

Consumer Policy Framework Inquiry,
Productivity Commission,
GPO Box 1428,
Canberra City, ACT 2601, Australia.

Monday, 4 February 2008

To Whom It May Concern:

My name is Michael Stokes and I wish to make a submission concerning Builders' Warranty Insurance (BWI) as contained in the draft recommendation 5.5 of your Review Of Australia's Consumer Policy Framework. I am doing this as a private individual but one with very relevant experience.

My background is that I was a senior manager with Housing Guarantee Fund Ltd (HGF) from 1984 until 1992 and again from 1997 to 2007. From 2001 to 2007, I was CEO of the company. In February 2005, HGF was taken over by the State Government and "merged" into the operations of the Victorian Managed Insurance Authority. My management contract expired in February 2007 and I left at that time.

As you may know, HGF was the company that provided Victoria's builders' warranty protection for all dwelling houses from 1984 until 1996. The company continued to operate until 2007, because of the "10 year liability tail" of its liabilities. Further, the State Government selected HGF to administer its "HIH Assistance Package" for those homeowners with BWI issued by HIH. It did this under legislation entitled House Contracts Guarantee Act 1987 (as amended). Protection was in two parts:

- Financial assistance to owners where the builder failed to complete construction (usually due to financial failure) and
- Seven year's warranty against defects occurring in the dwelling as a result of builder's poor workmanship.

Please see "IN CONFIDENCE" attachment #1, which summarises the statistics of HGF in its lifetime as Victoria's guarantor.

I present the above as proof of my credentials and experience. I have only just been informed of your enquiry, so will make this submission short as your deadline is 6th February 2008.

Your draft resolution states:

"Australian Governments should take early action to provide better and uniform protection for those having a home built or renovated. Specifically, this should entail:

- *Guaranteed access for consumers to alternative dispute resolution mechanisms;*
- *Provision of greater scope to de-register builders who do not meet appropriate performance standards; and*
- *A revamping of compulsory Builders' Warranty Insurance to ensure that it is of genuine value to consumers and that consumers understand the product."*

I could not agree more. In my opinion, you can consolidate the first two points, leaving the third (insurance) as a separate issue but being controlled by a Warranty Body as the “alternative dispute resolution mechanism”. It is also critically important that a new scheme be national and, although State Governments may implement the scheme in each of their individual states, it should be as common as possible and be directed at the Federal level.

I assert that there are four elements that make up a warranty system:

- 1 A Licensing Authority to assess the technical competencies of builders.
To do this, a full register of all builders, related parties (directors etc) and trading names is established.
- 2 Adequate inspection of houses during construction.
To do this, a full register of all guaranteeable properties is established.
- 3 A Warranty Body to provide cover for consumers and process consumer complaints.
- 4 An independent but realistic appeals mechanism for both owners and builders.

I believe that the current privatised insurance system **does not** achieve any of the outcomes listed in your draft resolution above.

I am happy to assist you in any way in your endeavours to improve Builders' Warranty in Australia.

Yours faithfully,

Michael Stokes,

The following are background items for your consideration.

RATIONALE BEHIND PREVIOUS SCHEMES

The first issue is whether the Government continues to treat BWI as just another form of insurance (in this case, useless to the consumer) or treats the issue as a social imperative. If you look at normal products in the marketplace (whitegoods, vehicles etc), they all carry a warranty and in most cases, there is little difficulty for a consumer to make a claim and have their product repaired or replaced. However, as you state, “a home will typically be the single largest purchase a consumer will ever make”. Under the current last resort private insurance scheme, unless the builder is dead, insolvent or disappeared (DID), there is virtually no protection for the consumer. State Government instituted schemes are toothless as they cannot place pressure on builders and have no recourse to the insurers.

NATURE OF BUILDING INDUSTRY

The scheme as run by the Queensland body and, until last year by HGF in Victoria, was a recognition by State Governments of the past that, unlike the motor vehicle industry (few suppliers, hundreds of thousands of products supplied annually), the building industry is the exact opposite (thousands of suppliers but only tens of thousands of products supplied annually). In 1983, the Victorian State Government recognised that a dwelling house should have warranty protection better than most products but realised that, due to the fragmented nature of the building industry, it needed a central registration body to administer the scheme.

The current privatised insurance system is decentralised and its operations are fragmented over a range of bodies, both Government and private companies. There is no “one stop shop” for builders and consumers and the Government cannot obtain any real information from the insurers relative to claims experience.

INSURANCE OR FUND?

As stated, I was with HGF at its inception. It did not take us long to realise that we were not an “insurer” but instead were the financial guarantor of builders’ performance. This means we stepped in when the builder failed in some way, either financially (gone for good) or remained in business but there were issues with workmanship.

Secondly, we realised that financial failures and claims arising from poor workmanship were endemic issues in building; claims were simply going to occur. Therefore, if these “normal” events are simply a **working loss** of the industry, you did not need insurance but rather a fund to pay such claims. Thus, HGF effectively “self-insured” and, based on actuarial projections, collected sufficient funds each financial year that, combined with future interest earnings, would fund all claims arising from that financial year (both claims cost and administration of the scheme) for the next 10 years.

However, to be safe, even though there was prudential margin in the actuarial projections, we took out “catastrophe cover” insurance (with the same insurers as operate today) in case there was a blow-out in claims arising from each financial year. As you can appreciate, because the insurers were so far removed from the risk, the premiums were very low. For the last 10 years of its life, HGF did not call on the external insurers for reimbursement and **never cost the State Government a cent!**

Recommendation: Return To A Government Controlled Warranty Body.

The starting point for the Government is to decide philosophically why builders' warranty legislation was originally introduced in the 1980's. It was to protect owners from builders' financial failure and/or poor workmanship. HGF administered three Acts over 23 years and had no doubt that the legislation was introduced as consumer protection, a social imperative where the Government took some risk.

However, in 1996, this changed totally to a commercial concern with the philosophy that "this is simply private insurance for owners to purchase in the marketplace". Percy Allen, in his report, correctly described the system as "insurance of the last resort".

Further, since the collapse of HIH, we have seen the Government lose control of the system to the private insurers. There is an impression that the State Government will not revert to a state controlled scheme because they see a potential liability that could attach to the state. But, as a result of the failure of HIH in the private insurance system, both the Victorian and NSW State Governments have paid tens of millions of dollars via assistance packages to owners with BWI issued by HIH.

In my opinion, this legislation is about consumer protection. For the Government to achieve its objectives in this area, the most important element is that the Government regain control of its legislation and the Warranty mechanisms. The Government is now in the hands of commercial insurers who will continue to dictate the terms.

Therefore, I recommend that the Government return to a system where:

- a. The total warranty operation is responsible to Government and
- b. Control of the building surveyors and inspectors is returned to local Government or Councils.

KEY ELEMENTS

1. **A Licensing Authority** whose key role it is to examine the qualifications of building practitioners (builders, inspectors, consultants etc) and, if acceptable, recommend them to the Warranty Body as being suitable candidates. The criteria should be:
 - a. Technical competence,
 - b. Good repute and character,
 - c. Sufficient financial capacity to enter the building industry and to be able to perform xx units of building work with adequate working capital.
2. **Adequate inspection of houses during construction.** The licensing of these building inspectors should be the responsibility of the Licensing Authority but the inspectors should be responsible to Local Government or to municipal councils. I am not saying that Councils are the perfect platform, but
 - a. they are aware of local conditions,
 - b. they can exert managerial pressure on the inspectors and
 - c. owners can approach the council if they have complaints.

The inspections should not only cover safety of construction but confirm that builders are performing to acceptable standards of workmanship.

The number of inspections during construction should be increased to 6 or more and those inspections should be the sign-off points to make progress payments to the builders.

Where there are doubts about the quality of inspections, the Council may refer these to the licensing body for review.

3. **A Warranty Body** that guarantees the work of builders. It is important to understand that the only way this system functions properly is the concept of financial guarantee of a builder's performance, not insurance. This body should have the right to reject candidate builders in the first instance (recommended by the Licensing Body). Should a member builder's workmanship be unacceptable, the Warranty Body should have the power to refer to the licensing authority for a review of the builder's licence or registration.
4. **An appeals mechanism** that is non-legalistic, cheap and efficient. This body must be independent of both the licensing and warranty bodies. It is a forum for both owners and builders to appeal decisions of either the licensing or warranty bodies. The Licensing and Warranty bodies would be bound by these decisions, unless they are of such a nature as to create precedents that would be detrimental to the viable operation of those bodies. As such, the bodies should be able to appeal such decisions in a higher court.

The following factors need serious consideration.

SCHEME COVER

- a) A warranty scheme must be founded in legislation.
- b) The legislation should clearly prescribe all domestic building works covered by warranty.
- c) The legislation should prescribe the warranty covers and limit of indemnity.
- d) The owner must always be the beneficiary and must have direct access to the Warranty Body to make a claim.
- e) The legislation should provide universal coverage and in situations where an illegal builder does not provide warranty (unbeknownst to the owner when signing the contract), then that owner should be deemed to be covered and the builder held liable.
- f) There should be only one type of warranty cover for all properties, regardless of their contract value. The dollar limit of indemnity should be standard for all.

BUILDER REGISTRATION

- a) There is a need for a registration or licensing body to ensure that builders meet minimum entry criteria and their work conforms to a minimum set of standards.
- b) Architects, engineers, inspectors and consultants involved in domestic building should also be registered.
- c) Property developers should be required to share all responsibilities with the builder and should be registered themselves. With the builder, they should be jointly and severally responsible for any claims that may arise on their buildings.
- d) When builders renew their registration each year, there should be compulsory disclosure by renewing builders of any valid claims made against them in the prior 12 months. In this regard, the Licensing Body should liaise with the Warranty Body to obtain this information.

- e) There are many builders who simply hold a license and do not build for many years. When they do decide to build, their knowledge of building regulations and practices could be severely out of date. Therefore, any builder that has not built in the previous 12 months prior to registration renewal should show cause why they should have the license renewed. If the authority is not satisfied, the builder should undertake training to come up to date.
- f) There needs to be flexibility in the discipline of builders by the Licensing Body and quick response in influencing a builder to answer the requests of the Warranty Body.
- g) The class of builders known as “owner–builders” needs to be controlled to ensure that:
 - (i) owners are not operating as builders and “illegally” selling houses,
 - (ii) builders are not manipulating owners to become owner–builders,
 - (iii) there is a limit on the number of projects a genuine owner–builder can undertake in a given period.

The warranty would only be invoked when the property is sold to a new owner. There would be no protection afforded to the owner–builder because, whilst they are domiciled at that address, they are the “builder” and hence cannot claim on warranty.

- h) An ongoing, low cost education & awareness program is needed to inform builders and owners on the operation of both the builder licensing and warranty systems.

CLAIMS HANDLING

- a) There should be a single Warranty Body, a one stop shop for consumers and builders. It should be “insurance of the first resort”, not last resort as it is now. The Warranty Body should perform as follows (or have the power to do so).
 - o Have full access to builders’ registration information,
 - o Record all builders’ constructions so that there is a central register of all properties protected by a warranty,
 - o Manage the claims handling process for all owners,
 - o Where it is determined that the builder is at fault and the builder is still in business, use all possible means to ensure the builder rectifies the defects,
 - o Where it is determined to be the builder’s fault and the builder is in liquidation or insolvent, seek competitive quotations and pay for completion and/or rectification within the financial limits prescribed in the legislation,
 - o With a central warranty register, proof of warranty will be easily ascertained by both the Warranty Body and future successors in title provided that:
 - (i) Before the original Building Approval is issued, proof that the work had been registered with the Warranty Body must be furnished in the form of a certificate,
 - (ii) Later, when a property changes hands, legislation should stipulate that a certificate of warranty status must be provided by the vendor to the purchaser.

CHANGE APPROACH FROM “INSURANCE” TO A WARRANTY FUND

When insurers take the full risk of warranty up front, it results in high premiums. However, with only one Warranty Body, the approach can be totally different. The Body recognizes that claims are endemic to the building industry and that, each year, it will pay out significant sums in claims. Rather than treat this as insurance, it is treated as a “working loss” and a fund is created to pay these inevitable claims.

To defray claim costs, the Warranty Body must have the right to attempt full recovery from offending builders, using all normal commercial debt collection methods.

Actuaries should be used to calculate future risk and include a prudential margin. Once the magnitude of risk is calculated, this is accepted as the “primary insurance layer” which is retained by the Warranty Body. It then approaches external insurers and seeks “catastrophe cover” in case claim costs in any given insurance generation year exceed the self-insured retention of the Warranty Body.

APPEALS MECHANISM

To safeguard against either the Licensing or Warranty Bodies making incorrect or arbitrary decisions, there needs to be an independent body or tribunal to hear complaints from either owners or builders. However, there needs to be checks and balances to make sure that this body is not bogged down in trivial or pointless complaints, simply to string out the process.

Further, if the Appeals body makes a certain decision in one case and later, a separate but identical case is presented (as they often are), then there ought to be a situation of precedent where the same decision prevails.

ATTACHMENT 1

In its time, HGF:

- (1) Registered 81,000 approved builders,
- (2) Registered 503,000 properties eligible for warranty cover,
- (3) Received 114,000 complaints, of which 68,500 became formal claims.
- (4) The outcomes of those claims were:
 - (a) 13% – at some point in the claims process, owners did not proceed.
 - (b) 34% – for a range of reasons, these claims were rejected.
 - (c) 28% – on HGF's direction, the original builder rectified the defects.
 - (d) 25% – HGF paid the claims.
- (5) In present value, the company paid the equivalent of \$115 million on claims (25%) and via its direction to builders to rectify (28%) saved the community \$223 million equivalent of claims cost if the consumers had paid for rectification.