has an independent scheme board responsible for the monitoring of the operation of the scheme.*

This same criticism has bought on the past 30 plus State based inquires and reviews with their limited and controlled terms of reference that only see band-aids applied as the supporters of such a fundamentally flawed scheme continue to defend the indefensible. This defence can only be seen as a very selfish approach to such a major problem in the building industry best described as a running sore by the Productivity Commission.

NSW say they are different because they have a Scheme board, equally Victoria has the Building Commission and then all have exactly the same product with different levels of perceived cover under the same legislation, however the insurers do not abide by it in terms of reporting as Victoria changed the Ministerial Order to even relieve them of this requirement in 2005, and the NSW data is considered meaningless by a significant actuary in a written opinion provide to the inquiry.

*Insurers are required to provide the Office of Fair Trading with premium and claims data on a quarterly basis.*

This data is questionable as noted by Taylor Fry actuaries, it also relates to 40,000 policies in NSW where as in Victoria there are some 100,000 policies issued.

*The scheme board has a memorandum of understanding with APRA to formalise information sharing and reporting arrangements.*

Why? APRA do not collect data on BWI

*The minimum level of cover in NSW is now \$300,000 from 1 March 2007.*

Access to the cover remains the issue, besides as history clearly states insolvency is the risk area, and for non-completion there is only 20% of the original contract value available therefore rendering any limit no matter how large not relevant.

*Introduce to the scheme a further trigger for a consumer to lodge a claim under their home warranty insurance. This trigger would be suspension of the license. Mr Griffin - So to activate a trigger at that early stage, from our point*

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# A Review of the NSW Home Warranty Insurance Inquiry, 2003

## Executive Summary

On 5 May 2003, the New South Wales Minister for Commerce, the Hon. John Della Bosca MLC, appointed Mr Richard Grellman to conduct an Inquiry into the NSW Home Warranty Insurance Scheme. The Terms of Reference for the Inquiry asked for ten issues to be considered. The Inquiry submitted a descriptive Interim Report on 30 June 2003, with the Final Report containing recommendations presented on 30 September 2003. The Minister announced on 22 October 2003 that the government would in principle accept and implement the seven primary recommendations.

Essentially, those recommendations were for a continuation of the existing Home Warranty Insurance scheme, including changes legislated in 2002, but with stronger governance mechanisms to assist the scheme's stability, and to encourage additional insurers to enter the market. In the longer term, the option of a system where consumers purchased their own insurance might be considered.

Mr Grellman has extensive experience in the insurance industry, and has been an adviser to State and Federal governments. He is currently chairman of the Motor Accidents Authority of NSW, the statutory body that regulates third party motor insurance in that State.

Although the Terms of Reference provided a broad brief to examine alternative systems, the attitude of the government was foreshadowed prior to the Inquiry. As early as March 2002 the New South Wales Government together with the Victorian Government entered into an arrangement to provide a uniform compulsory Home Warranty Insurance scheme in both States. Even before the Inquiry reported, the two governments announced their support for an enhanced insurance policy available from Royal & Sun Alliance Insurance for members of the Housing Industry Association. Press reports made it clear that a government-run scheme would not be entertained.

There is considerable dissatisfaction with the outcomes of the Inquiry amongst consumer representatives, building contractors and design professionals. A few parties will benefit, mainly in the "big end of town". Some groups have adopted the pragmatic approach of trying to make the scheme work, despite its apparent faults. Although the Inquiry acknowledged that many stakeholders would be critical of the proposals, it did not recommend radical changes.

Because the existing scheme is one of "last resort" there is no benefit to consumers, except in the occasional case when a builder dies, absconds, or becomes insolvent. In the more frequent cases where rectification of faulty work is sought, the consumer is obliged to pursue the contractor through various legal tribunals. Nevertheless, because it is a mandatory scheme, the cost of a new home for consumers is increased by the not insubstantial amount of the insurance premium.

In December 2003, the government announced that high-rise residential buildings would be excluded from this mandatory insurance, although a large proportion of new housing in New South Wales is of that type. As a result, the total size of the insurance market is greatly reduced, and may discourage potential new entrants.

The home warranty insurance market in New South Wales is dominated by one insurance company and one broker, closely linked to an industry association. Effectively, it is a monopoly situation, with a guaranteed income stream because the product is compulsory. Insurance premiums have continued to rise despite the government's attempts to reduce the risk. For these reasons the government is anxious to create competition in the area, but four months after the adoption of the Inquiry Report, there had been no new entrant. However, there are indications that another insurer is about to participate, although the impact of this is uncertain.

Home Warranty is a unique form of insurance, where the insurer cannot lose. In the rare event of a claim for rectification of faults after a builder disappears from the scene, his assets become security for the amount of that claim. If the claim is for an extremely large sum the government pays, because it has agreed to underwrite cover above \$10 million. Although this means that the insurance industry is protected from the risk of a catastrophic payout, the whole community is the potential loser. In effect, the insurance industry is being subsidised by new home purchasers.

Many smaller builders who typically build individual new houses to a client's or architect's specifications are disadvantaged when compared with a company that markets standardised "project homes" in large numbers. This occurs not because of intrinsic quality differences, but because of the insurer's attitude to risk management. Sufficient capital backing is demanded to cover the amount of a claim; where cash resources of this scale are not available, a builder is required to pledge personal assets or obtain a bank guarantee. This is in addition to paying the insurance premium for each job undertaken.

Even when a qualified builder is licensed by the regulatory authority, this does not ensure that Home Warranty Insurance will be available, or that the insurer will provide a sufficient amount of cover to conduct a viable business. The Grellman Inquiry did not attempt to alleviate this situation, which inevitably provides a competitive advantage for the larger company.

The Inquiry received numerous written submissions, and met with many of the authors, in some instances several times. Much of their argument is expressed in emotional terms, and may not have influenced the Inquiry. Nevertheless, a significant number of major bodies representing consumers and subcontractors did not make submissions to the Inquiry and were not consulted. Some are aggrieved that their viewpoint was not considered.

Many submissions favoured a "first-resort" scheme on the profitable Queensland model, but the Inquiry did not examine this proposal in depth. Instead it preferred a blending of the Victorian and New South Wales schemes, in line with earlier decisions of the Government. This plan provides economies of scale for the insurance industry, but less protection for the consumer.

The option of an industry-based mutual scheme was rejected by the Inquiry because of fear of a building industry monopoly. In any case, the proposal was not authorised by the Australian Prudential Regulation Authority, which is a condition demanded by the New South Wales Government, although similar restrictions do not apply in other States. Non-APRA approved insurance schemes operate effectively in other sectors of the Australian economy.

The Inquiry described, but made no serious evaluation, of a few of the schemes operating in other countries, although it was asked to do so in the Terms of Reference. A number of interesting examples from comparable countries were not considered. The Grellman Inquiry did not make a financial and actuarial assessment of the several alternative models proposed, as required in the Terms of Reference, nor did it attempt to measure the impact of the preferred Home Warranty Insurance option. Without this information, the Inquiry Report has little validity other than as an expression of opinion.

Allegations are rife that there has been a proliferation of owner-builder activity intended to circumvent the Home Warranty Insurance provisions, but there is no hard evidence to support that contention, despite the efforts of the Inquiry to determine this. Generalisations from isolated incidents are all that exist.

Similarly, there are complaints from industry that a decline in the number of building apprentices is related to the difficulty of obtaining insurance, but the available statistics do not confirm that this is the case. Against this, it must be pointed out that the Inquiry's assertion that building apprenticeships actually have increased is incorrect. The intake of apprentices into home building related trades has remained fairly constant for some years, despite the growth in the industry.

The Inquiry was uneasy about any schemes that might lead to the "capture" of regulatory processes by the building industry. At the same time, there remains a danger that Home Warranty Insurance will be captured by the insurance industry and its associates.

Finally, the Inquiry made several subsidiary recommendations that were outside its main brief, and not central to the question of Home Warranty Insurance. Some of these recommendations reveal a misunderstanding of the current position. It is disappointing that all the proposals related to cure of the symptoms, rather than addressing the cause by providing incentives for improved performance.

The Report from the Home Warranty Insurance Inquiry does not withstand critical scrutiny. It did not deal satisfactorily with the Terms of Reference. The Report contains errors of fact, inconsistent arguments, and misleading statistics, together with some misapprehension of previous legislative reforms. The limited time allowed for conduct of the Inquiry may have prevented adequate consideration being given to complex issues, but tends to diminish the Report's credibility. Despite this, the deficiencies in the Report do not appear to have had a material effect on the substantive recommendations from the Inquiry. The NSW Government had indicated its preferences prior to the Inquiry. After cursory discussion of alternative proposals, the Report endorsed those preferences, with minor modifications.



# Review

## INTRODUCTION

On 18 December 2003, I was commissioned by a consortium of contractor associations and professional institutes to consider these matters:

- Whether the Grellman Report fulfilled its Terms of Reference;
- If it did not fulfil its Terms of Reference, identify those areas;
- Conduct an analysis of the Report identifying any contradictions, anomalies and errors; and
- Identify alternate models which would comply with the Terms of Reference given to Grellman by the NSW Government.

## METHODOLOGY

In performing this assignment, I have undertaken these tasks:

- Carried out a comprehensive analysis of both the Interim and Final Grellman Reports, identifying issues requiring further examination.
- Contacted leading industry associations that did - or did not - make a submission to the Inquiry, to ascertain whether their concerns had been addressed adequately in the two Grellman Reports. These organisations are listed later in this report (Appendix "A"). Contact was made by correspondence, telephone, and personal interviews.
- Acquired relevant supporting documents, including copies of several original submissions. These documents are listed later in this report (Appendix "B"). This material was not examined until the initial findings of this Review were completed, in order to avoid compromising the conclusions.
- Perused industry journals, ministerial news releases, and other publications likely to offer comment on the Grellman Reports.
- Researched newspaper archives for relevant articles or commentary.
- Quantitative analysis of the written submissions and stakeholder discussions held by the Inquiry staff.
- Conducted preliminary company searches with ASIC to establish credentials of certain contributors to Inquiry.
- Compilation of detailed home building-related apprenticeship statistics from Construction Industry Training Advisory Board. Comparison with TAFE statistics published in the Grellman Report.
- Compilation of additional statistics on home building supplied by Australian Bureau of Statistics, and comparison with Grellman Report statistics.
- Compilation of statistics related to the largest home building companies in NSW (Appendix "D").
- Prepared this Review containing my conclusions arising from careful analysis of relevant material.

## **RESEARCH CREDENTIALS**

I practice as a research consultant under the registered business name Peter J. Tyler Associates. I am an Accredited Professional Historian, experienced in forensic documentary research and analysis. I hold the degrees of Doctor of Philosophy, Master of Letters (Distinction), and Bachelor of Arts from University of New England, and the Graduate Diploma in Adult Education from University of Technology, Sydney. I have published monograph histories of the Australian Institute of Building, and the charity Community Health and Tuberculosis Australia, plus numerous journal articles and conference papers.

I have undertaken management training at NSW TAFE and the University of NSW Institute of Administration, becoming an Associate Fellow of the Australian Institute of Management, and a Fellow of the Australian Society of Association Executives.

I have over twenty years' experience as chief executive of associations involved with the building and construction industry, including the Australian Institute of Building Surveyors, the Building Careers Centre, and the Building and Construction Council of NSW (BACC).

Currently I am Chairman of the Construction Industry Training Advisory Board NSW (CITAB), and have been a Director of the national training body, Construction Training Australia. I am also Secretary of the Industry Liaison Committee of the Australian Building Codes Board. I have served on building course advisory committees at TAFE, University of Sydney, University of Technology Sydney, and University of Western Sydney.

Previously I have been engaged as a research consultant on a project for the NSW Department of Public Works and Services related to construction contracts. On behalf of the Building and Construction Council, I made a written submission to the National Review conducted by Professor Percy Allan, and gave evidence before the Campbell Inquiry into building quality. I did not make a submission to the Grellman Inquiry, either privately or on behalf of BACC.

## **BACKGROUND TO THE NSW HOME WARRANTY INSURANCE INQUIRY (THE GRELLMAN INQUIRY)**

Home Warranty Insurance (HWI) was introduced in New South Wales in 1972. Subsequently, the scheme has undergone a number of changes and has been the subject of several official inquiries. A description of these events appears in the Interim Report from the Grellman Inquiry. During this period, the level of government involvement has fluctuated, but the State Government retains some ongoing financial commitment at least until 31 October 2006.

In June 2002, Professor Percy Allan reported to the Ministerial Council on Consumer Affairs with a national review of home builders warranty insurance and consumer protection (the "Allan Inquiry"). Shortly afterwards, the NSW Parliament Joint Select Committee of Inquiry into the Quality of Buildings handed down its report (the "Campbell Inquiry"). This led to the Building Legislation Amendment (Quality of Construction) Act. In response to a threatened withdrawal of home warranty insurers from the market, the Home Building Amendment (Insurance) Act was introduced in September 2002, with a proviso that its impact should be reviewed by the Standing Committee on Law and Justice.

On 21 March 2003, the then Minister for Fair Trading, the Hon. John Aquilina MP, announced that the NSW Government had 'moved to improve the operation and accessibility of home warranty insurance'.<sup>1</sup> Many of these measures were aimed at increasing the transparency of existing insurance procedures. Insurers would be required to implement a Code of Practice. The Minister stated that 'regulations to achieve this will be implemented immediately if the Carr Government is re-elected'. He was confident that another insurer would soon enter the home warranty market, and stated that 'the Government would...support the establishment of an APRA-approved industry-based warranty scheme'.

Following the State elections a week later, when the Carr Government was returned to office, there was a major re-alignment of ministerial portfolios and departmental responsibilities. Following lobbying from industry associations and contractors, the Minister for Commerce, the Hon. John Della Bosca MLC announced the NSW Home Warranty Insurance Inquiry on 5 May 2003. Mr Richard Grellman was appointed to conduct the Inquiry, assisted by staff from an international firm of accountants and business advisers. The Inquiry Secretariat was provided by the Office of Fair Trading within the Department of Commerce. The Government expected an Interim Report by 30<sup>th</sup> June, barely eight weeks later. An additional three months was allowed for preparation of the Final Report, due on 30 September 2003.

Mr Richard Grellman is a chartered accountant, who was a partner of KPMG Australia for eighteen years prior to his retirement. In 1997, Richard Grellman was commissioned by the NSW Government to conduct an Inquiry into workers' compensation insurance, and was later appointed as Chairman of the Board of the Motor Accidents Authority of NSW (MAA). The MAA is a statutory corporation that regulates the Compulsory Third Party personal injury insurance scheme for motor vehicles registered in NSW. Since his retirement, Mr Grellman has accepted directorships on the Board of several public companies, most notably AMP Insurance, where he is also chairman of the Audit Committee. He was engaged by AMP as Financial Expert for the demutualisation and public listing of the company in 1998. He is also chairman of Mission Australia.

Mr Grellman has a detailed knowledge of the insurance industry in Australia, as a result of his extensive involvement at a senior level of financial management. Coincidentally, at the very time that he was appointed by the Government to conduct the Home Warranty Insurance Inquiry, Richard Grellman and another director were being criticised by disaffected small shareholders of AMP Insurance and sections of the financial press, who were calling for their resignation because of the deteriorating performance of the company.<sup>2</sup> At the AMP annual general meeting several days later, however, Mr Grellman was re-elected to the Board by a comfortable margin.

In selecting Mr Grellman for this Inquiry, the government may have believed it was likely that his conclusions would be sympathetic with their own preferred outcome.

## **TERMS OF REFERENCE FOR THE INQUIRY**

The Government stipulated ten terms of reference for the Inquiry:

- "1. Consider whether the legislative framework governing Home Warranty Insurance in New South Wales (including changes made to the existing scheme in 2002) is currently effective for consumers and industry."
- "2. Assess the potential for the entry of one or more additional



insurers to the Home Warranty Insurance market and identify any legislative or administrative changes that would encourage the entry of additional insurers into the market."

"3. Consider the need for, and viability and effectiveness of, options other than the existing scheme for the delivery of Home Warranty Insurance including, but not limited to:

3.1 industry based schemes operating in Australia and elsewhere; and

3.2 schemes incorporating government as insurer or re-insurer."

"4. Having regard to the existing scheme and possible alternative options, identify a preferred Home Warranty Insurance model for consideration. The model should be accompanied by full financial and actuarial modelling to ensure it is robust and sustainable."

"5. Identify the likely impact of a preferred model on the Home Warranty Insurance market."

"6. Identify appropriate conditions of approval for any new model including requirements for prudential regulation."

"7. Identify and assess any other issues requiring consideration in relation to the introduction of any new model for the Home Warranty Insurance market."

"8. The inquiry is to have regard to, amongst other things:

8.1 The June 2002 Report of the National Review of Home Builders Warranty Insurance and Consumer Protection by Professor Percy Allan.

8.2 The July 2002 Report of the NSW Parliament's Joint Select Committee on the Quality of Building ("the Campbell Inquiry") and the Government's response to that Report.

8.3 The September 2002 Report of the Legislative Council Standing Committee on Law and Justice on the Home Building Amendment (Insurance Act) 2002."

"9. In undertaking the inquiry consult with both stakeholders and service providers."

"10. Provide the following reports:

10.1 An interim report by 30 June 2003.

10.2 A final report by 30 September 2003."

## **CONDUCT OF THE INQUIRY**

A rather tight time frame imposed by the Government placed significant constraints on the Inquiry. Press advertisements invited submissions that were accepted until 18 July 2003. In other words, submissions were still being received over a fortnight after the Interim Report was released. This was rationalised on the grounds that it allowed interested parties to take note of information in the Interim Report. A total of 219 written submissions were received in response to the public invitations. Authors of submissions were permitted to request confidentiality for their documents.

The short period allowed for responses placed heavy demands on the numerous organisations that represent diverse sections of the building and construction industry. Some of these have limited resources, so they can find it difficult to divert senior staff for the preparation of a detailed submission, and they may not be in a position to engage outside consultants. Even more importantly, submissions to government by most associations customarily require the endorsement of their governing Board, which may meet at monthly intervals or even less frequently. Possibly as a result of these factors, there is a notable under-representation by industry associations amongst the submissions to the Inquiry. Several significant organisations were unable to present their written submissions until the closing date after the publication of the Interim Report.<sup>3</sup>

The Inquiry conducted 76 meetings with people selected as stakeholders or representatives of service providers, and other interested parties. Twenty-one of these meetings occurred before the Interim Report was completed. Because the final three meetings did not take place until the last week before the Inquiry submitted its Final Report, the comments at those gatherings may have been too late to influence the recommendations. A number of participants were disappointed that they did not meet Mr Grellman in person, since he was represented at many meetings by a member of the Inquiry staff. On the other hand, a few respondents who did meet him remarked on his courtesy and interest in their submission. Two "roundtable discussions" were held with major stakeholders during August to explore some issues that had been raised earlier.

Both the Interim Report and the Final Report are attractively designed, but show signs of hasty preparation and lack of editing, with spelling errors, faulty syntax and occasional malapropisms.<sup>4</sup>

## THE INTERIM REPORT

The Interim Report was presented to the Governor of NSW on 30 June 2003. It is a descriptive document of some 53 pages that sets the scene for the subsequent Final Report. Indeed, much of the Final Report can only be comprehended by reference to the Interim Report.

The Interim Report clearly states that it did not intend to foreshadow any recommendations, but aimed to provide a 'concise record of the history of New South Wales Home Warranty Insurance'.<sup>5</sup> It goes beyond this, to identify some of the concerns of stakeholders and service providers.<sup>6</sup> The Interim Report compares existing home warranty schemes throughout Australia,<sup>7</sup> and in some other countries.<sup>8</sup> It provides useful "balance sheets" showing the comparative advantages and disadvantages of different scheme models.<sup>9</sup>

In its conclusion, the Interim Report remarks that 'The majority of stakeholders are critical of a variety of aspects of the current Scheme'.<sup>10</sup>

The Interim Report is a useful secondary source of information, weakened by the fact that most of the statements are not attributed to organisations or individuals, so it is impossible to differentiate between serious evidence and mere anecdote or hearsay. Statements such as 'one builder said...'<sup>11</sup> or 'another consumer said...'<sup>12</sup> are worthless unless placed in a context. One of the disadvantages of an Inquiry such as this, compared with a more formal investigation such as a Parliamentary Select Committee or a Royal Commission, is that there is no transcript of evidence, nor are

the written submissions available for public perusal. Inevitably this raises questions about the relative weight given to different submissions.

Furthermore, because submissions are not subject to challenge or cross-examination, it is not possible to test the validity of claims presented to the Inquiry. The Inquiry itself is at a disadvantage because it is not able to subpoena witnesses or documents that may yield critical information.

## **THE FINAL REPORT**

The Final Report was presented to the Governor of NSW on 30 September 2003. After the Minister for Commerce publicly released the Final Report on 22 October, it was available for downloading from the Inquiry internet website. It is a document of 106 pages, identical in format and style to the Interim Report. Generally speaking, the content of the Interim Report is not repeated in the Final Report. Because the Reports are complementary, it is desirable to read both in order to place the recommendations in context.

One of the weaknesses of the Interim Report was dealt with, in that quotations from a number of submissions are included in the text, and the source identified. Twelve of these quotes came from sections of the building industry, seven from government agencies, five from the insurance sector, and one from the legal fraternity. Notably, there was no direct quotation from consumer interests.

## **COMMENTARY ON THE REPORTS AND THE ISSUES RAISED**

In these comments, the terms "Grellman" and "Inquiry" are used as generic terms to refer both to the Interim Report and the Final Report, but do not imply that Mr Richard Grellman personally was the author of the particular section under discussion. Because some of the same themes are covered in both reports, comments have been consolidated in this analysis, with references to the relevant source given in footnotes. The paragraph headings used here refer to chapter headings in one or both of the reports.

### **Executive Summary**

The Grellman Inquiry accepts 'that there is a need for change', but notes that the challenge is to balance the concerns of stakeholders with aspirations of service providers without compromising stability.<sup>13</sup> Essentially, that challenge comprises the first Term of Reference for the Inquiry, so it is an unexceptional statement.

Grellman claims to have 'consulted extensively...to ensure that all concerns were heard'. This is a misleading description of what actually occurred. Certainly, numerous written submissions were received, and many interviews or discussions took place with some of the respondents. However, there are notable omissions from the list of organisations that presented a viewpoint ("evidence" would be too strong a term to apply to some of these comments, as far as can be judged from the submissions that have been made public). The unbalanced response may have been due to ignorance of the Inquiry's existence, indifference as to its outcomes, or simply a lack of time. Whether the Inquiry attempted to remedy this deficiency by asking directly for comment is not stated in the Report.

The Inquiry could have conducted an extensive survey of stakeholders and service providers to some advantage, for example by distribution of comprehensive

questionnaires to all relevant parties. Although the percentage of responses to mail surveys are notoriously disappointing, some valuable and comparable information would have been acquired nevertheless. Generally, the returns from such a survey can be improved through direct personal follow-up, but no doubt the constraints of time and budget precluded any consideration of this strategy.

From analysis of the appendices to the Final Report, it is possible to give a rough breakdown of the sources of submissions to the Inquiry:<sup>14</sup>

Written Submissions (219 received)

Builders/contractors/consultants	60%
Industry associations	13%
Consumers (and unidentified)	11%
Politicians & government officials	6%
Insurance industry	4%
Designers, manufacturers, etc.	4%
Lawyers & accountants	<u>2%</u>

100%

Stakeholder Meetings (111 individuals)

Builders/contractors/consultants	24%
Insurance industry representatives	23%
Industry associations	20%
Politicians & government officials	17%
Consumers (and unidentified)	10%
Lawyers & accountants	4%
Designers, manufacturers, etc.	<u>2%</u>

100%

Roundtable Discussions (25 participants)

Insurance industry representatives	36%
Industry associations	28%
Builders/contractors/consultants	16%
Lawyers & accountants	8%
Government officials	8%
Consumers	<u>4%</u>

100%

These figures provide a crude measure of where the Inquiry sourced its information, but of course are no indication of the value of that input to the Terms of Reference. Many of the submissions may have been repetitive, or irrelevant.

Perhaps the only question that can be answered is 'did all interested parties receive a fair opportunity to express their viewpoint'? It is evident that certain organisations were given several opportunities for consultation. Thus, consumer representative Mrs I. Onorati, president of Building Action Review Group (BARG), made four appearances at stakeholder meetings, as well as one of the roundtable discussions, although BARG did not make a written submission to the Inquiry. From the

construction side, Mr P. Dwyer made four written submissions on behalf of The Builders' Collective or his private company, took part in two stakeholder meetings, but did not participate in the roundtable discussions. The basis for these selections is not explained in the Reports, which understandably creates a suspicion that those with the loudest voices received the longest hearing. At the same time, some organisations that made detailed written submissions were aggrieved when they were not invited to participate in meetings with the Inquiry staff, and so were unable to clarify or expand on points that had been made.<sup>15</sup>

Despite this apparent imbalance, it is apparent that the concerns expressed by the more vociferous respondents were not influential, suggesting that the Grellman Inquiry was quite discriminating in the weight given to various remarks. No doubt individual attitudes were affected by personal experiences, which may differ within a particular stakeholder group. The Inquiry recognised that their grievances were genuinely felt, but were unrepresentative.

The building industry, through builders and their associations dominated the written submissions, accounting for nearly three-quarters of the total. They were also given almost half of the opportunities for personal meetings and discussions. Insurance industry representatives played a more significant part in the face-to-face meetings than in the written submissions. Consumers had a relatively minor voice, although some of those classified as lawyers or accountants may have been acting as consumer advocates.

The General Manager of the Home Building Service within the Office of Fair Trading (Mr L. Le Compte) appeared before the inquiry on several occasions. This is entirely appropriate, in view of his official position, and his likely involvement in implementing the Grellman Inquiry recommendations. The only qualification to this statement might be that he was a relatively new appointment to the position at the time of the Inquiry, his previous management experience being in quite different areas of the public service. Lacking a background knowledge of the building industry could be considered an advantage or a disadvantage, depending on one's perspective.

### **Introduction**

Grellman admits that no actuarial modelling was carried out, because it was 'not appropriate'.<sup>16</sup> This means that the Inquiry Term of Reference No.4 has not been met. As a result, there is no way of assessing the validity of any of the recommendations. This goes to the very core of the Inquiry, and means that its conclusions become nothing more than expressions of opinion. Some financial modelling that is available was not used by the Grellman Inquiry.<sup>17</sup>

### **What is Home Warranty Insurance?**

Grellman's definition of Home Warranty Insurance is good - 'financial loss caused by the builder's failure to rectify or compensate for the builder's defective or incomplete work', except that in NSW at present it can only be claimed as a last resort after 'the builder has died, disappeared or is insolvent'.<sup>18</sup> The Master Builders Association argues that the term "insurance" is a misnomer for this limited cover.

In some jurisdictions, the customary terminology is "Home Owners Warranty Insurance", which may be a more descriptive nomenclature.

The Inquiry Report states that 'the Home Building Service is also responsible for...education and training'.<sup>19</sup> This remark is inaccurate. Although S.115 of the *Home Building Act 1989* provides that payment may be towards stipulated forms of

education, research and apprenticeship support, this is mainly achieved through the competitive Home Building Grants Program, which has a strong focus on providing consumer information. Education and training in building technology is the responsibility of statutory bodies such as VETAB through the Department of Education and Training, advised by the Construction Industry Training Advisory Board. Unlike its ancestor, the statutory Building Services Corporation, the Home Building Service is not a major facilitator of industry education and training. Actual provision of training comes from universities, TAFE, and other Registered Training Organisations.

### **Home Warranty Insurance in NSW**

The Report states that one of the Inquiry's aims was to 'closely examine' the 2002 legislative reforms, and report the findings.<sup>20</sup> This is in line with Term of Reference No.1. However, in perusing the Final Report, it is not apparent that the Grellman Inquiry did this. Indeed, the Inquiry's "close examination" managed to confuse the reforms initiated in the *Home Building Amendment (Insurance) Act 2002*, with the recommendations from the Joint Parliamentary Inquiry Into the Quality of Building (the "Campbell Inquiry"). This misapprehension may not have been significant for the Grellman Inquiry's conclusions, but it may diminish the credibility of the findings.

The Grellman Report states that the Building Service Corporation 'scheme's assets have been exhausted and all claims are now being funded out of the Government's consolidated funds'.<sup>21</sup> Superficially this is true, but the comment needs to be considered in the context that when disbanding the BSC, all assets were appropriated by the Government.<sup>22</sup> Many builders believe that these funds, originally derived from their licence fees, were later dissipated in the failed HomeFund project, which provided fixed-rate mortgages to low income earners. Whether the BSC, if it had survived, would have had sufficient funds to meet outstanding warranty claims is an open question. The Report implies that the Government rescued the BSC scheme from disaster, when the reality could be the reverse of this.

Some of the statistics produced by the Inquiry are revealing. Royal & Sun Alliance (now Promina following the sale of its Australasian interests by the UK parent company) underwrites 92 per cent of current HWI business; Reward underwrites the remaining 8 per cent.<sup>23</sup> Promina is the third largest general insurer in Australia, and the 65<sup>th</sup> largest company listed on the Stock Exchange, with a significant proportion of the shares held offshore.<sup>24</sup> Promina almost has a monopoly of the market, and clearly is in a position to dictate terms to builders, and probably to the government, which would be fearful of their withdrawal, as this would leave most consumers unprotected. And herein lies the crunch. If an insurer collapses as happened with HIH, or withdraws from that class of business, as did Dexta, the State Government (i.e. the whole community) ends up being the underwriter of last resort. Potentially, it becomes a classic case of privatising profits and socialising losses. Ten years ago, following the disastrous HomeFund venture, a State Parliamentary Committee expressed concern 'at the ease with which the pressure exerted by the [financial] markets affected Government policy'.<sup>25</sup> Despite a change in government, those threats are still powerful.

The existing legislation requires that owner-builders be covered.<sup>26</sup> Clearly this is desirable for the protection of future owners of the property, but it may tend to distort the viability of the HWI scheme. Understandably, practising builders oppose the concept of owner-builders, whom they perceive as unfair competition. Builders

also claim that the construction standards of owner-built houses are dubious. Comparative claims statistics might clarify whether this assertion is justified, but that information is not available .

The minimum insurance cover for \$200,000 seems somewhat arbitrary,<sup>27</sup> given that 88 per cent of disputes are for less than \$25,000.<sup>28</sup> This suggests that most problems are relatively minor, yet the sum of \$200,000 would be inadequate in the case of a catastrophic failure of large (but not necessarily luxurious) houses,<sup>29</sup> which represent approximately 3 per cent of the market.<sup>30</sup> No remedy is proposed by Grellman, although the Report notes that builders are entitled to seek insurance cover above the minimum. In any case, for the home owner building a \$10 million house, insurance cover of \$200,000 in the event of builder insolvency is a rather trifling amount.<sup>31</sup>

The Grellman Inquiry overstates the size of the domestic housing market in NSW. A quote from HIA about building activity refers to Australia as a whole, not NSW.<sup>32</sup> The statement that there were '39,000 buildings under construction' should be

**NSW HOME BUILDING STATISTICS**

(Compiled from ABS 8752.1)

Residential Building Commencements					Value			HOUSES:
YEAR	QUARTER	No.			\$m			AV'GE
		HOUSES	OTHER	CONVER.	HOUSES	OTHER	ALTNS.	COST
2000	Sept 2000	4,404	3,433	224	681.1	520.9	273.4	\$154,655
	Dec 2000	4,669	4,611	211	719.8	739.2	293.6	\$154,166
2001	Mar 2001	4,078	3,344	310	691.4	547.7	308.2	\$169,544
	June 2001	4,600	3,441	105	773.8	477.2	288.4	\$168,217
	Sept 2001	5,827	4,916	267	949.7	925.0	343.9	\$162,983
	Dec 2001	7,158	6,043	208	1,183.4	1,008.8	358.9	\$165,326
2002	Mar 2002	6,001	4,488	303	1,049.6	678.5	356.0	\$174,904
	June 2002	6,250	5,578	419	1,142.5	946.6	470.7	\$182,800
	Sept 2002	6,948	5,847	477	1,251.3	918.2	469.5	\$180,095
	Dec 2002	6,425	7,220	308	1,210.3	1,407.3	425.1	\$188,374
2003	Mar 2003	5,372	5,035	259	1,003.9	1,026.0	404.0	\$186,876
	June 2003	5,572	4,433	367	1,106.5	690.5	470.0	\$198,582

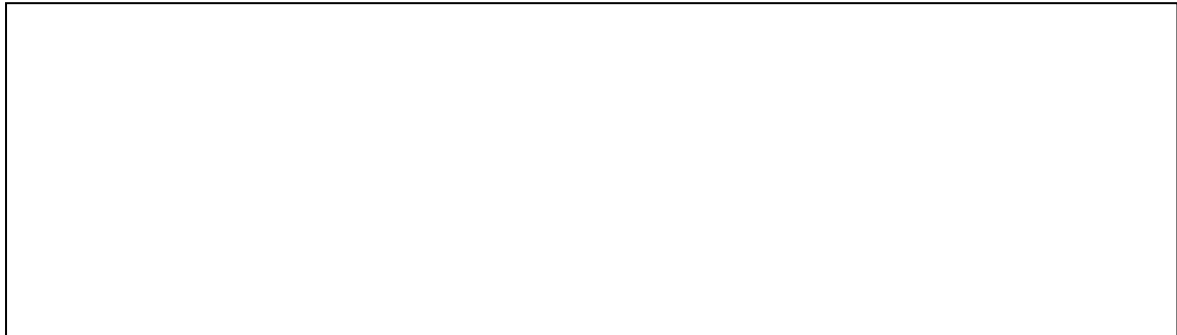
N.B: These are estimates based on sampling. Two chances in three that actual numbers of new houses will be within 3.9%, and other residential work within 2.0%.

**DEFINITIONS:**

"Houses" include cottages, bungalows, detached caretakers'/managers' cottages, rectories.  
 "Other residential buildings" include blocks of flats, home units, attached townhouses, villa units, terrace houses, semi-detached houses, maisonettes.

A building job is regarded as commenced when the first physical building activity has been performed on site in the form of material fixed in place and/or labour expended (this includes site preparation but excludes delivery of building materials, the drawing of plans ... and the construction of non-building infrastructure such as roads.

qualified to read "residential buildings".<sup>33</sup> 13,000 were new houses; 25,000 were multiple dwellings; 1,000 were conversions/renovations. A large proportion of the multiple units would be high rise apartments, now exempt from HWI. These should be excluded from any statistical comparison.



Appendix "D" to this Review presents some information about the largest home building companies operating in New South Wales. It is interesting to observe that fewer than one-third of the 100 largest homebuilders in Australia has a presence in NSW. From these figures it is not possible to dissect the number of houses built in NSW by companies which work across borders (most commonly in Queensland). The largest home building company which operates solely in NSW/ACT (Masterton Homes) is ranked nineteenth on the list. The Grellman Inquiry assumes that because the industry is currently enjoying a comparative boom, this is evidence that builders are not being impeded in obtaining insurance. However, this activity is not spread evenly through the industry. In the twelve months to July 2003, forty-four per cent of detached dwellings in NSW were constructed by only thirty project home companies.<sup>34</sup> After deducting a further 2.6 per cent for owner-builders, the remainder has to be shared amongst more than 30,000 other licensed builders. Many of these report great difficulty in securing sufficient insurance to be able to build enough homes to conduct a viable business.

Statistics based on the value of work completed do not necessarily reflect 'increased building activity' as Grellman asserts.<sup>35</sup> Fewer but larger dwellings could produce this result, as could the use of more expensive materials. The figures used in the Inquiry Report have not been adjusted for inflation in labour and materials costs. The ABS statistics quoted in the above table indicate that the average value of a new house in NSW has risen from \$154,655 in September 2000 to \$198,582 in June 2003, an increase of 28 per cent in under three years.<sup>36</sup> Likewise, statistics related to building approvals are not a measure of building activity, but intent. The only meaningful measure for the purposes of this discussion is the number of commencements.

Using irrelevant statistics, the Grellman Inquiry then proceeds to dismiss submissions that availability of HWI insurance is declining. In any case, the ABS statistics used by Grellman were about six months in arrears at time of submissions; subsequent statistics from ABS confirm that the trend in number of commencements is declining. The high point was the December quarter in 2001, when 7,158 new houses began to be built. By the June quarter 2003, this had fallen to 5,572, a drop of 22 per cent.<sup>37</sup>

The Inquiry notes that the number of Home Building Service licences is increasing. On this basis, Grellman contends that assertions that many builders have left the industry must be false.<sup>38</sup> That statement assumes that builders who leave the industry automatically relinquish their licenses, but obviously they retain their licences to give themselves the option of returning at a later date. Incidentally, it is known that some people have never practised as a builder, although licensed to do so for many years. Furthermore, in an expanding economy one would expect a natural growth in the number of licensed builders as qualified younger people entered the industry.

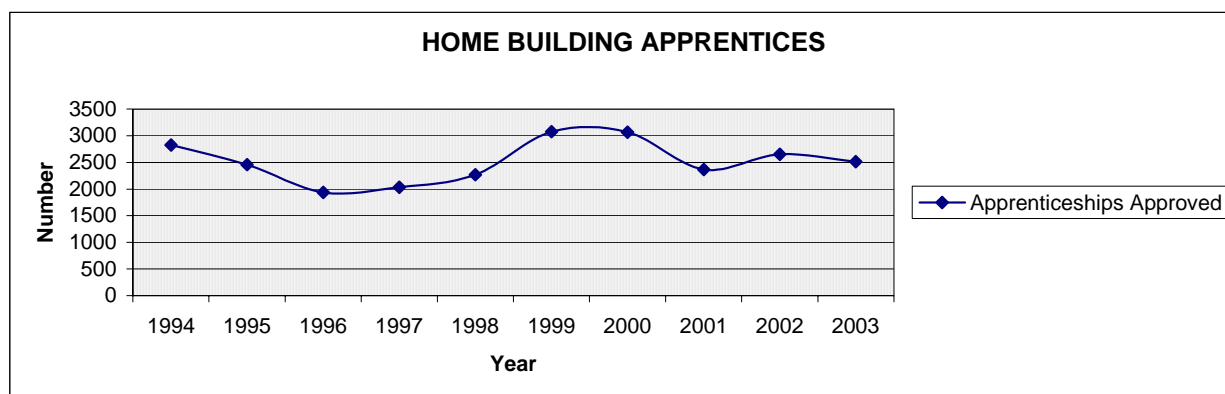
Moreover, since publication of the Final Report, it is clear that the Inquiry's conclusions were premature, and statements about builders leaving the industry are correct. At 30 September 2003, there were 32,574 current building contractors' licences in NSW; three months later this had declined to 30,454 full builder's licences - 7,317 companies; 1,961 partnerships; 21,176 individuals.<sup>39</sup> It cannot be determined how many of these are active.

Furthermore, the Report states that the percentage of licensed builders with insurance eligibility declined to approximately 41 per cent 'over the past six months',



but had since stabilised.<sup>40</sup> Grellman noted that this number had been 42.5 per cent at the end of 2002, so presumably the six months period referred to in the Report means June 2003. However, figures obtained at 30 September 2003, the date of the Inquiry Final Report, show that there had been a further decline to 39.5 per cent, with only 12,867 licensed builders then holding insurance eligibility.<sup>41</sup> The assertions made by the Grellman Inquiry about stabilising numbers are obviously incorrect. The proportion has declined by three per cent in nine months, and shows no sign of abating.

The Grellman Inquiry dismisses the difficulty in recruiting/retaining apprentices, by using gross Department of Education and Training construction statistics without restricting the analysis to housing-related occupations.<sup>42</sup> It is regrettable that the Inquiry did not consult people with a direct involvement in this area, such as CITAB and the Group Training Companies, who could provide more meaningful



information. Separating out those trades applicable to the residential sector (even though many of the individual apprentices will actually be working in the commercial sector), there is a marked fluctuation in the number of apprentices over time, with the overall trend static despite the growth in the industry. Apprenticeships in relevant trades approved during 2003 (2,823) were slightly fewer than the previous year (2,931), but significantly less than the high point in 1999 (3,503).<sup>43</sup>

A number of factors may contribute to this situation. There are anecdotal reports that the difficulty of obtaining HWI has prevented small builders from employing apprentices, but it is impossible to verify this. Even more relevant to the analysis, but overlooked by the Inquiry, is the high rate of dropout from apprenticeships. Many leave after a short period of training to find more lucrative employment. They might still work in the building industry, but will never become tradespeople. Sometimes a builder is forced to relinquish an apprentice because there is insufficient work available, but the statistics quoted in the Report ignore these variables.

Much more sophisticated analysis is required, to determine whether there has been a fall in apprenticeship numbers within the small-to-medium builder sector. Perhaps this has occurred, but has been offset by stronger recruitment by the larger builders. Furthermore, there may be a different experience in country regions when compared with the capital city. Although it is dangerous to make generalisations based on crude numbers, the claims put forward by advocacy groups such as B-Fair that 'apprenticeship intake is down by 40 per cent'<sup>44</sup> seem greatly exaggerated. Counterbalancing the builders' assertions, Grellman's statement that apprenticeship numbers have increased by 31 per cent is equally wrong.<sup>45</sup>

## **Stakeholders and Service Providers**

The Terms of Reference for the Inquiry introduced the notion of separate stakeholders and service providers, without defining these terms.<sup>46</sup>

The concept of "stakeholders" needs some clarification, and how they are differentiated from "service providers".<sup>47</sup> Only two stakeholders are identified by the Grellman Inquiry - consumers and the NSW government. The customary meaning of "stakeholder" implies somebody having a financial relationship to a transaction (it is a term derived from the gambling industry, which may or may not be appropriate in this discussion). Surely the builders and sub-contractors have the most central of these relationships, since only these "service providers" stand to lose their livelihood.<sup>48</sup> One would also like to think that the broader community is a stakeholder, but Grellman makes no reference to concepts such as social justice, community cohesion, or wealth creation that arise from the activities of the building and construction industry.

The Grellman Inquiry maintains that 'A number of consumer representative groups are outspoken critics'.<sup>49</sup> The only group of consumer activists identified in the appendices to the Final Report is BARG (Building Action Review Group - incorrectly called Building Action Reform Group in some parts of the Report). This is an incorporated association, whose membership composition is unclear. Some members are believed to be related to each other, or come from the same ethnic community. Their diligence is to be applauded; at least one of the leading activists in BARG has appeared previously at every other inquiry into consumer protection of home owners. It is conceivable that some individuals are pursuing personal vendettas, having become obsessed by their repeated failure to achieve outcomes that satisfy them.

The Australian Consumers' Association is regarded as the peak body representing consumers, but did not make a submission to the Inquiry. This was largely because of their policy of dealing primarily with national, rather than State-based issues. Subsequent to publication of the Grellman Inquiry Report, however, the ACA has made highly critical remarks about the recommendations. The position adopted by ACA is that last-resort insurance provides no meaningful protection for consumers.<sup>50</sup>

The Grellman Inquiry dismisses the role of sub-contractors in one sentence.<sup>51</sup> This suggests a serious misunderstanding of the nature of the modern building industry, which except for small family-owned building companies, is largely carried out by individuals or firms working as sub-contractors to the principal builder. It is commonplace for larger building firms to be owned and managed by people whose expertise lies outside the construction industry, but who employ licensed supervisors to oversee the work of sub-contractors. Work carried out by sub-contractors very often exceeds the \$12,000 threshold, and so is subject to Home Warranty Insurance. Most of these sub-contractor groups have their own representative industry associations, but only a handful of the largest made submissions to the Inquiry.<sup>52</sup>

Although many trade and professional groups did not make submissions (e.g. the Building Industry Specialist Contractors Organisation; the Australian Institute of Building), individual members of those bodies may have. Certainly the Minister believed there was comprehensive coverage when he stated 'Mr Grellman has been listening to the criticisms of...sub-contractors'.<sup>53</sup> As noted earlier, few of the people who were invited to attend interviews actually saw Mr Grellman, but instead met with a member of the Inquiry staff.

The Grellman Inquiry assumes that between the Housing Industry Association and the Master Builders Association, the interests of home builders are represented adequately.<sup>54</sup> Both these contractor associations have a high public profile, but they compete for members and are cautious about disclosing membership numbers, although their combined financial membership in New South Wales is probably fewer than 15,000. Even if all of these were engaged in home building, it would represent less than one-half of licensed home builders. Of course, it may well be that MBA and HIA members account for a much larger proportion of the actual homes constructed than do non-members of these associations. MBA has a number of members who work solely in the commercial construction sector. HIA has a considerable number of members from the product manufacturers and suppliers arm of the industry who are mainly involved in marketing - note that the word "builder" does not appear in the Association's name. Both HIA and MBA have members from specialist consultancy or sub-contracting areas who are not "builders" in the traditional sense. So the total number of home builders within their respective associations must be fewer than membership numbers suggest in any case. MBA and HIA may have been given credence by Grellman out of proportion to their active membership numbers. The relative weight of these associations varies between States: MBA is dominant in Queensland, HIA in Victoria, and they are more evenly-matched in NSW. Both associations conducted a vigorous campaign at the Inquiry, with their national offices making submissions as well as their State and Regional branches.<sup>55</sup>

Furthermore, in the case of high-rise residential projects and the development of large suburban estates, some of the major firms are members of Australian Constructors' Association (Australian Industry Group) rather than, or in addition to, membership of HIA or MBA. AIG did not make a submission to the Inquiry, but encouraged members to make their own response.<sup>56</sup> Subsequent to the Inquiry, the Government removed high-rise dwellings from Home Warranty Insurance, so the views of AIG members may now have become less relevant, although this was not the case at the time the Report was being prepared.

Some industry groups such as B-FAIR and The Builders' Collective were formed largely as a result of dissatisfaction with Home Warranty Insurance - thus becoming an industry counterpart to the consumer activists in BARG - but were still identified as "service providers" rather than "stakeholders".

Amongst the statistics relating to stakeholders, the Inquiry Report mentions that there were 50 requests for information, but does not explain the nature of these requests, or where they originated.<sup>57</sup> Possibly some of these came from organisations which decided not to make a submission after obtaining this information. Without some explanation, it is a snippet of gratuitous comment, irrelevant to consideration of the Report.

Grellman noted the alleged difficulty for new/younger builders to enter the market,<sup>58</sup> and conceded that other models of Home Warranty Insurance might do better, but was unable to recommend these. Obviously it is in the commercial interests of the insurers, and established builders with insurance, to preserve the status quo.

The Report draws attention to consumers' concerns about the lack of 'regulatory intervention during the construction period'.<sup>59</sup> This now has been addressed by legislative amendments and the Department of Infrastructure, Planning and Natural Resources requirements for mandatory inspection at critical stages of construction. However, consumers - and the Grellman Inquiry - may expect too much from this intervention. The intention of building regulations is often misunderstood: dealing

only with health, safety & amenity, not the very subjective issue of quality. Regular inspections may not satisfy consumer demands in many instances; the best that can be hoped for is that dwellings will be "fit for purpose". In other words, they will not collapse, or leak; but the brick courses still may not be straight or the walls perfectly even.

Builders frequently draw attention to the problems caused by low standards, which are not excluded by the regulatory process, and are often caused by the so-called "cowboys" in the industry.<sup>60</sup> In some building trades, a majority of the practitioners are not qualified tradespeople. Through ignorance, these operators may use inferior materials or inappropriate construction techniques in order to minimise costs. Although the licensed builder or supervisor should detect these potential problems, commercial pressures militate against this in many instances. Building regulations and critical stage inspections will not deal with these issues, nor will they be covered by Home Warranty Insurance. A comprehensive scheme for the mandatory accreditation of competency for all building and construction practitioners is being promulgated currently by an Industry Working Group that has been meeting for the past three years, in an effort to deal with this problem up front, rather than depending on subsequent rectification of faulty work.

After misquoting the Campbell Report, the Grellman Inquiry recommended that high-rise construction should be exempted from HWI.<sup>61</sup> Subsequently, the Government announced that this would be done, bringing NSW practice in line with other States. Ironically, it was because of strident consumer complaints and adverse media coverage of the faults in high-rise apartments that led to the Parliamentary Joint Committee Inquiry on the Quality of Buildings. The Campbell Report arising from that Inquiry only briefly touched on the question of Home Warranty Insurance, mainly to propose that there should be a public database of HWI claims. It certainly did not recommend that HWI should be removed from high-rise dwellings. Campbell did propose an appeals mechanism for builders whose insurance applications are rejected, and made a firm recommendation that the HWI policy should be attached to a contract of sale.<sup>62</sup> Both of these proposals in the Campbell Report were ignored by Grellman.

One of the objectives in privatising Home Warranty Insurance was to allow freedom of choice within a competitive market. Initially, this appeared to occur, with five companies involved, but subsequent events led to the present situation. Most stakeholders would like to see additional APRA-approved insurers in that market. However, there is only room for one, or possibly two more according to Grellman.<sup>63</sup> The existing insurers could be expected to advocate this position forcefully, using the threat of withdrawal to reinforce their case. Their attitude probably is inconsistent with national Competition Policy. Furthermore, insistence upon APRA approval may be a diversion from the main issue. The legal profession places its professional indemnity with non-APRA overseas insurers, and it is understood that a number of government agencies do the same. The Local Government and Shires Association of NSW have operated a mutual insurance scheme for many years, but this would be unlikely to appeal to Mr Grellman, who was involved in the demutualisation of Australia's largest insurer, the AMP Society. In Victoria, Tasmania and the Australian Capital Territory, warranty insurance providers are not required to have APRA approval. Incidentally, HIH, the company whose spectacular collapse led to the present insurance crisis, was APRA-approved.

The Grellman Inquiry received a suggestion about an independent licensing body, as an alternative to the existing Home Building Service, but considered this would only

work if the body is not "captured" by the industry it regulated.<sup>64</sup> This is a valid criticism, but it must be remembered that the BSC was a government authority, which according to some consumers was captured by the building industry; in other words the alleged danger is not inherent in the structure of the organisation. More likely, it reflects an organisational culture that is related to the background of the staff who are employed. As part of the mandatory competency accreditation scheme proposed by the Industry Working Group referred to earlier, there would be an independent accreditation agency responsible to government for the integrity of this service through a co-regulatory approach.

The Grellman Inquiry says that the lack of mandatory building standards is a problem for both consumers and builders.<sup>65</sup> This shows a lack of sympathy with the concept of performance-based criteria in the Building Code of Australia, and would be considered a retrograde step in terms of national uniformity. More education/public information in this area is clearly necessary to explain the objectives as well as the potential benefits. DIP&NR is the Department concerned with the promulgation of building regulations. Although the Department made a written submission to the Inquiry, its contents are unknown. Perhaps what the Grellman Inquiry was really seeking is a schedule of measurable tolerances to describe an acceptable standard of finish, although this would rarely be useful in a last-resort insurance scheme, where claims can only be made during the first two years in the case of non-structural failure, and only in the case of builder insolvency.

### **Recurring Criticisms**

The Grellman Inquiry lists some of the issues of concern to consumers.<sup>66</sup> Often these are based on emotion rather than logic, and clearly arise from ignorance of the building regulatory process, but builders frequently express similar misunderstandings. Building regulations, inspection and control are solely concerned with the health, safety and amenity of a building. Quality is a subjective issue, and is not governed by the regulatory regime. As with most consumer products, there is usually a direct relationship between price paid and the quality of materials and workmanship. It is human nature to want superlative quality for minimal cost.

Grellman also remarked on several issues of concern to builders, such as a requirement to pledge their own assets.<sup>67</sup> In effect, this means that the insurer is carrying negligible risk, because in the event of default (or even death) those assets will be called upon to make good any losses. The problem is particularly acute for smaller builders who do not have the comfort of substantial funds available. These concerns do not appear to have been addressed adequately in the Final Report; their impact was not assessed as the Terms of Reference required.<sup>68</sup>

The fact that both consumers and builders have complained about a lack of objectivity in decisions of the Consumer Tenancy and Trader Tribunal should be taken as a positive sign, suggesting that the CTTT is working effectively. In any jurisdiction, one expects that fifty per cent of litigants will be dissatisfied with the outcome.

Grellman notes that most parties expressed concern about the lack of stability and predictability since the inception of HWI in NSW.<sup>69</sup> This is not surprising, given the changes to the scheme made by successive governments over a period of thirty years, culminating in the withdrawal of most private insurers from the market more recently. It forms the strongest argument for preservation of the *status quo* for the next few years, in order that everybody involved may work within known boundaries.

## **Scheme Issues and Reform Principles**

In comparing private underwriting with a government scheme, the list of advantages is potential rather than actual. There is no evidence that insurers really do employ people with appropriate skills to assess the building industry.<sup>70</sup> This has been one of the recurrent criticisms made by builders.

The Grellman Inquiry correctly observes that HWI is the only form of home insurance that is compulsory.<sup>71</sup> In principle, what is the difference if a homeowner suffers property loss through a bushfire or a defaulting builder? The only other area where compulsory insurance is found is in third-party motor insurance, which exists to protect not the car owner, but innocent third parties injured by that person. Mr Grellman, as chairman of the authority which administers that scheme, would be thoroughly familiar with its operations. It could be argued that Home Warranty Insurance is a form of subsidy for the insurance industry, through a compulsory levy on all persons purchasing a new home.

The Grellman Inquiry maintains that one of the advantages of a last-resort scheme is that more onus is placed on the builder to rectify faulty workmanship.<sup>72</sup> This line of reasoning is unclear. Surely a builder is more likely to be concerned with the quality of his product under a first-resort scheme, rather than one which is only enforced if he dies, absconds or becomes bankrupt. Solvency cover is a unique feature of the current scheme, but many consumers would prefer cover for quality in workmanship.<sup>73</sup> Incidentally, the only jurisdictions in Australia that offer first-resort schemes are Queensland and Northern Territory.

The Terms of Reference for the Inquiry required recommendations for a scheme that is 'robust and sustainable'.<sup>74</sup> Amongst the dictionary definitions of "robust"<sup>75</sup> is 'lacking in subtlety' (OED) and 'rough, rude' (MD). Hopefully, these are not the qualities the community is looking for in an insurance scheme. At the very least, the Inquiry should have attempted some definition of the term "robust" as he perceived it for the purposes of this Inquiry. Grellman does, however, list what are considered to be the five hallmarks of a robust, stable scheme.<sup>76</sup> These are: Accessibility; Affordability; Fairness; Efficiency; Viability.

The Report remarks that no scheme is likely to satisfy all parties, but it must be fair. Grellman describes the scheme's 'ultimate purpose - consumer protection'.<sup>77</sup> This may be government policy, but is not what the Terms of Reference for the Inquiry stipulate. Rather, the first of those Terms of Reference states that the Inquiry must consider whether the existing scheme is 'currently effective for consumers and industry'.<sup>78</sup> Presumably this means the building industry, not the insurance industry.

National consistency is favoured by the Grellman Inquiry, to be achieved by blending the two biggest schemes, NSW and Victoria.<sup>79</sup> Although this would cover 75% of the HWI market according to Grellman, it is certainly not "national" because six of the eight State or Territory jurisdictions are not included. In any case, the argument in favour of national consistency is not self-evident, although Grellman refers to its significance for 'insurer operating efficiencies', i.e. maximising profits. There is no indication of what benefits, if any, accrue to consumers or builders by having the NSW scheme identical with that in Victoria (or anywhere else). Victoria differs from NSW in one significant respect, in that non-APRA approved insurers are not precluded from that market.<sup>80</sup>

Echoing the conclusion of the Interim Report that 'The majority of stakeholders are critical of a variety of aspects of the current Scheme',<sup>81</sup> the Final Report remarks that

'the extent and consistency of recurring criticisms supports the need for early change'.<sup>82</sup> Nevertheless, Grellman believes any such changes will take considerable time to implement, and recommends against them.

A criticism raised by one insurance company in its submission to the Inquiry, as quoted in the daily press, was that 'the absence of an efficient, effective and sustainable regulatory framework' had stopped it from entering the market.<sup>83</sup> There was a concern that previous reform proposals had not been implemented. That is an incorrect generalisation - some changes had been introduced. Grellman meets the criticism with recommendations for a Scheme Board, an Industry Deed, and regulation of premiums through the Home Building Service.<sup>84</sup>

### **Home Warranty Schemes in Australia**

The Grellman Inquiry reported that 'many interested parties have expressed a strong interest in this [QBSA] model.'<sup>85</sup> Although it makes a profit for the Queensland Government, Grellman seems to have a prejudice against government-run schemes. Although written material describing the QBSA scheme was obtained from Queensland, the Inquiry staff apparently conducted only a brief interview with the scheme managers, unlike their Victorian counterparts (Grellman's preferred model).<sup>86</sup> Amongst the "stakeholder representatives" interviewed by Grellman, we find from Victoria the Minister for Finance & Consumer Affairs, as well as senior officials from Treasury and the Building Commission.

Fourteen months before the Grellman Inquiry commenced, the New South Wales and Victorian governments had announced uniform Home Warranty Schemes.<sup>87</sup> The Victorian Minister (Hon. John Lenders) made the position clear when he stated 'the things that we were trying to do with HIA, operating nationally, was to also work with obviously the other great player in this, being the New South Wales government, to have a joint approach from the two major states which covered seventy per cent of the construction industry so that we could keep this important product of builders warranty insurance alive'.<sup>88</sup> The Minister went on to eulogise the role of Royal and Sun Insurance and the Housing Industry Association in achieving this outcome. He did not mention that this was an exclusive product, with the benefits apparently available only to HIA members. The press conference at which the new joint venture was launched took place in Melbourne the day before the Grellman Report was presented to the Governor of New South Wales. Unfortunately, it has not been possible to document the part played in these negotiations by the NSW Government, but it is noted from an appendix to the Final Report that Minister Della Bosca met with the Inquiry on three occasions between publication of the Interim Report and the Final Report. Following such clear statements of government policy, it would have been politically unacceptable for the Grellman Inquiry to recommend any other structure. The best that Grellman could expect to achieve was some minor improvements at the fringe.

### **International Examples**

The Interim Report contains a description, but no evaluation, of selected overseas schemes.<sup>89</sup> Much of this material was already available, in more detail, in the Allan Report. Other possibly relevant comparable countries are not mentioned, e.g. New Zealand, Scandinavia, Japan. This response provides only a perfunctory acknowledgement of the Terms of Reference.<sup>90</sup> International examples are ignored completely in the Final Report.

The Grellman Inquiry appeared to be unaware that there is a triennial International Housing & Home Warranty Conference, which has met twice in Australia (Melbourne, 1996; Sydney 1984). Reports are available from the nine conferences that have been held to date through the Australian Building Codes Board, and would have yielded additional information for the Inquiry.

The Director of the Australian Centre for Construction Innovation informed the Grellman Inquiry about the European *Decinale* defects liability insurance, where the insurers include an allowance for quality auditing fees in their premiums, in order to manage their risks.<sup>91</sup> This provides benefits for both consumer and insurer.

As an example of another option, in Japan all builders are required to warrant new houses for 10 years (and they build 100,000 new dwellings each year, about 20 per cent of which are detached houses). Eighty per cent of the repair cost is paid when a defect occurs. There are two mandatory inspections during construction. It is optional for builders to take out insurance against warranty claims. They pay an annual registration fee of AUD\$400, plus a premium of around AUD\$1,000 for each dwelling built. There is a discount for small and medium-sized builders.<sup>92</sup>

### **Recent Reviews of HWI**

In his national review, Percy **Allan** concluded that HWI was in crisis, and proposed making the building process more reliable and less acrimonious.<sup>93</sup> Grellman appears to be much more sanguine about the current situation. The Parliamentary Standing Committee on **Law and Justice** favoured indemnity by industry associations to counteract an implied threat by insurers to desert the industry.<sup>94</sup> This option was rejected by the Grellman Inquiry.

The **Campbell** Inquiry noted that the building regulatory regime is poorly understood by builders and consumers.<sup>95</sup> This suggests the need for education of these stakeholders, rather than changing the regime. Campbell believed that 'the greatest form of consumer protection was considered to be prevention and getting the right outcome at the beginning'.<sup>96</sup> The Grellman Inquiry has not followed-up on this important issue. The Government did not adopt Campbell's proposal for an Independent Building Commission,<sup>97</sup> perhaps because it was reminiscent of the BSC, and it would be politically unacceptable to revert to a model that had been disparaged many years ago because of its apparent failure.

**Dodd** was critical of the "one-stop shop" concept, and considered that government should not run a monopoly insurance business.<sup>98</sup> In contrast, the Australian Consumers' Association has remarked that the "one-stop shop" is much better for consumers, who usually do not have the time or knowledge to negotiate a labyrinth of multiple agencies.<sup>99</sup>

**Crawford** believed that the BSC had developed a culture to minimise claims.<sup>100</sup> This would be characteristic of any insurer, public or private. Insurers are notorious for invoking the "fine print" clauses in their policies. Indeed, it is likely that the profit motive will encourage private insurers to be more rigorous than the public sector; there is anecdotal evidence to support this, with suggestions that BSC tended to be lenient with dubious claims. A claimant always believes that their claim has indisputable merit, but assessment by a third party sometimes does not support that view.

### **Options**

#### **OPTION 1: IMPLEMENTATION OF THE 2002 SCHEME**



There is a serious factual error when the Grellman Report states that the NSW and Victorian Governments jointly announced reforms to HWI following the Campbell Inquiry.<sup>101</sup> There was no connection with the Campbell Report, which only touched on insurance very briefly. The trigger for these "reforms" came when the remaining insurers threatened to withdraw from the existing scheme in 2001.<sup>102</sup> Legislative changes were introduced in 2002, with their impact later scrutinised by the Parliamentary Standing Committee on Law and Justice,

The Grellman Inquiry recognises that for long-term stability, the HWI scheme needs to improve the builder's skills.<sup>103</sup> Grellman assumes that stronger licensing will achieve this. However, the existing licensing regime is intrinsically quite firm; the problem may rather be one of enforcement. Grellman does not recommend any attention to better recruitment, training and accreditation - and may not realise that the Building Services Corporation used to fund such services directly. In the opinion of many practitioners, this was a legitimate use of their licence fees, and there has been a noticeable deterioration in quality standards since that time.

Grellman suggests that 'entry of additional insurers may be destabilising'.<sup>104</sup> It is difficult to reconcile this reasoning with arguments in favour of a competitive, privatised insurance scheme. The Terms of Reference for the Inquiry envisage that one or more insurers should be encouraged to enter the market.<sup>105</sup>

#### OPTION 2: ACCELERATED ENHANCEMENTS TO CURRENT SCHEME

The Inquiry's argument for the creation of a Scheme Board is unconvincing,<sup>106</sup> although it has now been implemented. It appears to introduce another layer of bureaucracy for little effect. Avoidance of fragmentation between government authorities is one justification.<sup>107</sup> This co-ordination may have been achieved already by the creation of the high-level inter-departmental Building Consultative Committee, which can be seen as a quasi-Ministry of Construction.

An Advisory Council as proposed by Grellman may be worthwhile, but the fact that building industry representatives are effectively appointed by MBA and HIA is a concern, because this potentially omits large sectors of the industry.<sup>108</sup> Most of the affected parties will not be members of the Advisory Council. Incidentally, both the Scheme Board and Advisory Council will be susceptible to industry "capture" in the same way as the BSC was, it is alleged.

Not surprisingly, Mr Grellman thinks the Motor Accidents Authority is a good statutory model.<sup>109</sup> After all, he is Chairman. Note that Third Party Motor Insurance used to be a government monopoly (GIO) until the economic rationalists allowed private insurers in the market. The role of the MAA is to regulate these insurers, similar to the proposed Scheme Board. Regulatory oversight of insurers is fraught with difficulty. How can the regulator determine whether the return to the insurer is excessive, particularly if he represents that industry. If the industry deed proposed by Grellman is a non-binding agreement, it is legitimate to ask where its value lies?<sup>110</sup> Reliance on industry goodwill is rather naïve. Some sanctions are necessary.

The Grellman Inquiry notes with approval the recent Queensland licensing reforms, which have created a link between licences and competency assessment.<sup>111</sup> This is one of the reasons that many people from the building industry support that model. Grellman states that reform in this area is 'a priority for the Home Building Service', but doesn't seem to follow-through into the recommendations.<sup>112</sup> Furthermore, he appears to have a poor grasp of existing licensing provisions in New South Wales. In commenting on the Queensland requirement that it will become an offence to engage

an unlicensed trade contractor,<sup>113</sup> the Inquiry seems to be unaware that this provision has been in place for many years in NSW.

To state that there is no independent private sector interest in developing a grading system is incorrect.<sup>114</sup> Such schemes are already in place at the professional and para-professional level, through the Australian Institute of Building, the Institution of Engineers Australia, and the Australian Institute of Building Surveyors, for example. An Industry Working Group involving a number of contractor associations and professional institutes is currently engaged in developing an industry-wide accreditation and grading scheme. Because these bodies did not make submissions to the Inquiry, Grellman has ignored their presence. As noted earlier, the whole performance of the Inquiry has been dominated by a reactive approach, rather than a fact-finding mission.

### OPTION 3: AN INDUSTRY SCHEME

The Grellman Inquiry observed that current legislation in New South Wales would allow this option.<sup>115</sup>

Understandably, after the insurance fiasco of the past two years, there are misgivings about any proposals based on a non-APRA approved insurer.<sup>116</sup> At present, the NSW Government requires that any home building indemnity scheme must be underwritten by an insurer authorised by APRA, or the scheme itself must be authorised by APRA. However, the Minister is given power to authorise alternative indemnity arrangements.<sup>117</sup>

The Canadian 'condo crisis' is cited by HIA as an example of a catastrophic failure of an industry-based scheme - the New Home Warranty Fund established by Canadian Home Builders Association of British Columbia.<sup>118</sup> The Canadian experience resulted from an unsuspected flaw in the design and regulations governing multi-storey timber-framed apartment blocks, which are uncommon in Australia. A private insurer may well have failed under similar circumstances. The outcome may be due to the particulars, not the principles of the warranty scheme. New Zealand has also encountered problems with condensation in unventilated timber-framed dwellings. A recent investigation by the Australian Building Codes Board has produced no indication that similar problems have been detected in this country.<sup>119</sup> If, as alleged in the daily press, HIA is a beneficiary of the existing insurance scheme, it could be expected to have a vested interest in denigrating alternatives.<sup>120</sup>

The Grellman Inquiry claims that 'creation of an industry monopoly is insupportable'.<sup>121</sup> At present in NSW we have a virtual monopoly by one insurer. Is Grellman referring to the insurance industry or the building industry? If the latter, why is this worse? At least the profits are likely to be returned to the industry that generated them. Does Grellman really mean "insupportable" = "unjustifiable", or "unsupportable" = "cannot be supported".

The Master Builders' Association of NSW put forward comprehensive plans for several alternative industry-based schemes:<sup>122</sup>

Model 1 - High-rise exclusion model. This need not be considered further, since the government has now exempted high-rise developments from HWI requirements.

Model 2 - Scheme based on licence fees. This would be administered through a not-for-profit company established for that purpose. Reinsurance would be purchased for portion of the liability, possibly through an overseas company. As a not-for-profit

scheme, the cost of premiums is likely to be lower than with a private, commercial scheme. This model is based on USA practice.

Model 3 - Queensland-type scheme run by industry and/or government. This links licensing with insurance; a licensed builder is guaranteed access to home warranty cover.

Model 4 - This offers four variations on other schemes, with provisions such as exclusion of projects that are administered by third party professionals, e.g. architects.

MBA offered to provide financial modelling in relation to these schemes, but because they did not involve the participation of an APRA approved insurer, the Inquiry did not investigate the proposals in any detail.

#### OPTION 4: CONSUMER HOME COVER

Under this option, insurance would be purchased directly by consumers, providing cover of "second last" resort. To succeed, this option needs a 'robust' licensing regime.<sup>123</sup> The Inquiry considered it is an attractive option, but would be accompanied by significant risk. Accordingly, it is an option that is not favoured by insurers, although at least it includes them in the equation.<sup>124</sup> Nevertheless, Grellman believes it should be explored as a possible future pathway.<sup>125</sup>

#### OPTION 5: A GOVERNMENT SCHEME

One potential model is the QBSA scheme, underwritten by government with private reinsurance.<sup>126</sup> This is not a politically acceptable option for a NSW government which has divested itself of commercial undertakings, although it is noteworthy that Queensland makes a profit from their scheme. Indeed, the NSW Minister for Commerce is reported to have given the Government's 'reassurance' that it would not re-institute a state scheme.<sup>127</sup> That pre-empts any recommendations under the Terms of Reference, where the Inquiry was specifically required to report on 'schemes incorporating government as insurer or re-insurer'.<sup>128</sup>

It is interesting to note that the QBSA Board includes representation from unions and trade contractors. This would have been unacceptable to the Dodd and Crawford Inquiries, which both complained that the BSC scheme in NSW had been 'captured by the industry'.<sup>129</sup> Ideological issues are apparent in many of these Inquiries, which have shown a marked predilection for the alleged greater "efficiency" of the private sector. On the other hand, Professor Percy Allan spoke favourably about the consensus that had been achieved through the involvement of all parties, which he believed was central to the success of the Queensland scheme.<sup>130</sup>

Despite the Grellman Inquiry's assertion that financial and actuarial modelling is not feasible, as required by the Terms of Reference, this information is available in relation to the QBSA scheme, but was not sought by the Inquiry. However, in view of the Government's dogmatic attitude about becoming involved in a public insurance scheme, Grellman probably accepted that there was little room to move when discussing this option.

It is not widely known that the NSW Government (and thus the community in general), is in fact acting as a substantial underwriter of Home Warranty Insurance. Until 31 December 2003, it reinsured all high-rise construction policies. It has also undertaken to reinsure all future claims above \$10 million arising from the collapse of any one builder - effectively covering all major project home builders. It continues to underwrite the Home Warranty Insurance policies issued by the failed HIH

insurance group, previously the largest company in this field . There also remains some exposure for claims arising from the former BSC scheme. So in reality, the government has not withdrawn from the market but has been left with a large exposure. Undoubtedly this is one reason why it is reluctant to become involved in the single-dwelling market, and so increase the risk to government finances.

#### OPTION 6: A VOLUNTARY SCHEME

The "optional insurance" option. The scheme could be coupled with enhanced licensing and regulatory criteria to minimise the risk of failure, but it would be up to the consumer to decide. Other home insurance is voluntary - fire, flood, contents; why should HWI be mandatory?<sup>131</sup> An obvious fear is that price-sensitive consumers would be the most vulnerable, because they might not insure.<sup>132</sup> These are the same people who decide not to insure their house, then expect charity, the community, and/or the government to compensate them when their home burns down in a bushfire. No doubt they would expect the same service when their cheap and shoddy builder absconded, leaving a catalogue of faults. This seems to strengthen the case for compulsion, yet with the average claim around \$12,000, it would cost less for the community to meet this cost than to maintain a large public or private insurance infrastructure. It may even be beneficial in terms of the overall effect on the economy.

An alternative proposal for achieving defect-free work in residential housing recognises that most building activity is carried out by licensed sub-contractors working for the builder, yet these sub-contractors suffer no penalty for poor performance. Under this scheme, all residential sub-contractors would be required to lodge an appropriate security bond as a condition of retaining their trade licence. The bond could be called on by builders or owners to rectify defective work, once the matter had been adjudicated in the appropriate tribunal. The bond would be analogous to a rental bond paid by tenants.<sup>133</sup> This proposal was not submitted to the Grellman Inquiry for consideration, but is worth examining.

Another option, of course, would be to abandon any attempt at providing home warranty insurance, allowing the market to prevail using the fine old legal principle *caveat emptor*.<sup>134</sup>

Even if this was had been contemplated, the Grellman Inquiry doubtless would have felt constrained under its Terms of Reference from making a recommendation along these lines.<sup>135</sup>

Insurers would not like any of the alternatives discussed under this heading, because their guaranteed risk-free income stream would be destroyed. While they would still to be able to offer an appropriate form of cover for interested parties, the market may then be too small to be viable, or the premiums excessive.

#### **Additional Matters**

The Grellman Inquiry advocates rationalisation of industry bodies, being concerned that they met 13 groups from the building industry, offering many divergent opinions.<sup>136</sup> Apparently, diversity is not valued. Moreover, the report fails to mention that one submission came from a group of 20 stakeholders (or service providers) who presented a common position.<sup>137</sup> Perhaps the Inquiry should have felt relieved that there were relatively few submissions - there are over 80 registered groups in NSW alone connected with the building industry. This fragmentation reflects the nature of the industry itself, with the use of new materials and technology combined with an increasing trend towards specialised sub-contracting. In the past,

the building and construction industry has shown that it is able to form a peak body for specific issues, e.g. for the calculation of cost adjustment indexes related to contract prices, but on more general matters it has proved very difficult. Partly this is due to the historic rivalry - at times antipathy - between HIA and MBA, which probably has been exacerbated by the Grellman Inquiry.<sup>138</sup>

Governments have tended to use this fragmentation to suit their purposes variously at different times. "Divide and conquer" can be a useful strategy. Confronted by multiple sources of advice, governments may implement whatever is politically expedient.

Fragmentation does not only occur throughout the building and construction industry, but also within the constituent associations and institutes themselves, which often find it difficult to achieve a consensus position on an issue. From the responses to the Grellman Report, it is apparent that individual members' views differ according to their selfish interests. This is part of human nature.

Grellman heard many anecdotes about the alleged proliferation of "phoenix" companies, which he accepted at face value. Whether this remains a problem is debatable, given that NSW has introduced legislation preventing a person from holding a licence for three years after becoming bankrupt, or associated with an entity that has been wound up. There is a limit to the number of family members who could be recruited as sham directors.

The Grellman Inquiry considers that it is desirable to have a register of previous claims on a property.<sup>139</sup> The necessity for this is not explained, although it was one of the few recommendations relating to HWI arising from the Campbell Inquiry.<sup>140</sup> Because it is insurance of last resort, surely there can be only one claim, although of course the owner may have pursued the builder earlier over other matters that do not come within the scope of HWI. The analogy with REVS seems to be irrelevant.

As noted before, although the Grellman Inquiry favours mandatory building standards, this is contrary to the whole rationale of national performance-based standards, which are intended to provide consumers with a wider variety, built in accordance with international best practice.<sup>141</sup> The re-badged Victorian *Standards and Tolerances Guide* that is being distributed by Home Building Service has met strong opposition from NSW builders because it is not based on accepted practice in this state, and its provisions are unenforceable. However, arrangements are already being made for the *Standards & Tolerances Guide* to be reviewed regularly.<sup>142</sup>

The Grellman Report suggests that the Scheme Board exclude residential building work that is carried out by an individual tradesperson, unless the work requires a Development Application.<sup>143</sup> This position is supported by some of the sub-contractor associations, particularly as the smaller trade contractors find it extremely difficult to obtain warranty insurance. Grellman may not realise that in NSW these people are all licensed by the Home Building Service.

The Inquiry heard reports about the growth in owner-builder activity, but was unable to determine the extent of non-approved owner-builder work.<sup>144</sup> Such anecdotes are certainly rife throughout the industry, with various stratagems being described to keep below the \$12,000 threshold. The only indication of trends would be through the number of licences issued, and the enrolments in courses conducted by various Registered Training Organisations, including TAFE. The Home Building Service refused to make that information available for this review of the Grellman Report. In

any case, some (or many) of the applicants for owner-builder licences may not proceed with the proposed work.

### **Recommended Approach**

The Grellman Inquiry recommends that, ultimately, consumers should purchase their own insurance. However, there should be a lengthy transition period, with oversight from an Interim Scheme Board, and regular reviews.<sup>145</sup> There is no indication that insurers actually sought this transition period.

Meanwhile, we are to work with Option 2 - described as 'Accelerated enhancements to the current scheme'. The Grellman Inquiry does not identify the likely impact of this preferred model, as required in the Terms of Reference.<sup>146</sup>

A long transition period is not a satisfactory solution for those small or medium-size builders who are claiming a serious disadvantage because of difficulty in obtaining Home Warranty Insurance. If their concerns are justified, few are likely to survive in business during that transition period, according to The Builders' Collective.<sup>147</sup> This alarmist view is rejected by the major insurer, who states that 'the best way for a good builder to survive is for the business to have sufficient assets to allow them to live through the cycle.'<sup>148</sup>

The Inquiry recommended the appointment of an Interim Scheme Board comprising, *inter alia*, 'five part-time independent professional persons'.<sup>149</sup> This is a curious composition. What (who) are these professionals? Independent of what? Government? Insurance? The building industry?

### **WERE THE TERMS OF REFERENCE MET?**

The Final Report does not contain a lot of detail, and so it is possible that some questions referred to the Grellman Inquiry were discussed or analysed in depth, but did not receive extensive coverage in the published Report. Accordingly, the extent to which the Terms of Reference were met can only be judged on the available documents.

- Term 1** - The Inquiry appears to be confused about the legislative framework. There is no indication that much consideration was given to the effectiveness for both consumers and the (building) industry, as required.
- Term 2** - Has been met and appropriate recommendations made.
- Term 3.1** - Not fully met. Industry based schemes rejected without sufficient analysis.
- Term 3.2** - Not met. Government schemes rejected after superficial investigation.
- Term 4** - Not met. The Inquiry admits that it did not conduct financial or actuarial modelling, although this information would appear to be critical to any recommendations.
- Term 5** - Not met. The essential impact statement was not prepared.
- Term 6** - Has been met and appropriate recommendations made.
- Term 7** - Partially met. Some issues that are peripheral to Home Warranty Insurance also were considered.
- Term 8** - Has been met, although there is some confusion about the content of these documents.

Term 9 - Partially met, but significant groups were not consulted. The Inquiry adopted a reactive approach rather than conducting an investigative mission.

Term 10 - Met in full.

## RESPONSES TO THE INQUIRY

When the Minister for Commerce publicly released the Inquiry Final Report on 22 October 2003, he announced that 'the Government would accept in principle the report's seven primary recommendations'. In summary, these recommendations involved:

1. Creating a Scheme Board and Advisory Council.
2. Introducing a system to regulate insurers.
3. Creating an Industry Deed to control the smooth entry of insurers.
4. Creating an independent licensing function.
5. Strengthening the licensing processes and enforcement.
6. Monitoring of the new dispute resolution mechanisms.
7. Excluding high-rise developments from the scheme.

The NSW Government moved quickly to appoint an Interim Scheme Board to oversee the home warranty scheme. It also decided to remove insurance requirements from residential developments above three storeys. The Government hopes that by preserving elements of the existing system within a more stable regulatory environment, additional insurers will be encouraged to enter the market. Unless this happens, the charge that the government is hostage to a particular company and its allies cannot be rebutted. Initially, there was a hint that another insurer (IAG, trading as NRMA) may be interested, but five months after the report was completed nothing had happened. This situation may be about to change, with the government announcing that negotiations were proceeding with IAG, and that the Minister expected a 'positive response shortly' for CGU Insurance (a brand of IAG) to enter the market from 1 April 2004.<sup>150</sup>

Whether the introduction of another insurer will make any significant difference to the operations of the Home Warranty Insurance scheme is a moot point. It will still only provide "last resort" cover for the consumers. Greater competition for business may make it easier for builders to obtain insurance, and may reduce premium costs.

Some contractor associations issued statements that generally supported the recommendations from the Grellman Inquiry; other associations or professional institutes have expressed a contrary view, or substantial misgivings. In some cases, there is divided opinion within an organisation, reflecting the personal experience of individual members.

The **Housing Industry Association** noted that the Grellman Report made recommendations for improvement of the existing privatised warranty system. 'These improvements will provide builders with additional faith in the process and home buyers with more confidence in the industry. Increased availability has been effected with no requirement for additional capital on the part of the builder'.<sup>151</sup> According to the acting CEO of HIA NSW, the report is "adequate", and addresses all the concerns of his organisation.<sup>152</sup> 'It gives the building industry a stable platform to get on with business', said the executive director of HIA NSW at the time the Report was released.<sup>153</sup>

To place these remarks into perspective, it must be recognised that there is a close commercial link between the Housing Industry Association and the major insurer. HIA Insurance Services is a wholly owned subsidiary of AON Risk services, one of the largest insurance broking companies in the world. The HIA emblem appears on AON promotional material, and the broking office is located in the HIA headquarters building. Grellman notes that AON is the predominant home warranty insurance broker in NSW.<sup>154</sup> HIA, in conjunction with AON and Royal & Sun Alliance (now Promina, trading as Vero) has developed a range of insurance products for builders, including home warranty insurance. When announcing an upgrade of their home warranty scheme in November 2003, with benefits including raised turnover limits for their own members, the HIA estimated that small to medium builders should be able to double their activity levels in the coming year.<sup>155</sup> There is no indication that premium rates would be reduced, so it can be expected that total insurance payments will increase in line with expansion of activity. Indeed, in the same publication,<sup>156</sup> HIA admits that home warranty insurance premiums 'have definitely increased' following the collapse of HIH Insurance in 2002. A commission on these insurance premiums may flow on to the Housing Industry Association. Although no figures have been published, it is alleged that this represents a substantial income source for the HIA. The availability of insurance through HIA is also attracting additional members to the Association, resulting in further revenue growth.

**Master Builders Association of NSW** believes that the report is founded on biased and unsubstantiated opinions, and in some cases on misinterpretation of previous Inquiries.<sup>157</sup> MBA considers that a number of crucial issues have not been dealt with satisfactorily by the Grellman Inquiry, particularly the viability of alternative schemes. The current scheme has been "captured" by the insurance industry, effectively controlling which licensed builders can obtain work.<sup>158</sup> As a result of dissatisfaction with elements of the Inquiry Report, MBA NSW subsequently joined with a consortium of other industry groups to commission this independent review of the Inquiry.

The chief executive of Master Builders Australia was reported to have asked 'how the thousands of builders currently unable to access home warranty insurance will be able to do so in the future'.<sup>159</sup> Some commentators suggested that this response is a case of "sour grapes", and that MBA would not be concerned if they had been the broker for a successful insurer.

**Master Painters Australia** considers the outcome might be positive, provided that the Interim Scheme Board eliminates warranty insurance where the work is non-structural and involves only a single trade.<sup>160</sup>

**Master Plumbers Association of NSW** is concerned by the extent that devious measures are being used to circumvent the \$12,000 threshold, through misuse of Owner-Builder licences. They are also concerned by the proliferation of "shelf companies", formed to build a single house and then dissolved. (This practice has now been stopped through the licensing regime). The present HWI system favours the larger builders, perhaps on the mistaken assumption that mass producers of project homes provide a better outcome than the smaller company. The reality is often very different, because the typical family firm that takes pride in its work offers better quality (because of closer supervision) and less disputation with the consumer.<sup>161</sup>

**Newcastle Master Builders Association** takes the pragmatic view that the Inquiry recommendations are not the best outcome, but nevertheless the industry



should try to make them work, as a foundation for further changes. Grellman produced a compromise report, aimed at creating improvements that would be politically acceptable to government, and might encourage additional insurers into the market. Newcastle builders are still complaining about the availability of Home Warranty Insurance, with some expressing concern about pledging their own assets. There has been growth in owner-builder applications, in some cases to assist builders attempting to circumvent the difficulties associated with gaining HWI cover. There has been no decline in apprentices in the Hunter region.<sup>162</sup>

The President of the **Royal Australian Institute of Architects**, NSW Chapter considers the Inquiry conclusions are "astonishing", and it is difficult to understand the logic that lies behind them.<sup>163</sup> The existing system is not working, although there has been some easing in the availability of HWI over the past two years. A builder who is licensed should be able to obtain insurance. Placing an arbitrary cap on the value of a project they can build is "outrageous", considering that the maximum claim is \$200,000. Architects and owners are precluded from engaging their preferred builder because insurers are reluctant to provide cover for architect-designed houses. Nearly 43 per cent of Institute members reported difficulties as a result, but not all members have experienced this problem, so it is difficult for the Institute to present a unified response.<sup>164</sup> In March 2004, the Institute decided to conduct another questionnaire survey of members, in order to ascertain whether their perception had altered.<sup>165</sup>

**Building Designers Association of NSW** described the privatisation of HWI insurance as an "abject failure".<sup>166</sup> There has been a notable decline in the number of builders available to provide competitive quotes. This in turn is damaging the livelihoods of building designers. One of the unintended consequences of the scheme is that incompetent builders are encouraged to enter into illegal covert arrangements with owner-builders, at the expense of reputable builders who are being driven out of the industry.

The **Australian Consumers' Association** dislikes the present HWI cover in NSW - and hence the Grellman Inquiry recommendations - because it is a last resort scheme that offers no real consumer protection. It is *faux* insurance. A typical building owner does not have the time or skills to pursue a builder to rectify faulty work. ACA favours the Queensland model. The old Building Services Corporation had its faults, and was perhaps too inclined to favour the builders, but it worked better than the present scheme. The BSC scheme should have been amended, not disbanded.<sup>167</sup>

The **Australian Centre for Construction Innovation** (Professor M. Marosszky) regards the proposals as 'seriously dysfunctional'.<sup>168</sup> The scheme is biased towards insurers, and disadvantages the consumers. Insurers are not interested in managing risk, but in quantifying it.<sup>169</sup> Licensing should not be divorced from insurance; in Queensland they are linked. Substandard builders should be removed from the industry through harsh penalties, including raised insurance premiums. In principle, the BSC was good; any problems were due to leniency by individual general managers who were too close to the building industry. The BSC condoned bad behaviour by not enforcing penalties. Professor Marosszky is disappointed that the government has no policy for the building industry, no continuity, and no attempt at performance management. The government shows no concern about improving industry efficiency. Removal of insurance requirements from high-rise apartments is a retrograde move, according to ACCI.

The **Australian Constructors' Association** (linked with Australian Industry Group) represents the major construction contractor companies in Australia, but did not make a submission to the Inquiry, instead encouraging member companies with a concern in the area of Home Warranty Insurance to prepare an individual response.<sup>170</sup> Several are involved in major developments, including high-rise residential buildings, but after the removal of this category from mandatory insurance, those companies had no direct interest in the outcome of the Inquiry.

A response from the **legal profession** describes Grellman's preferred option for HWI as 'conservative, but progressive'.<sup>171</sup> Doubts are raised about the quality of some advice that has been given to the Minister. It is noted that the report does not address the situation where insurers will not provide the level of indemnity required. The threshold of \$12,000 is unjustified. Removal of high-rise construction from the HWI provisions will cause the insurance market to contract, and discourage new participants.

There has also been adverse **media** publicity following publication of the report.<sup>172</sup> In the financial press it was alleged that the NSW and Victorian governments 'have become captive to the major insurer, Royal & Sun Alliance and its insurance partner, the HIA.'<sup>173</sup> Many of the published articles raise similar doubts to those expressed by some of the contractor associations, particularly MBA of NSW. It is clear that a sympathetic relationship has been established between certain contractor associations and a few senior journalists.<sup>174</sup> Conversely, the consumer viewpoint or the insurers' position have received scant attention in the media.

The New South Wales Government should feel concerned about adopting a Report that is described by industry leaders and consumer representatives as an 'abject failure', 'seriously dysfunctional', 'faux insurance', 'astonishing', 'outrageous', and in daily press headlines such as 'This mess will ensure home owners suffer' or 'Building insurance still in need of repair.'

## **SOME ISSUES THAT WERE NOT CONSIDERED BY THE INQUIRY**

One of the main criticisms of past and present Home Warranty Insurance regimes is the lack of consistency and predictability, arising from constant tampering with the details of the scheme. This has not improved. Builders are now complaining about different tests of the liquidity of a builder being applied by Home Building Service and the insurers. It should be simple to determine common principles of acceptability. However, a report commissioned by the Office of Fair Trading indicated that private insurers were adamant that they would not accept a financial soundness test for the purposes of licensing as being a substitute for their own assessment.<sup>175</sup>

The Campbell Inquiry recommended a mechanism for resolving disputes between a builder and insurer, but this has not been picked up by the Grellman Inquiry. The Master Builders Association of NSW advocated the appointment of an independent warranty insurance ombudsman as one means of dealing with this question.

A firm recommendation from the Campbell Inquiry, that the HWI policy should be attached to the contract of sale for a new dwelling, was ignored by the Grellman Inquiry.<sup>176</sup>

In Queensland, a builder who can obtain a licence is assured of being able to obtain Home Warranty Insurance. In New South Wales, this is not the case. Although a

builder may be deemed by the government's Home Building Service to be appropriately qualified, the decision as to whether or not a person can work as a contractor in the home building industry is decided by insurers with no understanding of that industry. Restrictive trade practices are usually blamed on a cartel of peers within an industry, rather than being imposed from outside.

## IMPLICATIONS FOR CONSUMERS

Under the existing Home Warranty Insurance scheme, insurance is only required above a construction value of \$12,000. Presumably home owners are expected to self-insure for work less than that sum. However, Grellman reports that the average claim is \$10,000, so it might reasonably be asked why the owner needs to be reimbursed.

If builders are unable to obtain sufficient insurance to operate profitably, they either withdraw from the market, or build as sub-contractors for other companies. Either way, there is a reduction in the number of independent building firms from which consumers (and designers) can select. The net result of this reduction in competition is an increase in the prices charged by the remaining firms, to the detriment of the consumer.

Home Warranty Insurance inevitably adds to the cost of new housing for the homebuyer, because the builder naturally includes the premiums in the contract price. HIA has argued against the perception that the costs of HWI have adversely affected the affordability of homes. HIA claims that this is a myth, for 'the size of any premium increase has been swamped by the massive hikes in land prices'.<sup>177</sup> Without debating the validity of that assertion, it must nevertheless be the case that house prices have increased by the amount of HWI premium paid, unless the builder absorbed this sum from his profits. Premiums charged by HIA Insurance Services are related to the value of the home, the classification of the builder, and whether or not he is a member of the Housing Industry Association. For a non-HIA Category 3 builder who is about to construct a new dwelling in Sydney at the current median value of \$199,000, the premium is \$2,973. For a house costing \$260,000, the premium is \$5,106 - two per cent of the contract price.<sup>178</sup>

However, the real burden on consumers is caused not by the additional cost of the premium, but the reduced number of builders available to tender for a project. Architects report the situation that arises frequently where the preferred builder's quote is accepted by the client, only to find that the builder cannot obtain insurance for the job. Fresh tenders are then called from major building corporations, whose quote can be as much as 40 per cent higher.<sup>179</sup> The client then is unable to proceed with the job - depriving both architect and builder of work, and the client of a new home.

Because insurers are wary about extending cover to one-off designs by professional architects or building designers, consumers are often forced to accept a standardised project home as the only affordable alternative, although it may not suit their aesthetic preferences or family needs. The situation becomes worse for home owners in regional or rural areas, where often there is no builder of project homes, but only small firms with a long-standing local reputation for a good product, but who cannot obtain insurance.

Purchasers of apartments in high-rise buildings above three storeys will not receive any protection through Home Warranty Insurance. Their only recourse is through the legal system. Close to half of all new dwellings constructed in New South Wales consist of residential buildings other than detached houses, and the proportion is increasing.<sup>180</sup> Not all of these are high rise dwellings, because the figures include townhouses, villa units and small blocks of flats. Furthermore, many of the high-rise dwellings are investment properties, purchased for rental, so the owners are not occupiers. Nevertheless, a substantial number of consumers will not have access to insurance.

## **IMPLICATIONS FOR BUILDERS**

Insurers and their brokers generally do not have the qualifications or experience to assess the quality of construction. There seems to be an implicit but unjustified assumption that larger builders in the project home market produce a better product than their smaller counterparts, when the reverse is true in many instances. Indeed, when launching the 2004 Year of the Built Environment, NSW Premier the Hon. Bob Carr MP, announced that because of the poor standards of many project homes, the government will be releasing a "pattern book" later in 2004 to demonstrate examples of best practice.<sup>181</sup> Architects and building designers producing one-off homes matching their client's needs usually provide close supervision of the builder's performance to ensure that high standards are maintained. The mass-production project builder who replicates a few standardised designs, irrespective of topography or orientation, cannot provide that level of personal service. The one advantage possessed by the larger project home builders is that they have adequate capital resources to underwrite their HWI policies. The insurers prefer the latter because their product is perceived as relatively risk-free.

Although the Grellman Inquiry recommends a strengthening of builders' licensing requirements, this is not an accurate guide to competency. Because the insurance scheme is one of last-resort, it does not matter to the insurer if the builder is competent, provided that he does not die, disappear or become insolvent. Grellman makes no positive recommendations for improving the recruitment, training or assessment of building tradespeople or other practitioners, other than a mention of Continuing Professional Development, which is now mandatory in any case.

Some commentators have characterised the disaffected builders as small, husband and wife partnerships with too little capital or business skills to conduct a viable business. This is rarely true. There are a number of medium-sized building companies, including respected family firms of more than one hundred years' experience in the construction industry, who are unable to get adequate insurance cover to build the number of domestic houses they wish, yet who are constantly engaged by the commercial sector to build schools, shops or factories worth millions of dollars.<sup>182</sup>

## **IMPLICATIONS FOR THE INSURANCE INDUSTRY**

The Grellman Inquiry proposes tighter regulation of the entry of additional insurers into the Home Warranty Insurance market, which seems contrary to the government's desire for increased competition. Nevertheless, HWI should remain an attractive proposition, given its mandatory character, together with the 2002 reforms to minimise risk. In effect, HWI is a compulsory subsidy for the insurance industry,

levied on homebuyers. The fact that other players collapsed or withdrew from this field of insurance, suggests they lacked commercial acumen, rather than it being an inherently unprofitable venture.

On the other hand, by removing the need for HWI on high-rise projects, the government is making a drastic reduction in the total size of the insurance market. Although the Inquiry Report did not recognise the symptoms of an impending decline in home-building activity as shown by statistics provided in this Review, supported by the predictions of some economic forecasters, it is another situation that will lead to a reduction in the potential market. These factors could have a serious impact on the profits of existing insurers, and act as a disincentive to prospective new insurers.

Grellman's proposals for greater accountability by insurers may yield some interesting information about the profitability of their Home Warranty Insurance business.

## **BROADER SOCIAL IMPLICATIONS**

There is a suggestion of concern about wider social issues in Grellman's remark that 'problems...can have a broader impact across the...economy'.<sup>183</sup> This needs further explanation to identify those potential impacts.

It is not only the stakeholders and service providers who are affected, however these participants may be defined. Although the direct costs of HWI ultimately are borne by consumers purchasing a new home, there are flow-on distortions throughout the economy. For example, because of market forces, the prices of existing houses will tend to rise to remain comparable with the new houses in a particular area.

There is also an inherent bias in favour of the owner-builder, unless that person sells his/her house within six years of completion, because the insurance component is not part of their building costs. They stand to make a greater profit on re-sale.

The governmental regulatory machinery becomes a cost on the whole community, not just the people directly affected by HWI. The profits from insurance, however, are distributed to the private shareholders of the insurance providers. It is believed that a substantial portion ends up offshore in European re-insurance companies. Again, this is a form of hidden subsidy for the insurance industry.

Home Warranty Insurance makes it difficult for a qualified, ambitious young builder with limited capital to enter the industry other than as a corporate employee or sub-contractor. In a society that values the contribution made by small business entrepreneurs, this will lead to a loss of innovation and a lack of personal fulfilment. At least one suicide has been directly linked to the difficulty in obtaining insurance. As the MLA for Orange said in the NSW Parliament, 'this is an indictment on a system that has let him...down very badly'.<sup>184</sup>

Because insurance cover is not linked to the quality standards of a builder, but to their financial standing, substandard builders are permitted to continue in the marketplace. It has been pointed out that this has the effect of transferring wealth from the community 'into the pockets of a relatively small number of unscrupulous builders/developers'.<sup>185</sup> The market is distorted because of the preference given to builders with access to ample capital. It may well be an example of Gresham's Law, where the bad drives out the good, and the community ends up with a standard set by the lowest common denominator.<sup>186</sup>

An unintended collateral effect of the existing Home Warranty Insurance regime is that it imposes an unrelieved conformity on the built environment. On the one hand we have the NSW Government promoting better design and environmental sustainability through the planning process, whilst at the same time a mandatory insurance scheme is introduced that penalises innovation and encourages the proliferation of inefficient houses built to a standard formula of design, materials and finish.<sup>187</sup>

Finally, the notion of compulsion sits uneasily in a liberal democracy such as Australia, where there is a presumption that the individual should have as much freedom as possible, consistent with the national well-being. Insurance should be a matter of choice.

## **SOME CONCLUSIONS**

In many respects, the conduct of the Inquiry was superficial and inconsistent, but this did not affect Grellman's recommendations. As far as can be judged from the Final Report, some evidence presented to the Inquiry was discounted. Consideration of alternatives appeared to be cursory and selective. Some of the Inquiry's Terms of Reference were ignored; in other instances the Inquiry went beyond its brief. Sadly, the Inquiry resembles a public relations exercise rather than a serious effort to find the best solutions.

There is evidence that significant decisions about Home Warranty Insurance had been made before the Inquiry reported to the NSW Government. Given Mr Richard Grellman's close involvement with the insurance industry, and reports about his consistent position in other circumstances, the fact that his recommendations were compatible with the Government's preferences is not surprising.

The Inquiry Report is disappointing because it missed an opportunity to reduce warranty claims by demanding better performance up front. If all persons engaged in the home building industry were truly competent in their tasks, much poor workmanship would be avoided, and the need for expensive rectification eliminated. Grellman does encourage skills upgrading through Continuing Professional Development, but did not recommend active support for better training and assessment programs, preferring to rely on a punitive approach.

The whole question of Home Warranty Insurance is surrounded by a great deal of emotional debate from both sides. Individual consumers and builders have different responses, depending on their own experience. The Grellman Inquiry concedes that the present system is flawed, but then proceeds to recommend its retention, at least in the short term, subject to some tightening of regulations. This will not lead to any reduction of dissatisfaction.

The critical question that remains unanswered is: who benefits from mandatory last-resort home warranty insurance? Not the average consumer, who misunderstands the nature of the scheme, only to find it is often a callous deception when the time comes to claim. Certainly not the smaller builders who must pledge their personal assets in addition to paying insurance premiums. Governments can reassure the electorate that they are protecting the consumers' interests. The major builders benefit from a reduction in competition through the elimination of smaller building firms who cannot gain adequate insurance cover. The real beneficiaries are the insurers, who have an assured income stream with negligible risk, together with the insurance brokers who charge a generous commission to service them.

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17 January, 2005

## REFERENCES



## Appendix "A"

### COMMENTS RECEIVED FROM ORGANISATIONS/INDIVIDUALS

Australian Centre for Construction Innovation Marosszky	Professor M.
Australian Consumers Association	Mr N. Crothers
Australian Contractors' Association	Mr J. Barrett
Australian Institute of Building, NSW Campbell	Mr J. Lewer & Mr H.
Building Designers Association NSW	Mr R. Brown
Building Industry Specialist Contractors Organisation	Mr I. Warren
Construction Industry Training Advisory Board	Mr D. Greening
Housing Industry Association	Mr R. Loveridge
Master Builders Association of NSW Meredith	Mr B. Seidler, Mr P. & Mr P. Stokoe
Master Painters Australia, NSW Association	Mr G. Sheldon
Master Plumbers Association of NSW Duggan	Mr P. Naylor & Mr B.
Newcastle Master Builders Association	Mr R. Fuller
Royal Australian Institute of Architects, NSW	Mr G. Adams, Ms C. Pidcock & Mr T. Kemeny
The Builders' Collective of Australia	Mr P. Dwyer

Some other organisations and individuals provided information related to particular aspects of this research, but are not directly quoted in this review. Organisations that were contacted seeking comments, but which chose not to respond are: NSW Urban Taskforce; Swimming Pool & Spa Association.

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## Appendix "C"

### **ABBREVIATIONS AND ACRONYMS**

ABCB	Australian Building Codes Board
ABS	Australian Bureau of Statistics
ACA	Australian Consumers' Association
ACCC	Australian Competition and Consumer Commission
AIB	Australian Institute of Building
AIG	Australian Industry Group (formerly Metal Trades Ind)
ASIC	Australian Securities and Investments Commission
BACC	Building and Construction Council of NSW
BARG	Building Action Review Group
BCA	Building Code of Australia
B-FAIR	Builders for Active Industry Reform
BSC	Building Services Corporation
CITAB	Construction Industry Training Advisory Board, NSW
CTTT	Consumer Tenancy and Trader Tribunal
DIPNR	Department of Infrastructure, Planning & Natural
<b>Resources</b>	
HBS	Home Building Service (Office of Fair Trading)
HIA	Housing Industry Association
HWI	Home Warranty Insurance
MBA	Master Builders Association
MD	The Macquarie Dictionary
NSW	New South Wales
OED	Concise Oxford English Dictionary
OFT	Office of Fair Trading (Department of Commerce)
QBSA	Queensland Building Services Authority
RAIA	Royal Australian Institute of Architects
RSA	Royal and Sun Alliance
RTO	Registered Training Organisation
TAFE	Technical and Further Education
VIC	Victoria

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- <sup>152</sup> R. Loveridge, Technical Director, Housing Industry Association, telephone communication, 9 January 2004.
- <sup>153</sup> E. Crouch, HIA, quoted in 'Building on a house of straw', *The Australian Financial Review*, p.35.
- <sup>154</sup> *Interim Report*, p.15.
- <sup>155</sup> *Housing*, November 2003, p.95
- <sup>156</sup> *Housing*, November 2003, p.46.
- <sup>157</sup> NSW MBA internal document.
- <sup>158</sup> MBA NSW, 'Analysis of NSW Home Warranty Insurance inquiry Final Report', internal document.
- <sup>159</sup> W. Harnisch, MBA, quoted in 'Building on a house of straw', *The Australian Financial Review*, p.35.
- <sup>160</sup> G. Sheldon, General Manager, Master Painters Australia, correspondence, 16 January 2004.
- <sup>161</sup> P. Naylor, General Manager, Master Plumbers Association, interview, 9 February 2004.
- <sup>162</sup> R. Fuller, Executive Director, Newcastle MBA, telephone communications, 17 & 25 February 2004.
- <sup>163</sup> C. Pidcock, President, RAIA NSW Chapter, telephone communication, 20 February 2004.
- <sup>164</sup> G. Adams, State Manager, RAIA NSW Chapter, telephone communication, 25 February 2004.
- <sup>165</sup> T. Kemeny, RAIA Chapter Council member, telephone communication, 9 March 2004.
- <sup>166</sup> R. Brown, President, BDA NSW, correspondence, 25 June 2003, and telephone communication, 18 February 2004.
- <sup>167</sup> N. Crothers, Acting CEO, Australian Consumers Association, telephone communication, 11 February 2004.
- <sup>168</sup> Professor M. Marroszky, telephone communication, 20 February 2004.
- <sup>169</sup> M. Marroszky, Director, Australian Centre for Construction Innovation, submissions to Parliamentary Joint Committee on the Quality of Buildings, July 2002., and Grellman Inquiry, June 2003.
- <sup>170</sup> J. Barrett, Executive Director, Australian Constructors' Association, telephone communication, 27 February 2004.
- <sup>171</sup> R. Riddell, Gadens Lawyers, *New South Wales Building & Construction Update*, October 2003.
- <sup>172</sup> M. Devine, 'This mess will ensure home owners suffer', *Sydney Morning Herald*, 5 February 2004, p.11.
- <sup>173</sup> R. Harley, 'Building insurance still in need of repair', *The Australian Financial Review*, 8 October 2003, p.49.
- <sup>174</sup> See, for example, articles by Linda Morris and Miranda Devine in the *Sydney Morning Herald*, or Robert Harley in *The Australian Financial Review*. A selection of these articles is listed in the bibliography appended to this report.
- <sup>175</sup> Ernst & Young, *Report in respect of Financial Soundness Test for Licensees in terms of the Home Building Act 1989*, May 2003, p.1.
- <sup>176</sup> *Report Upon the Quality of Buildings*, ("Campbell Report"), July 2002, Recommendation 32 (v).
- <sup>177</sup> *Housing*, November 2003, p.46.
- <sup>178</sup> Royal & SunAlliance. Home Warranty Insurance premium schedule, New South Wales, August 2003.
- <sup>179</sup> P. Dwyer, telephone communication, 20 February 2004.
- <sup>180</sup> In the twelve months ending 30 June 2003, there were 24,317 new single houses commenced in NSW, compared with 22,525 other dwellings. ABS 8752.1.
- <sup>181</sup> Hon. Bob Carr, speech at launching of YBE2004, Kogarah Town Square, 4 February 2004. See also subsequent press articles about the proliferation of "McMansions".
- <sup>182</sup> The firm of Kell & Rigby is cited as an example.
- <sup>183</sup> *Interim Report*, p.8.
- <sup>184</sup> R.W. Turner MLA, NSW Parliament, *Hansard*, 9 May 2003.

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- <sup>185</sup> M. Marosszeky, Director, Australian Centre for Construction Innovation, submission to Parliamentary Joint Committee on the Quality of Buildings, July 2002.
- <sup>186</sup> Gresham's Law is a principle of economics, usually expressed as "bad money drives out good money from circulation".
- <sup>187</sup> Royal Australian Institute of Architects, NSW Chapter, Submission to the NSW Government Minister for Commerce, July 2003, p.4.

*of view, would perhaps be unfair. It would seem much fairer for the issue to have gone right through the dispute resolution process to afford the builder some procedural fairness and natural justice in a court or a tribunal before that point was reached*

This is unacceptable as it is not timely, and open to abuse with out any recourse for the builder in any jurisdiction.

*Further reform including home warranty coverage for high rise residential properties.*

Why was it removed initially? What was the rationale at that time?

*In New South Wales the Home Building Act 1989 contained statutory warranties that oblige a builder to rectify any defects for a period of seven years.*

Same applies in all jurisdictions and Tasmania has just removed warranty insurance and now relies on the **building act** as better serving their consumers and builders.

*Home warranty insurance forms part of the consumer protection framework that kicks in when a builder is incapable of filling their responsibilities.*

But not in the case of the Beechwood failure as the NSW Government and the Receivers are still seeking a buyer for the failed group. Why?

***Mr McCarthy**— I wish to draw the committee's attention to data the for 2007 calendar year. During that period, the total premium collected in New South Wales, inclusive of fees and charges, was \$45.4 million. By the end of 2007 a total of 1,252 claims had been made upon the scheme, with a total of \$16 million in claim payments and a further \$7 million in estimated future payments on those claims which have been accepted.*

Data for one year, and claims for 5 years. Mr McCarthy has inadvertently misled the Senate committee.

*Despite information from other ill-informed sources, insurers are not making super economic profits from the scheme.*

Unqualified statement by Mr McCarthy because we don't have accurate data. A mandated product must be transparent.

*It would be my submission to the committee that, for every complaint you receive about the scheme from a consumer, there would be many more who are happy with the protection provided to them by home warranty insurance. I am sure that these people do not consider home warranty to be junk insurance.*

If they have no building problem they simply would not know!

*The final point I wish to make before taking questions is about the failure of detractors of the scheme to recognise the long tail nature of the scheme.*

Virtually all claims are for insolvency that occurs during construction which is a historical fact, therefore the long tail aspect does not apply. If audited actuarial data was available it would demonstrate this fact.

*Mr McCarthy—That is right. The board made a recommendation again to government which they accepted. I also should stress that \$300,000 is a minimum. If people wish to take out more insurance, they can.*

Mr McCarthy should know that is not correct. The builder can only buy the **one** policy from the **one** insurer that he has **eligibility with** based on the contract value to rate the premium cost. Policy Cover cannot be extended under any circumstances.

*Mr Griffin—(Insurance Certificate) That is given as part of the contractual arrangements. At the same time the contract is signed, the builder receives the five per cent deposit under the contract and is required to give the consumer a certificate of insurance from the insurer.*

Not correct! Contract is signed and when building is ready to start insurance is sourced on the initial contract value as a prerequisite to obtaining the building permit. Refer to the 580 Beechwood consumers with contracts and no warranty insurance policy.

*Scheme board or the Advisory council specifics could not be answered in terms of who and the representation*

The specific manager and Regulator of the scheme had to take those questions on notice.

*Senator MILNE—is any requirement for the consumer to be shown the policy by the builder and have it explained to them.*

Short answer is no! However If the builder did truthfully explain the policy he/she would never achieve a contract signing as the consumer would want to go to a builder that had a better policy, not knowing they are all exactly the same.

*Senator MILNE—I just want to go through the collection of money. You said you collected about \$45 million in premiums last year and you paid out \$16 million.*

Again this is one year of premiums, and five years of claims!

*Senator JOYCE—Is there good market knowledge? Do people know they can get a cheaper premium than what they are offered?*

NO! They are not even offered! Because the builder can only buy from the **one insurer** he **has eligibility with**. The consumer has no input whatsoever.

*Mr McCarthy—I think we would say yes to that because we have seen the premiums dropping in the last several years as a result of their ability to be able to shop around.*

Incorrect presentation, as there is absolutely zero competition at a consumer level, and virtually none at a builder level simply because most builders are hesitant to change to another provider because they may not achieve the same annual turnover and project levels they hold, and besides securities held are not transferable. The recent insurers survive on new builders and those returning to the compliant industry through tighter legislation in relation to the owner builder method of building where warranty insurance is not required.

**Senator JOYCE**—*I can understand that, but what I am pointing out is that it is a flaw in the legislation because obviously the builder is going to buy something cheap and nasty because it does not really worry him—it is not his house.*

Total misconception, and builders take exception to our Regulators not correcting this false information. There is only the **one same policy** from all the providers and a builder can only buy from the **one insurer he has eligibility with**.

*But isn't it true that the builder buys the policy based on the contract value?*

**Mr McCarthy**—*In terms of the pricing of the policy, yes, it is. As you know, there are some contracts that are greater than \$300,000 and it is in that instance that I am referring to the fact that someone could purchase a greater level of cover if they desire.*

No! They can't as all policies are the same and in NSW the maximum available under legislation is \$300,000.00 limited to 20% of the original contract value for non-completion. Example: \$300,000.00 house x 20%= **\$60,000.00** maximum payout available less any overpayments to the builder as determined by the insurer.

**Senator MILNE**—*How long have you been collecting this data that is going up on your website?* **Mr McCarthy**—*Twelve months.*

The scheme board was set up in 2003 and promised this information at that time “**scrutinise insurers, all of whom are to report for the first time annually on premium calculations, claims costs and profit margins**”

See the storey from 2003 here:

<http://www.smh.com.au/articles/2003/11/23/1069522472189.html?from=storyrhs> titled “**Sweeteners to lure building insurers**” and as a result 20 angry industry associations commissioned the [Tyler Report](#) attached above, a document that is critical of the regime and holds precisely the same concerns we present today.

**Mr McCarthy**—*I can only comment on the current scheme. Within the current scheme, the board is not aware of any complaints on that issue. I cannot comment for prior schemes.*

Yes he can! But no one is aware of the Scheme Board or the advisory council as bodies to receive complaints. Even these managers and regulators don't know about them in any detail.

**Senator MILNE**—*You are saying that there are no complaints at the moment from anyone, that the insurance companies are paying out and that nobody is complaining?* **Mr Griffin**—*I think the complaints that do exist relate to the issue of quantum and arguments over quantum in terms of insurance claim payout. They do exist.*

Yes we are all aware they exist, so we need to be serious and have appropriate consumer protection for the building Industry and the consumers that need it and the appropriate industry management.

Yours Faithfully

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