PUBLIC BENEFIT TEST —

QUEENSLAND BUILDING SERVICES AUTHORITY ACT 1991 AND REGULATIONS

PREPARED FOR THE

DEPARTMENT OF HOUSING

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The primary concerns are the provisions of the legislation that restrict competition by —

Three key restrictions to competition are examined

- Establishing a barrier to entry to the building industry through the requirement to meet skill-based technical licensing requirements.
- Restricting the conduct of business through controls on the financial standing of all license holders.
- Preserving a statutory monopoly for the provision of warranty insurance in the residential construction sector by the Building Services Authority (BSA).

Queensland shares with most other states and territories a licensing regime that seeks to restrict who can supply certain building services and a compulsory requirement for home building to be covered by insurance. But Queensland sets considerably tighter financial standards through the licensing system than other states or territories. Queensland is also the only jurisdiction to restrict the supply of a comprehensive home warranty insurance to a public monopoly.

An assessment has been undertaken of the costs and benefits of these restrictions on competition based on —

- an in-principle assessment guided by economic principles;
- a review of interstate practice based on consultation with industry participants and government representatives; and
- extensive consultation in Queensland in relation to the performance of the current system and the potential performance of alternative systems.

Within Queensland a range of industry participants, industry associations and consumer representatives were consulted along with senior staff of the BSA and relevant government departments. A survey was also undertaken of 100 licensees to provide quantification of key impacts of the licensing regime. A review was also conducted of submissions received on an Issues Paper released for public comment by the Department of Housing.

Considerable effort was also taken to determine the performance and recent changes in interstate home warranty insurance schemes. This included consultation on a face-to-face basis in Sydney and Canberra in June 2002.

Our assessment of the costs and benefits of the current regime and the alternatives has found that a clear case can be made at this stage for the following components of the regulatory regime —

These components of the regulatory regime are clearly sensible

- The specification of technical criteria in licensing.
- A compulsory requirement to obtain home warranty insurance.
- Retention of a public monopoly in home warranty insurance at least until new arrangements in interstate markets demonstrate their effectiveness.

There is a particularly strong argument for setting technical criteria via licensing, mainly because this helps to provide a good standard of consumer protection in an efficient manner. A number of opportunities to further enhance these components of the regulatory regime have also been identified.

In relation to financial requirements, it is considered that these should be retained in the short term but modified to raise the threshold for self-assessment and be closely and flexibly attuned to better reflect and manage risk. However, in the longer term, it is considered that formal statutory financial requirements would not be necessary if private insurance was introduced.

In principle we consider that over time it should be possible to enhance the licensing and associated regulatory arrangements (including via improved arrangements for the provision of readily available information about the performance of builders) such that it would no longer be necessary to specify that home warranty insurance should be mandatory. And in principle it should be possible at some point to relax the requirement that home warranty insurance be provided only by a public monopoly.

However, given recent developments in interstate home warranty markets and associated regulatory arrangements it would not be sensible to make major changes to the insurance arrangements in Queensland at this stage. In particular, the experience of New South Wales and Victoria suggests that a cautious approach to reform be adopted. In these states, the performance of home warranty schemes has been a problem as a result of ineffective scheme design, the insolvency of HIH and general difficulties in certain insurance markets.

The current instability in insurance markets means that it is not feasible to make major changes to the insurance arrangements in Queensland at this stage

In short, the current instability in the insurance industry and uncertainty about the new interstate home warranty insurance schemes lead to an environment that is not conducive to the introduction of competition in the provision of home warranty insurance in Queensland. It is expected to take an extended period of time before new insurance providers would be prepared to enter the Queensland market and to establish if the new arrangements recently adopted interstate are effective and whether further changes are required.

It is not feasible to introduce competition in Queensland at this stage

Although it is not feasible to introduce competition into the Queensland market at this stage, we expect it would be sensible to do so at a later stage. We consider that it would be worthwhile to undertake a further review of the potential to introduce competition into the Queensland home warranty insurance scheme before mid-2004 when the BSA is next negotiating its reinsurance contracts.

There is merit in considering improving current arrangements by separating the licensing and insurance functions of the BSA

Despite our conclusion that any major reforms be approached with caution, some immediate improvements in home warranty insurance appear achievable through minor revisions. In particular, we consider there is merit in improving the current arrangements by separating the licensing and the insurance functions of the BSA. Furthermore, we believe that consideration should be given as to whether the Queensland arrangements are too generous in terms of the product that is specified, whether better financial assessments and risk-based pricing could be adopted and whether it is necessary to seek an exemption under the Trade Practices Act for the public monopoly status of the BSA.

A summary of restrictions and preferred options is provided in Table ES.1.

TABLE ES.1 SUMMARY OF RESTRICTIONS AND PREFERRED OPTIONS

Restriction	Option	Assessment of Key Effects
Skilled-based technical requirements and dispute resolution requirements	1. Current arrangements - technical and experience qualifications - over 100 categories - restrictions on scope of work - BSA dispute resolution and Queensland Building Tribunal for contractual disputes	Too many license categories, too restrictive in terms of scope of work. More scope to convey information about builders' performance to consumers should be pursued. Dispute resolution system works well.
	2. More flexible and focussed technical requirements - Adopt BSA proposal to streamline license categories - Reduce restrictions on scope of work - Provide more information to consumers about builders' performance - Retain existing dispute resolution process	Will reduce compliance costs, increase competition and provide better information for consumers. **Preferred option in the short term and long term.**
Financial requirements for licensing	1. Current arrangements - Target levels of net assets and liquidity ratio - Self-assessment for turnover <$250,000 - Professional indemnity insurance	Imposes costs on low risk operators and penalises good performers.
	2. More flexible and focused financial requirements for licensing - Raise the threshold for self-assessment, focus financial checks more closely on risk characteristics	Lowers costs for licenses, provides greater scope for expansion and competition, homeowners are still protected. **Preferred option for the short term.**
	3. No compulsory financial requirements, but insurers would still do financial checks (existing phantom compulsory legislation also provides some protection)	Most effectively focuses risk management on areas of highest risk and avoids substantial costs imposed on the industry from compulsory requirements supervised for a public monopoly. **Preferred option for the long term if private insurers enter the market.**
Statutory monopoly for the provision of home warranty insurance by the BSA	1. Current arrangements where BSA provides both insurance and licensing functions	Conflict of interest between commercial and regulatory functions necessitates separation of functions
	2. Public monopoly for statutory home warranty insurance but with separation of BSA licensing and industry development functions	Instability in the interstate insurance markets, the relatively low premiums in Queensland at present and the likely reluctance of private insurers to enter the market until their confidence is restored in interstate markets mean that this option is clearly **preferred in the short term** (for at least 2 years).
	3. Private providers of statutory home warranty insurance only	This is likely to be the **preferred option over the long term** as it can be expected to minimise insurance premiums over the long term and provide improved risk management of the industry as a whole. It will be effective if appropriate regulation is in place. However, it **is not feasible to implement at this stage** given the likely reluctance of private insurers to enter the market until their confidence is restored in the main interstate markets and given the relatively low levels of Queensland premiums at present.

1 INTRODUCTION

This is a Public Benefit Test of the Building Services Authority legislation

Economic Insights has been engaged by the Queensland Department of Housing to conduct a Public Benefit Test (PBT) of anti-competitive provisions in the *Queensland Building Services Authority Act 1991*, the *Queensland Building Services Authority Regulation 1992*, the *Queensland Building Services Authority Amendment Act 1999*, the *Queensland Building Services Amendment Regulation (No.1) 2001* and Board policies forming subordinate legislation to the Act.

The main restrictions on competition under the legislation are technical licensing requirements, financial criteria and a statutory public monopoly for the provision of home warranty insurance in Queensland

The primary concerns of the PBT are the provisions of the legislation that restrict competition by—

- Establishing a barrier to entry to the building industry through the requirement to meet skill-based technical licensing requirements. The licensing regime applies to builders, trade contractors, subcontractors and building designers engaged in residential and commercial building work above a specified minimum value.
- Restricting the conduct of business through controls on the financial standing of all license holders. Target levels of net tangible assets and liquidity ratios are set along with reporting requirements. While the controls apply to all license holders, around 70 per cent are able to provide a self-assessment of their compliance. The largest businesses must establish their compliance on a quarterly basis backed up by an audit report.
- Preserving a statutory monopoly for the provision of warranty insurance in the residential construction sector. The Building Services Authority (BSA) is the only primary provider of home warranty insurance in Queensland and this insurance is compulsory for all residential building work above a minimum level. The insurance is taken out by the license holder on behalf of the homeowner.

Queensland shares with most other states and territories a licensing regime that seeks to restrict who can supply certain building services and a compulsory requirement for home building (above a certain value) to be covered by insurance. But Queensland sets considerably tighter financial standards through the licensing system than other states or territories. Queensland and the Northern Territory are the only jurisdictions to restrict the supply of home warranty insurance to a monopoly and where the government provides home warranty insurance.

The PBT looks at costs and benefits of these restrictions

This PBT focuses on key provisions of the licensing regime and home warranty insurance with a view to assessing whether the restrictions on competition provide a net benefit and whether there are alternatives that are less restrictive and provide a larger net benefit (the terms of reference for the review is provided in Annex A).
In broad terms, the following options are assessed—

- Alternatives to licensing, including a reliance on the *Trade Practices Act 1974* and *Fair Trading Act 1989*, negative licensing and a legislation-based accreditation scheme.
- Alternative conditions on licenses, including more targeted technical and financial criteria.
- Alternative insurance schemes, including no insurance requirement, non-compulsory schemes and privately provided insurance.

The detailed options assessed include those identified in the Issues Paper released by the Department of Housing and additional alternatives identified through our assessment of costs and benefits or through consultation.

This report was prepared in two stages. An initial report was presented in February 2002. However in the subsequent three months there were a number of significant changes in interstate home warranty insurance markets, including very large premium increases, the withdrawal (and re-entry) of a major insurer, commitments by the New South Wales and Victorian governments to provide temporary reinsurance and various policy changes in several states. In the light of these developments, Economic Insights was asked by the Queensland Department of Housing to review developments in interstate home warranty insurance markets and adjust the report to take appropriate account of all relevant changes.

The starting point for the review was the development of a review methodology consistent with the National Competition Policy and the relevant Queensland Treasury Guidelines. The review methodology is described in Annex B.

A list of persons consulted is provided in Annex C. The PBT has built on extensive consultation to determine the nature and extent of the key problems being addressed by the legislation and the costs and benefits of alternative ways of addressing these problems. This consultation has included the conduct of a review of interstate regimes and the review of submissions received on an Issues Paper released for public comment by the Department of Housing. The consultation also entailed interstate visits to determine the extent of problems and possible policy responses in New South Wales, Victoria and the Australian Capital Territory.

A summary of interstate home warranty insurance regimes is provided in Annex D, with Annex E providing a summary of interstate licensing regimes. A summary of key issues identified in the submissions received in response to the Issues Paper is provided in Annexes F and G. The results of a survey of licensees is presented in Annex H. Annex I summarises a basic analysis of the performance of the Queensland licensing system relative to those operating interstate. Dispute resolution procedures are described in Annex J. Annex K summarises the 'gatekeeping' processes in place for BSA's interstate counterparts.

The next section of the body of the report summarises the objectives of the BSA Act. The statutory home warranty insurance arrangements are then examined, followed by a review of the licensing arrangements. Reform options for insurance and licensing are then evaluated. The final section presents the main conclusions of the PBT including an impact matrix that summarises the key issues that should be considered when evaluating reform options.

In preparing this report, staff of Economic Insights have relied on information obtained through extensive consultation with a wide range of public and private organisations and individuals. Much of the information has been provided informally and as such its accuracy cannot be independently verified. As the draft report was not made available for public comment, those that provided the information to Economic Insights have generally not been offered an opportunity to comment on its interpretation in this PBT. Analysis has been undertaken in good faith based on the assumption that the information collected is reliable (unless otherwise indicated), but Economic Insights is unable to provide any guarantee as to the accuracy or reliability of all the information contained in this report. However it is considered that sufficient reliable information has been collected to form the basis for assessment of the options as set out in this report.

2 THE OBJECTIVES OF THE BSA ACT

In conducting a PBT, an understanding is required of the objectives of the legislation targeted by the restrictions on competition (identified as licensing and the statutory home warranty insurance scheme). The objectives of a piece of legislation are normally taken from the Act itself or the accompanying second reading speech which formally sets out the rationale for the legislation.

The objective of the BSA Act is set out in the legislation as follows —

The objective of the legislation

> *"(a) to regulate the building industry —*
> *(i) to ensure the maintenance of proper standards in the industry; and*
> *(ii) to achieve a reasonable balance between the interests of building contractors and consumers; and*
> *(b) to provide remedies for defective building work; and*
> *(c) to provide support, education and advice for those who undertake building work and consumers."(s.3)*

Consumer protection is a prime objective of licensing and insurance

It is clear from the legislation and the second reading speeches that the licensing regime and home warranty insurance primarily target the protection of consumers.[1] This consumer protection is provided in a number of ways. Firstly, the intention of the BSA is that the technical requirements of licensing should be used to prevent the operation of poor quality builders, tradespeople or semi-skilled suppliers.[2] In this way a consumer should be confident that anyone they engage to do building work will produce work of an acceptable technical standard. The financial requirements of licensing are intended to help protect consumers by ensuring that the license holders they engage are financially stable and will be able to complete a project and remain in operation thereafter such that any defects can be corrected. The BSA Act also provides the basis for a low-cost dispute resolution system that can be used by consumers as a means of requiring license holders to correct defective work. And consumers are also protected by the statutory insurance scheme that ensures the cost of correcting any defective work will be covered for six and a half years from completion (for qualifying building work).

Building contractors are also protected

It is also reasonable to infer an objective of providing building contractors reasonable rights. Building contractors are protected from unreasonable consumers by the ability to seek the mediation by the BSA in relation to consumer complaints. The dispute

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1 See the second reading speeches of Hon. T.J. Burns, Deputy Premier and Minister for Housing and Local Government, November 27, 1991 on the Queensland Building Services Authority Bill and Hon. J.C. Spence, Minister for Aboriginal and Torres Strait Islander Policy and Minister for Women's Policy and Minister for Fair Trading, 21 July 1999 on the Queensland Building Services Authority Amendment Bill.

2 A builder can be thought of as someone that co-ordinates the various inputs to a building project. A tradesperson has normally completed an apprenticeship and is skilled in a broad range of skills of a trade, as opposed to some semi-skilled license holders that may only be skilled in some activities of a trade. Other skills involved in building include engineers, architects, other building designers and building certifiers (not all of which are licensed under the BSA Act).

resolution process provides for the independent review of consumer complaints by the trained inspectors of the BSA. This process can avoid the more time consuming and expensive dispute management processes of the Queensland Building Tribunal or the court system. The BSA Act also seeks to protect building contractors from the adverse effects on industry conditions of low quality operators. Low quality operators can both undermine consumer confidence in the industry making it difficult for better quality operators to compete (because better operators will tend to be more expensive and low quality operators could potentially drive prices down to unsustainably low levels). The intention of the Act is that the better quality operators will be protected from such effects through the mechanisms provided in the Act to prevent the entry of inappropriately trained suppliers and to discipline poor performers.

Some point to an objective of ensuring security of payment

Some parties consulted during the conduct of the PBT advised that they believed the financial requirements of licensing were intended to improve the overall financial stability of the industry and thereby reduce the likelihood of security of payment issues arising. Security of payment refers to problems faced at times by subcontractors and suppliers ensuring payment from a builder, trade contractor or subcontractor for goods and services provided. Minimising the security of payment problem could be interpreted as one of the 'proper standards in the industry' targeted by the legislation.

Our assessment is that neither the Act nor the second reading speeches specifically addresses the security of payment issue as an objective of the legislation targeted by licensing or home warranty insurance.[3] However, given the alternative interpretation raised by some parties, the PBT considers the implication of the alternative interpretation that ensuring security of payment is an objective of the Act relevant to licensing and home warranty insurance.

Other pieces of building legislation have similar objectives

It is important to appreciate that the BSA legislation is only one component of the regulatory regime overseeing the building industry. This means that the BSA Act and its supporting regulations and policies are not the sole legislative tool for addressing aspects of the objectives set out above. For example, local authorities have a key role to play in inspecting building work and ensuring minimum technical standards are complied with. But local authorities do not deal with licensing issues and disputes between builders and owners, as these matters are the responsibility of the BSA. Other building legislation is summarised in Box 2.1.

[3] For example, the second reading speech for the Queensland Building Services Authority Amendment Bill does not specifically raise the security of payment issue when rationalising the tighter financial standards introduced within the Bill. Yet the rationalisation for other provisions of the Act does make specific mention of the need to protect subcontractors (with an apparent focus on the provisions relating to contracts, notably those of Part 4 of the Act), suggesting that the protection of subcontractors was not a key motivation at the time for the tighter financial standards.

BOX 2.1 OTHER QUEENSLAND BUILDING LEGISLATION

Queensland Building Tribunal Act 2000

Disputes of a contractual nature can be taken before the Queensland Building Tribunal. Any dispute that cannot be resolved by the BSA mediation process can also be referred to the Tribunal.

The Act established the tribunal to deal in an expeditious, just, fair and cost efficient manner with domestic building disputes, commercial building disputes up to a value of $50,000, and provides a means to review the decisions of the BSA. The dispute resolution system within the Tribunal is intended to ensure that all litigants have an equal opportunity, regardless of their resources and that each case is treated alike.

An application to the Tribunal must state the facts or grounds on which it is based and the claims made and the outcome or order sought by the applicant. The person against who the claim is made must then file a defence within 14 days of being served with the application. Next, the Tribunal arranges a time and place for the proceeding. The proceeding is conducted with little formality and technicality. Subsequently, the Tribunal makes orders, gives directions and does whatever is necessary for the resolution of the proceedings.

A party to a proceeding before the Tribunal may appeal to the District Court against a decision of the Tribunal within 28 days.

Domestic Building Contracts Act 2000

The Domestic Building Contracts Act 2000 was introduced in July 2001 to improve the balance between the interests of building contractors and building owners in domestic construction and maintain an appropriate standard of contracts in the building industry.

The Act is intended to provide consumers with a range of rights without burdening them with unnecessary obligations. Key provisions of the Act are intended to provide consumers with information about the contract process before a contract is entered into. There must be a cooling-off period in which the consumer can cancel a contract. In addition, if a building project involves domestic building work valued at $3,300 or more, a written contract is required between the contractor and the client.

Subcontractors' Charges Act 1974

The Subcontractors' Charges Act 1974 was introduced to make better provision for securing the payment of money payable to subcontractors. Queensland is the only state in Australia to have this type of legislation. It requires building owners to set aside money, which would otherwise be paid to a contractor, if a charge is lodged by a subcontractor. Every subcontractor is entitled to a charge on the money payable to the contractor. Money may not be secured solely for the subcontractors who lodge a charge, it may be shared between a number of subcontractors.

Building Act 1975 and Standard Building Law and Building Regulation 1991

The legislation provides for the certification of building work and the accreditation of building certifiers. Primary responsibility for implementation rests with local authorities. For example, local authorities: perform inspections of work-in-progress to ensure the building work is in accordance with the approved plans; deal principally with matters related to relaxation of the Building Code (for example if somebody wants to build closer to the boundary than is allowed under the Act) and undertake compliance searches, a mechanism that allows buyers and others to obtain information about inspections done and approvals obtained for a particular property.

The certification process (building and planning approvals) is often undertaken by a stand alone business enterprise of a local authority, for example the Gold Coast Certification Group. In most local authority areas, some certification work is also undertaken by private certifiers.

Other Trades and Professions

In Queensland, certain occupations are deemed to have significant public risk/public health issues and are subject to occupational licensing. These are : Plumbers, by the Department of Local Government and Planning (Sewerage and Water Supply Act 1949 and Regulation); gas fitters, by the Department of Mines and Environment; electricians, by the Department of Industrial Relations (Electricity Act 1992 and regulation); and pest controllers, by the Department of Health (Health Act)

Building certifiers (ie. those in local government or in private organisations) are also licensed by Department of Local Government and Planning. Other professions working in the building industry that are subject to regulation include architects (*Architects Act 1985*), engineers (*Professional Engineers Act 1988*), surveyors (*Surveyors Act 1977*) and valuers *(Valuers Registration Act 1992 and Regulation)*

Source: Personal communication and NCC (2001), p. 24.3

3 STATUTORY HOME WARRANTY INSURANCE

3.1 NATURE OF THE PRODUCT

Home Warranty Insurance refers to insurance in relation to the non-completion of contracts and certain defects for residential building work.

All Australian States and Territories have a form of statutory home warranty insurance

All Australian States and Territories have a form of Statutory Home Warranty Insurance. Although there is variation in the coverage of this form of insurance, all jurisdictions except the Northern Territory provide coverage for residential work above a certain limit for non-completion of contracts and for breach of warranty in relation to certain defects or in the event of death, disappearance or insolvency of the builder.

Queensland is the only State that provides cover for uninsured consumers. The Northern Territory has a statutory scheme that provides a very basic product in the form of insurance against non-compliance with the building regulations. The Northern Territory's scheme is managed by the Government-owned Territory Insurance Office. Until recently some States, notably Queensland, New South Wales and Victoria also provided for coverage when contracts were terminated under certain conditions. This was recently changed in New South Wales and Victoria but continues in Queensland. Some jurisdictions provide coverage for owner-builders (eg. New South Wales, Victoria and Western Australia).

Queensland provides the most comprehensive product through a public monopoly

The Queensland scheme provides the most comprehensive coverage. The Queensland scheme is also notable for the operation of the Building Services Authority which provides a one-stop shop for licensing, insurance, information and certain dispute resolution activities.

With the exception of Queensland and the Northern Territory, private sector insurers are the primary insurers in all other States and Territories. In Queensland, the primary insurer is a public monopoly. However currently 75 per cent of the insurance liability in Queensland is re-insured in the private market.

In early April 2002, Dexta Corporation, which was one of the primary insurers in interstate markets, announced that it was withdrawing from the provision of home warranty insurance because it could not obtain appropriate reinsurance cover. The New South Wales and Victorian governments subsequently agreed to provide reinsurance for Dexta until 30 June 2002. The New South Wales Government also agreed to provide reinsurance for Royal and Sun Alliance for high rise buildings only. It is expected that the New South Wales and Victorian Governments will agree to extend the reinsurance arrangements at least until 31 December 2002.

A more detailed discussion of the differences between the various schemes operating in Australia is provided in Annex D.

3.2 RATIONALE FOR COMPULSORY HOME WARRANTY INSURANCE

A non-compulsory scheme would probably not be viable

In a well functioning market it could be expected that if there is adequate demand for a product it will be supplied and there would be no need for government to specify a compulsory scheme. However it seems that, in the absence of regulatory intervention, consumers collectively do not value home warranty insurance sufficiently to ensure that a non-compulsory scheme would be viable, as these schemes have only emerged when they have been made compulsory. A compulsory home warranty insurer scheme was first introduced in Queensland on 1 October 1978 and prior to that there was no product offered by insurers.

The starting point in a meaningful public benefit assessment is the identification of market failure as a rationale for some form of intervention. However the fact that a product is not supplied is not *per se* evidence of market failure. It could simply be the case that the value placed on such a product does not justify the cost of supply.

Homeowners are not likely to have sufficient meaningful information to purchase relevant insurance

The argument that is most commonly advanced to support the compulsory nature of home warranty insurance is that consumers are not capable of making a meaningful assessment of the risks they face and the costs they could incur if a builder becomes insolvent or is unable or unwilling to rectify defects. An aspect of home warranty insurance that contributes to the information problem is the "three party characteristic" of the product. The builder pays the insurance premium but the homeowner is insured and may have little meaningful information or choice about the insurer. An issue that will be important for consumers if they have to make a claim is the efficiency of the claims handling and dispute resolution process. However relevant information about this may not be readily available to consumers and builders will not be greatly concerned about this aspect and are likely to be more focussed on price. Specifying that home warranty insurance of a certain type is compulsory is one way of correcting for the three party characteristic.

The risks may be substantial

Given that the purchase of a house is a large and infrequent transaction and many consumers will be relatively young, the potential for poor decision making may be relatively high and the costs of a problem can be substantial. Further the potential scale of the problem in large busy markets mean that there is a community expectation that government has to take responsibility to ensure that consumers are protected.

The insurer also faces information problems that might affect the viability of voluntary insurance

Another dimension of the problem is that there are substantial information asymmetries for the insurer. This is particularly the case for insurance against insolvency as this requires insurers to make financial assessments of builders and contractors to determine the risk of insolvency. This is a difficult and costly exercise for insurers and with a voluntary scheme it may be that the size of the market would

be too small to ensure that even a basic product was supplied. Even with compulsory schemes the private market in the rest of Australia is highly concentrated and difficult to operate in, with profitability being very low for most of the period since the major schemes in New South Wales and Victoria were privatised in the mid-1990s.

It also needs to be recognised that, if a basic home warranty insurance product was not viable in the absence of a compulsory scheme and there were a significant number of builder insolvency or defect problems, then governments may be under considerable pressure to intervene to address the problem. This suggests that in this sector there is considerable scope for governments to assume significant liabilities that would be ultimately paid by taxpayers or consumers generally. Avoiding this situation is considered to be the strongest argument for a compulsory scheme.

Governments bear substantial implicit risk for major insurance problems and corporate failures

The willingness of governments to assume responsibility for many liabilities associated with the HIH collapse has confirmed the likelihood of governments taking responsibility for significant corporate failures. There are economic arguments against such intervention (eg. the effect of such intervention in encouraging irresponsible behaviour or a dependency mentality and creating an inappropriate role for government beyond its basic capacity) but they are not well accepted by the general community.

It is argued that consumers are not capable of determining whether it is in their best interests to buy home warranty insurance

For completeness it is also worth noting that the information problem that consumers face could potentially be addressed by the provision of compulsory information in contracts that alert the potential homeowner to the possible risks and costs they face from builder insolvency and building defects. An information based approach could also involve the BSA making its records on the performance of building contractors freely available. Given this information, it would be up to individual consumers to make their own assessment of whether insurance was worthwhile.

Rejecting such an approach really amounts to an assumption that consumers are not capable of making rational decisions by themselves when provided with the basic relevant information or that the product will not be supplied unless it is compulsory and that this will create an inevitable risk for government and taxpayers generally.

Many countries have non-compulsory home warranty insurance supplemented by information about the performance of builders

It is also relevant to note that there are many examples from other countries of non-compulsory home warranty insurance supplemented by mechanisms to provide relevant specific information about the performance of builders that seem to be effective.

In the United States there is a reluctance to adopt mandatory home warranty insurance with only two States having a mandatory home warranty insurance scheme. Similarly, the United Kingdom and Germany do not have legislation specifying a mandatory product. In Canada three provinces have a voluntary industry-based program. In Alberta, home warranty insurance is not compulsory but it is available from three entities. An association of builders is the dominant supplier and makes available information (including complaints of home owners in relation to specific

builders). Builders also compete to be rated in the top half of the market. The system seems to work well.

An information-based approach has merit

We are not convinced that consumers are incapable of acting rationally and consider that an information-based approach has considerable merit. However we do recognise the inevitable risk created for government if there is not a compulsory scheme and that it would probably not be socially acceptable to dispense with a compulsory scheme. We also recognise that it would probably take some time to enhance the current regulatory systems to the point that consumers are suitably informed and protected such that home warranty insurance could be voluntary.

A compulsory dispute resolution process may be beneficial

We also note that it is likely to be excessively costly for consumers to resolve disputes with builders through the normal legal processes so that there may be a role for a compulsory dispute resolution process in dealing efficiently with such transactions costs.

We consider there is a public benefit in having a compulsory home warranty insurance scheme

Taking all of the above factors into account we consider that at this stage there is a public benefit in having a compulsory home warranty insurance scheme. However the extent of coverage of such a scheme and the specific nature of regulatory arrangements are difficult to determine without consideration of the performance of different arrangements. The following sections consider the Queensland arrangements in more detail and outline the results of an interstate review undertaken to assist in the evaluation of options for the provision of home warranty insurance.

3.3 RATIONALE FOR PUBLIC MONOPOLY IN HOME WARRANTY INSURANCE

There is no clear in-principle argument to justify a public monopoly in the provision of home warranty insurance

Although the HIH failure is highlighted by some industry and government representatives as a key rationale for a public monopoly in home warranty insurance, we consider there is no clear in-principle argument to justify a public monopoly. This section develops this argument based on general economic principles. The HIH situation and developments in interstate home warranty insurance markets are considered in the following section.

Even if it were the case that the industry cost characteristics meant that there was a natural monopoly it is not clear that a public monopoly should be preferred over a regulated private monopoly. A private monopoly will normally have a stronger profit objective than a public monopoly and will also be less prone to political intervention. This can mean scope for higher prices but also greater incentive to minimise costs since this will mean higher profits. However the scope to take advantage of market power and to lift prices can be addressed through regulation. A public monopoly can be given a profit objective and be subject to the same regulation as a private monopoly but the profit incentive and the associated incentive to innovate and reduce costs will never be as strong since the government is the shareholder and the risk of unproductive political intervention is much greater.

A public monopoly can give a government more direct control but it is normally preferable for public enterprises with commercial functions to be effectively commercialised or corporatised. This approach is designed to help address key weaknesses of government control of public enterprises but it is difficult to implement effectively, and the underlying weaknesses can only be effectively eliminated with private ownership. The trade off is between effective regulation of a strongly profit-oriented private monopoly and government control/regulation of a less strongly profit-oriented public monopoly with a range of objectives. Key issues are the ability to achieve effective regulation in a private versus a public monopoly, reduced scope for arbitrary political intervention in a private monopoly, and the impact of clearer non-conflicting objectives for a private monopoly.

The choice is between a public monopoly and a highly concentrated private market

However the choice is not between a public and a private monopoly but between a public monopoly and a highly concentrated oligopolistic market structure.[4] The experience in other States suggests that in the absence of a public monopoly, the market structure is likely to be no more than two major firms and one to two minor firms. It is normally the case that an oligopoly, even a highly concentrated one, is preferred over a monopoly. It is well accepted as an economic principle that a monopoly with a commercial focus will normally lead to a worse outcome in terms of prices and service delivery than an oligopolistic structure. The monopoly represents the extreme case and the oligopoly outcome cannot be worse than a monopoly outcome. This is because a monopoly clearly faces no competition and the greatest scope to take advantage of any market power.

A 1996 study concluded that privatisation would not deliver much competition but that there were clear benefits from commercialising BSA insurance

In July 1996 Coopers and Lybrand undertook a study for the Building Services Authority on the performance of the home warranty insurance arrangements in Queensland and an assessment of alternative arrangements including commercialisation and full privatisation.

Key conclusions of that study can be summarised as follows —

1. Where there are only two competitors it is highly unlikely that there would be a high level of consumer choice and significant price competition in the long run.
2. Irrespective of any future consideration of deregulation there are clear benefits of commercialising BSA insurance.
3. Before the Government could even consider opening the market to competition it should aim to maximise the value of its asset and this can be best achieved through commercialisation.

The Building Services Authority has referred to the conclusions of this study in its submission to this PBT.

[4] An oligopolistic market is a market with a small number of suppliers. A highly concentrated market will have more of the market controlled by the larger suppliers than in a less concentrated market.

However, a highly concentrated market structure still offers scope for a much better price outcome than a monopoly

In relation to the first point it is important to note that this was merely an opinion in the report and not supported by any evidence or economic principles. It is also misleading to the extent that it implicitly compares a duopoly with a highly competitive situation rather than a duopoly with a monopoly outcome. It is reasonable to conclude that a duopoly would normally mean that there would not be a high level of price competition. However such a view is based on a comparison with competition and not a comparison with a monopoly. Although a duopoly is unlikely to deliver the extent of benefits consistent with a highly competitive market, provided there is no strong collusive behaviour, economic principles and general experience suggest a profit-oriented duopoly is likely to mean considerably more benefits than a profit-oriented monopoly.

This can be illustrated with a simple example comparing a monopoly and several forms of oligopoly. For the most basic non-collusive (Cournot) model of oligopoly it can be shown that:

$$(Price - Marginal\ Cost) / Price = Sum\ of\ squares\ of\ market\ shares / price\ elasticity\ of\ demand$$

Using this relationship Table 3.1 shows the extent to which prices are marked up over cost for several market structures relative to a monopoly situation. For a monopoly the ratio will be 1 as the monopoly price mark up is benchmarked against itself.[5]

TABLE 3.1 PRICE COST MARK UP FOR VARIOUS MARKET STRUCTURES RELATIVE TO MONOPOLY OUTCOME

Market Structure	Price Cost Mark Up Relative to a Monopoly Outcome
Monopoly	1.00
Duopoly with equal market shares	0.50
Oligopoly of 3 firms with equal market shares	0.33
Oligopoly of 4 firms with market shares of 40, 40, 10 & 10	0.34
Oligopoly of 4 firms with market shares of 45, 45, 5 & 5	0.41

The results in the table show that the move from a monopoly to a competitive duopoly with equal market shares means a very substantial reduction in the extent to which prices can be marked up above costs. The mark up is half of the monopoly mark up. For a three firm oligopoly with equal market shares the mark up is one-third of the monopoly mark up. For a 4 firm oligopoly, where two firms have market shares of 40 per cent and the other two have market shares of 10 per cent each, the mark up is also about one third of the monopoly mark up. However if two firms have market shares of 45 per cent and two have market shares of 5 per cent, the mark up is about 40 per cent of the monopoly mark up.

[5] Since the relationship is (sum of squares of market shares for relevant market structure ÷ price elasticity of demand) ÷ (sum of squares of monopoly ÷ price elasticity of demand).

These simple calculations demonstrate that the move from a monopoly to a highly concentrated market structure where firms compete can have a very significant impact on prices. Seen in this context the conclusion that a two firm structure is not justified because of competition concerns is not well supported. However as discussed below the situation is more complex in comparing a public monopoly and a private duopoly.

The second conclusion of the Coopers and Lybrand study was that commercialisation should be pursued. This recommendation reflects a well established acceptance by experts and governments that public enterprises undertaking commercial functions should at least be subject to a number of arrangements to clarify their objectives, minimise conflicts, improve their accountability for performance and remove special advantages and disadvantages they have relative to what would be present in a normal commercial environment.

The BSA is not commercialised in accordance with key commercialisation principles

We agree with this conclusion but note that the Building Services Authority is not commercialised in accordance with key commercialisation and corporatisation principles. In particular the entity undertakes both regulatory and commercial functions and has non-commercial and poorly defined commercial objectives. Weak accountability for commercial performance and an absence of competitive neutrality (for example no requirement to pay income tax or tax equivalent payments and non-compliance with APRA prudential standards) are also features of the Building Services Authority. Until recently the insurance operation was also subsidising the licensing functions and the operations of the Queensland Building Tribunal in a manner not consistent with the ideal approach to specifying and funding community service obligations. These aspects are considered in more detail below.

The third conclusion has not been well presented. For a monopoly entity undertaking commercial functions, maximisation of value without effective price and service regulation would imply the full exploitation of monopoly power. The review may have assumed an effective regulatory environment but this was not made clear.

It is noted that in the case of the Building Services Authority that the profit objective is not strong and the entity is not subject to the normal regulatory and commercial arrangements that would apply to a private entity. It could be argued that it is effectively regulating itself and serving a valuable community function by not adopting a strong profit objective and instead putting more emphasis on service delivery and fairness than private entities in a highly concentrated industry would.

However in considering this aspect of equity and service delivery it is also relevant to recognise the key reasons why public enterprises have been commercialised and corporatised. Those reasons include the potential for public enterprises to face objectives that are not clear and often in conflict and which in turn are likely to impose costs on the community. More specifically from a financial perspective public entities undertaking commercial functions are expected to earn a normal risk-adjusted return on capital. The rationale is that all public capital undertaking commercial

functions should make a clear and explicit contribution in terms of the opportunity cost of that capital to ensure that the community's collective wealth is maximised. Furthermore, effective corporatisation or commercialisation requires that non-commercial objectives be treated as explicit community service obligations and ideally funded directly from the government budget.

If the Building Services Authority is not required to earn a profit on capital supplied to it by the Government, the Government is in effect subsidising consumers that build houses at the expense of those that do not, with the subsidy highest for higher income consumers (that build higher cost houses). It is difficult to rationalise this as an equitable outcome.

Effective commercialisation of a public enterprise also requires an effective monitoring and accountability mechanism to ensure there are adequate pressures to minimise costs. We also have a concern that these arrangements are not as effective as they could be for the BSA.

The key issue to consider is the performance of the Building Services Authority relative to the performance of a structure that entailed more competition

Taking account of the foregoing considerations there is no convincing in-principle rationale for a public monopoly in the provision of compulsory home warranty insurance. One view is that a well-managed and well-regulated public monopoly can deliver a better performance than a highly concentrated oligopolistic structure, particularly when the product is difficult to provide and there is scope for numerous information failures and for collusion. However it is very difficult to achieve such an ideal public monopoly model in practice and there is also a view that generally, in practice, public enterprises are inferior to private enterprises in terms of pursuing efficiencies and commercial success and that equity objectives should be addressed by an effective community service obligations policy. If such a view was accepted it would require significant changes to the current arrangements.

We recognise that the disruption and complaints associated with the HIH failure and with the claims process in interstate markets and with problems in insurance markets generally make it harder to conclude that a private duopoly is preferred to a public monopoly in the home warranty insurance market. However we consider that over the long term a public monopoly will not generally be as effective as private providers in undertaking commercial functions, even if the market structure is highly concentrated, when an appropriate regulatory framework is in place. Our assessment is based on a view that public enterprises are generally fundamentally inferior to private enterprises in pursuing commercial objectives and that non-commercial objectives should be addressed by a community service obligations policy that clearly specifies and costs those objectives. We also note that this view about community service obligations is also reflected in Queensland's community service obligations policies for public enterprises generally and can see no reason this policy should not apply to the public provision of home warranty insurance.

3.4 HIH SITUATION AND DEVELOPMENTS IN INTERSTATE HOME WARRANTY INSURANCE MARKETS

The failure of HIH has been highlighted to support the retention of the arrangements in Queensland

The failure of HIH has been highlighted by some industry and government representatives as support for the retention of the arrangements in Queensland. The failure of HIH led to extensive disruption in interstate building markets as builders were unable to work while they were not clearly covered by insurance. The Commonwealth and State governments developed a number of rescue packages in home warranty and other insurance markets but there were still considerable delays and associated lost income and much dissatisfaction about the situation.

The HIH failure removed a major competitor from the market. It may have been responsible for around 50 per cent of the Home Warranty market outside of Queensland.

HIH was a large factor in the increase in premiums in interstate markets

The collapse of HIH was also a large factor in the dramatic increase in premiums in interstate home warranty insurance markets. In some South Eastern states, premiums have more than doubled since early 2002. Section 3.6 provides further details on premium increases.

Following the collapse of HIH, the remaining insurers were inundated with requests for insurance. With the demise of HIH, Homeowners Warranty (underwritten by Royal Sun Alliance) became the major direct insurer involved in all interstate markets except Queensland together with Dexta Corporation (underwritten by Allianz Australia). Dexta entered the market in the second half of 1999 and was writing much of the former business of HIH. Dexta stopped writing home warranty insurance in April 2002 because of a lack of support from international reinsurers. Dexta subsequently resumed underwriting home warranty insurance in New South Wales and Victoria following the decision of both State Governments to act as reinsurers for Dexta.

HIH was apparently providing insurance with minimal financial assessments and since its collapse, financial assessments have become more demanding with both major insurers requiring a fairly comprehensive risk assessment process compared with that undertaken by HIH. This has made it difficult for many builders who were formerly insured with HIH and there has been a greater number who have not been able to obtain insurance. However, according to Dexta, rejections were only about 10-15 a week in the period when applications were around 900 per week in 2001.

Some builders have expressed concern about delays in obtaining insurance and the requirements of the insurers

The Master Builders Association concedes that absolute rejection rates have been very low. However they note that many builders have been unable to obtain the level of insurance cover they want and that there are often very long delays (up to three months) to obtain insurance. The Master Builders Association also claims that the financial criteria and assessment process applied by private insurers are not immediately transparent, clearly defined or fixed for a specified period. This has made it difficult for builders to understand the requirements and created uncertainty

for them. However, insurers have indicated that they are considering making requirements more transparent.

The Master Builders Association also claims that some builders are effectively prevented from being able to work because they are forced to obtain insurance cover for a quantity of work which is significantly less than that needed to guarantee their livelihood and commercial viability. According to the Master Builders Association, there has been a dramatic increase in the level of owner-builder activity and it seems that some builders are taking on a supervisory role on behalf of their clients to avoid having to obtain insurance cover.

Builders also claim it is too difficult for new and younger builders to commence building due to the stringent financial requirements imposed by insurers. Builders are also greatly concerned that the insurers have become de facto licensing authorities since builders cannot work without insurance. However, insurers are also uncomfortable in this role.

It is not clear that the most effective response is for government to assume the ongoing responsibility for the provision of home warranty or other insurance where there is a major corporate failure

In evaluating the collapse of HIH it is important to recognise that the failure is not primarily attributable to an insurance failure in the home warranty insurance market but rather a broader corporate failure of a major insurer. This has led to a Royal Commission into the matter and a tightening of APRA regulation and monitoring. It is not clear that the most effective response is for government to assume the ongoing responsibility for the provision of home warranty or other insurance where there is a major corporate failure. The appropriate, future regulatory arrangements for the industry should become clearer as the Royal Commission undertakes its review and after the separate national review of home warranty insurance is concluded. Improved regulatory arrangements, which may entail some form of insurer-of-last-resort provisions, will reduce the likelihood of a HIH-type situation re-occurring.

Problems that occurred as a result of the HIH collapse seem to have been resolved as a result of State government rescue packages and as private insurers caught up with the backlog

In relation to the disruption that occurred following the HIH collapse one view is that many of the problems seem to have been resolved as a result of State government rescue packages and as private insurers caught up with the major backlog.

In relation to the "de facto licensing" that is perceived to occur as private insurers undertake their risk assessments, it needs to be appreciated that they are insuring against insolvency and this requires a thorough credit assessment

In relation to the "de facto licensing" that is perceived to occur as private insurers undertake their risk assessments, it needs to be appreciated that they are insuring against insolvency and this requires a thorough credit assessment. As the building industry is renowned for a frequency of solvency problems it is not surprising that these assessments need to be comprehensive and rigorous and that guarantees, premium differentiation and other measures to manage and control risk need to be used by insurers. The fact that HIH did not use these mechanisms effectively just highlights another aspect of how it was failing as a major private insurance entity.

It is also important to keep in mind that a reduction in the perceived high incidence of contractor failure will require the exclusion from the industry of high risk operators. The fact that some contractors are finding it harder to obtain insurance is potentially a good sign and a precursor to an improvement in industry standards. Clearly it is

incorrect to presume that all contractors are financially sound and should be allowed to operate.

A concern has been raised during consultation as to whether "de facto licensing" by insurers is in the public interest given that they will serve their own interests and not the interests of the building industry

A concern has been raised during consultation as to whether "de facto licensing" by insurers is in the public interest given that they will serve their own interests and not the interests of the building industry. This problem essentially arises because of the compulsory nature of the product and the need to assess the risk of insolvency. However, with effective competition insurers would serve the public interest because the combination of the pursuit of their own interests in effective competition with each other would deliver the best outcome for consumers. At the same time competition should ensure that builders are not exploited. This assessment is based on the proposition that, in the absence of market failure, competitive markets are generally the best means of ensuring that economic activities respond appropriately to consumer and producer interests.

Concerns that competition could not be effective and some builders could be unfairly treated could be dealt with by an "insurer-of-last-resort" provision in the design of the compulsory product. However, it is worth re-emphasising that not all trade contractors should be provided insurance as some are financially unsound.

In New South Wales and Victoria there have been examples of builders becoming bankrupt and restarting soon after under a different company

There is another important observation in relation to the need for these tests. In relation to New South Wales and Victoria we were advised that insolvency is the major risk and there have been numerous examples of builders becoming insolvent and restarting soon after under a different company. In the past there has also been scope for builders to collude with homeowners and deliberately becoming insolvent and organising for an insurance claim for completion of work. Limiting non-completion claims to 20 per cent of the contract value has been introduced to address this problem. However, it is notable that in Queensland the problem has been addressed through amendments to the Building Services Authority Act in 1999 to prevent "excluded individuals" and "excluded companies" from holding a contractor's licence for a period of 5 years from the bankruptcy event. Excluded persons include a director, secretary, influential person for a company or bankrupt individual. We consider this mechanism is more likely to be effective than financial solvency and liquidity tests in effectively reducing the incidence of insolvency.

In Queensland the problem has been addressed through amendments to the BSA Act

In Queensland there are a number of financial criteria that need to be passed to obtain a building license. A feature of the survey of licensees we undertook (with 100 respondents) was the difficulty in moving above the self assessment turnover threshold of $250,000 (which applies to around 70 per cent of builders in Queensland) and the amount of paperwork and time involved in meeting BSA requirements.

The major Australian insurer has advised that builders with a turnover of less than $1m are considered low risk and that their assessment for this category is less onerous than for higher risk categories. However to compensate for less onerous risk assessment in this category, a higher than average premium is charged (ie. the

premium as a percentage of the value of work is higher). Combined with other information about the risk assessment process of private insurers (see Annex D), this suggests that the assessment process for most builders in Queensland, under private insurance arrangements could well be less onerous but more risk focussed than under the current rule-based approach.

The current approach in Queensland is not effective enough in penalising builders with poor records

We consider that the current approach in Queensland is not effective enough in penalising builders with poor records or who are characterised by high risk. This is because it does not provide for higher insurance premiums to match the higher risk. We consider that it is appropriate to use credit assessments to identify high risk builders, apply premiums to reflect risk and poor records and for insurers at some point to have the option of refusing insurance. This is common for other insurance products.

There is scope for an "insurer-of-last-resort" function

However consideration should be given for an insurer-of-last-resort function or for an exemption to apply in certain circumstances to builders who cannot obtain private insurance due to temporary difficulties or special circumstances. If the Queensland market was opened up to direct private insurers, and the BSA insurance functions were separated from other BSA functions, the BSA could perform these functions.

3.5 RECENT DEVELOPMENTS IN THE AUSTRALIAN INSURANCE INDUSTRY

This section outlines the recent developments in the Australian insurance industry and draws on two reports (ACCC 2002 and Trowbridge Consulting 2002). The aim is to determine if there are general difficulties in insurance markets that are contributing to escalating premiums for certain insurance products and to better understand the likely implications for home warranty insurance.

The insurance industry has experienced low returns on equity over the last nine years

The Australian insurance industry has been in a state of flux over recent times. According to the ACCC (2002, p.ii) –

> *"the insurance industry has experienced low returns on equity over the last nine years. The average return has been little higher than could have been obtained by investing in cash although shareholders have borne a significant risk. The extent of the risk is highlighted by the liquidation of HIH Group where shareholders are expected to lose their total investment".*

The return on equity has averaged 7 per cent between 1993 and 2001

The return on equity (insurance profit after company tax divided by shareholder capital) has averaged 7 per cent between 1993 and 2001. In 1998-99 and 1999-00, the return for the Australian insurance sector as a whole was less than 5 per cent, which is significantly lower than the 13 per cent per annum achieved by the Australian Equity market over the same period. In 2000-01 the return was almost 10 per cent excluding the losses of the HIH Group. However, if the HIH Group losses are included then the return on equity could be zero or even negative.

The ACCC notes that the recent very low returns on capital are the result of:

- Inadequate premium rates
- Catastrophes
- Realisation of the extent of past losses
- Low investment returns
- Increasing reinsurance premiums
- Liquidation of the HIH Group.

Trowbridge adds that in public liability insurance, the two main reasons of the current 'crisis' situation are:

- Increasing costs of claims over the long term (claims can be very large and have a 'long tail'), and
- Insurance market crisis arising from an extreme market cycle in the short term.

Changing community attitudes; specialist plaintiff law firms; drift in definition of negligence; increased levels of compensation; perceived generosity of courts; increasing deregulation of legal fees, e.g. "no win no fee"; class actions; and reforms of other types of insurance, may also contribute to these trends.

The insurance market is characterised by its cyclical behaviour

The insurance market is characterised by its cyclical behaviour. When the market is 'hard' or expensive, profitability improves significantly and as a consequence capital flows into the market. As more insurers enter the market and 'chase' the relatively fixed pool of risk, premium rates decline and profitability is eroded. External events may also contribute to the erosion of profitability. As more insurers enter the market, the market becomes 'soft' and cheap. As insurers start to realise their losses, capital and capacity is withdrawn from the market and premiums start to rise. With increasing profitability, the market moves back into a 'hard' market.

Trowbridge states that in the last two years the insurance market has moved back into the 'hard' market and that traditionally insurers at this stage focus on profitability and have conservative attitudes towards growth opportunities. The terrorist attacks in the United States have compounded the expensive aspects of the market cycle. The direct insurance losses, the recognition of a major new risk factor and the greater caution throughout the business world have further reduced the willingness of insurers to write business and further increased premium rates.

New APRA capital requirements will come into effect on 1 July 2002

The introduction of APRA's new capital requirements for general insurance companies (to take effect from 1 July 2002) is also expected to strengthen the insurers' focus on profitability and reinforce their caution about growth opportunities. By increasing the minimum level of capital required by insurers, APRA is seeking to reduce the likelihood of insurers failing.

However, in order to achieve the necessary returns on a higher capital base, insurers are expected to increase profit either by achieving greater operating efficiencies; increasing investments; or increasing premiums. Initially the main impact is expected to be further upward pressure on premiums.

The Reinsurance Market

The reinsurance market is an international market, which is also subject to the insurance cycle described above. The ACCC notes that there is general consensus that the industry is emerging from a period in the cycle where rates were inadequate and substantial losses were incurred. Reinsurance rates fell in the second half of the 1990s, probably reaching their lowest point in 1999 or 2000. The previous low in the cycle was in 1990.

Catastrophic events have made the situation in the reinsurance market worse

Since the recent lows in the market, catastrophic events have had an important effect. There is evidence of increasing pressure on reinsurance rates as a result of the recent terrorist attacks on the World Trade Centre in the United States. The insured losses arising from the terrorist attacks in the United States are expected to reduce the amount of capital available within the insurance and reinsurance markets around the world and thereby accelerate the rise in reinsurance rates that was already underway.

Reinsurance costs have increased significantly for most classes of business, in particular, Householders, Domestic Motor, Public Liability and other Accidents. These increases seem to have been the result of greater protection of portfolios sought after poor underwriting experience (Householders and Domestic Motor) and increased reinsurance rates (Public Liability).

A change of 60 to 80 per cent in reinsurance costs would lead to a change of 16 to 21 per cent in insurer's premiums

The ACCC notes that for most classes of business, 20 per cent to 40 per cent of gross premiums are ceded to reinsurance with an average across all classes of approximately 26 per cent. A change of 60 per cent to 80 per cent in reinsurance costs would lead to a change of 16 per cent to 21 per cent in insurer's premiums.

In 2000 reinsurers reported a loss ratio of 135 per cent, which is considerably higher than the standard target ratio of 75 per cent. However, the impact of reinsurance premium rate increases that started to emerge at the beginning of 2000 is beginning to be reflected in the 2001 financial results and the loss ratio declined to 95 per cent in 2001. This indicates that the profitability of reinsurers has recently improved.

Premiums in the reinsurance market have not increased by as much as premiums in the direct insurance market

According to the ACCC, premiums in the reinsurance market have not increased by as much as premiums in the direct insurance market. This may be due to the fact that multi-year reinsurance contracts were entered into during the late 1990s to avoid renegotiating contracts during the end of the millennium due to Y2K concerns. As these contracts are now expiring and are being renewed, reinsurance rate increases are expected to occur.

3.6 INTERSTATE COMPARISON OF HOME WARRANTY INSURANCE SCHEMES

It has been possible to identify the main differences in interstate insurance coverage

With the exception of Queensland and the Northern Territory, private sector insurers are the primary insurers in the other States and Territories. It is therefore relevant to try to assess the situation in other States and Territories relative to Queensland. The recent collapse of HIH, the withdrawal of Dexta from the home warranty insurance market in most states (and subsequent re-entry following underwriting commitments from the New South Wales and Victorian Governments), the development and/or implementation of recent reforms in other jurisdictions and the Commonwealth government's national review of home warranty insurance, complicate the assessment process. As this review is not a major review it is not possible to undertake a comprehensive detailed assessment that would definitively identify the relative performance of the arrangements in Queensland relative to other States and Territories. However it has been possible to identify the main differences in insurance coverage, the premiums that apply and the main problems that have emerged.

Many of the problems in the jurisdictions are not necessarily a result of private sector involvement but are related to scheme design and regulatory arrangements

It is important to recognise that many of the problems that have emerged in the various jurisdictions are not necessarily a result of private sector involvement but are related to scheme design and the regulatory arrangements that apply. A key weakness in some jurisdictions has been the absence of an effective mechanism for handling disputes over insurance claims. This has often been a feature of other similar insurance markets such as compulsory third party and workers compensation insurance.

In the case of New South Wales and Victoria, many of the problems in home warranty insurance have been or are being addressed with a range of recent and proposed reforms

In the case of New South Wales and Victoria many of the problems in home warranty insurance have been or are being addressed with a range of recent and proposed reforms. On 1 January 2002, the Home Building Legislation Amendment Bill 2001 came into effect in New South Wales. The new legislation changed the dispute resolution process significantly, by introducing mediation steps prior to Tribunal hearings. In addition, the Home Building Amendment (Insurance) Bill 2002 has introduced further changes to the current home warranty insurance system, including changes to the scope of work insured, the minimum value insured and the nature of the scheme. These changes are expected to come into effect on 1 July 2002.

Similar to New South Wales, a Ministerial Order and the Domestic Building Contracts (Conciliation and Dispute Resolution) Bill will introduce several changes in Victoria on 1 July 2002. In particular, the dispute resolution process will include new conciliation procedures and government inspectors will play a major role in the resolution of disputes. In addition, the nature of the insurance product will change including the scope of insured work, the minimum insured value, and the period of cover.

It is not clear how effective these new arrangements will be and whether they will ensure a comparable performance in terms of claims handling and dispute resolution

as in Queensland. However, they are focussed on addressing key problems in the old arrangements.

Annex D provides a comparison of home warranty insurance schemes for each State and Territory. The specific objectives vary in wording but entail consumer protection and ensuring proper standards in the industry. In the case of Queensland the intent of the legislation and amendments may also encompass concerns about security of payment but this does not appear to be the case in other States.

In Tasmania and the Northern Territory licensing of builders is not required but insurance is required.

The coverage of policies varies considerably but the Queensland scheme provides the most comprehensive cover

For all jurisdictions, the insurance generally relates to residential building work including renovations. However in Queensland the coverage includes landscaping, driveways, fences, retaining walls and all contract work associated with residential building. In some jurisdictions owner builders are covered but in some, including Queensland, they are not covered.

The Northern Territory insurance product currently only covers failure to carry out work due to negligence or reasons beyond the builder's control. It is insurance against non-compliance with the building regulations rather than home warranty insurance as it is normally understood. However a proposed scheme for a more comprehensive home warranty insurance is being developed.

The minimum insured value is $3,300 in Queensland, $5,000 in the Australian Capital Territory and $12,000 in New South Wales, Victoria, Western Australia and South Australia. There is no minimum in the Northern Territory.

The period of cover is generally around 6 years from the date of completion but 10 years for the Northern Territory. In New South Wales and Victoria (following recent amendments) non-structural defects are covered for 2 years.

The maximum sum insured is $200,000 in Queensland, New South Wales and Victoria, $100,000 in Western Australia, $85,000 in the Australian Capital Territory, $80,000 in South Australia and $50,000 in Tasmania. There is no maximum in the Northern Territory.

Most states have an excess of around $500. Victorian claimants have to pay excesses up to $1,000 depending on the age of the home. Queensland has no excess. The coverage for deposits varies from 3-10 per cent of the contract value, except for the Northern Territory where there is no coverage.

All jurisdictions except the Northern Territory have some form of non-completion cover. In New South Wales, Victoria, Western Australia, South Australia, the Australian Capital Territory and Tasmania the cover only applies for death, disappearance or insolvency of the builder.

As of 1 July 2002, Queensland will be the only state that includes a termination clause. The termination provision relates to contractor default in relation to the building contract, for example refusal to complete work or wrongful failure as specified in the contract.[6] Without this provision there is scope for builders to refuse to complete a job, so that the only action consumers can take is to pursue the matter through the courts. There are also often situations where contractors cease work due to solvency problems but do not go into bankruptcy until a debtor takes action, that can be six months or more after they cease trading. Without termination provisions, an owner is forced to either wait to prove insolvency or instigate legal action.

Termination provisions complicate the product and have entailed exploitation of the provision in other jurisdictions

With the recent changes, New South Wales and Victoria are moving away from their termination provisions, as they had led to a number of "moral hazard" and fraud problems. Reported problems included consumers unreasonably terminating the contract because they considered certain work was not completed to their liking and builders and consumers colluding to terminate a contract and have the insurance pay for completion of the work.

In New South Wales and Victoria the termination provisions were apparently also exploited to use insurance to complete houses that were underpriced. A 20 per cent limit on the value of the contract was introduced to limit the scope for this problem in New South Wales and Victoria.

According to insurers the termination provision greatly complicated the pricing of the product and management of claims. In jurisdictions where this provision does not exist, the product is much easier to provide from the insurers perspective and less costly. It is noted that in those states where there is no termination provision that there are apparently no major problems and no proposals to introduce termination provisions. It could be the case that this is because these markets are smaller and that social constraints are effective in limiting the scope of the problem. However it could also be the case that this provision is designed to address a problem that would be relatively infrequent in the absence of the termination provision, even in the larger jurisdictions. It remains to be seen whether this is true in New South Wales and Victoria.

Queensland is the only state that includes a termination clause

Insurers also complained that they got involved in Tribunal proceedings in New South Wales and Victoria at too early a stage, i.e. before liability was determined, incurring excessive legal costs. With these recent and proposed changes this will no longer be an issue.

A termination provision is a key factor in affecting the pricing of the product, since it is clear that claims are likely to be much higher in jurisdictions where there are such provisions compared to jurisdictions where such provisions do not exist. The

[6] For example, according to a policy provided (prior to the recent changes) by one major insurer in New South Wales "the Insurer will also indemnify the Building Owner for loss or damage resulting from non-completion of the work because of early termination of the contract for the work because of the contractor's wrongful failure or refusal to complete the work".

The prospective removal of the termination provisions should reduce the cost of supplying home warranty insurance in New South Wales and Victoria. However, it is likely to be some time before there is a visible impact in lower premiums

prospective removal of the termination provisions should reduce the cost of supplying home warranty insurance in New South Wales and Victoria. However, given the recent escalation of claims costs, the poor profitability of home warranty insurance in these states and the highly concentrated home warranty insurance market, it is likely to be some time before there is a visible impact in lower premiums.

Most jurisdictions have coverage for defects but in New South Wales, Victoria, Western Australia and South Australia this now applies only in the event of death, disappearance or insolvency of the builder.

Queensland is the only State that provides no fault subsidence cover irrespective of the cause

Queensland is the only State that provides no fault subsidence cover irrespective of the cause. In other jurisdictions the cover relies on the work being defective i.e. a breach of warranty. Subsidence claims are not significant in other jurisdictions but they are around one-third of claims by value in Queensland. In Queensland the BSA has advised that a majority of claims are caused by the influence of external factors (e.g. the weather or other environmental factors) rather than defective work. According to the BSA less than 10 per cent are the result of defective work.

We have been advised by the main interstate insurer that the warranty is defined such that if subsidence was not a breach of warranty then it would effectively be the result of an "act of God" and should be covered under a normal house insurance policy. But it has also been suggested that in interstate markets the onus is on the homeowner to prove their claim. However insurers argue that this is not the case and it is the responsibility of the insurer to determine a breach of warranty.

It is not clear as to the extent to which the difference in subsidence claims in Queensland is primarily attributable to a more generous scheme or a deficiency in the contracting and regulatory arrangements or environmental conditions or some combination

It could well be the case that the "no fault" nature of the coverage in Queensland and the objective and approach of the BSA in being more likely to accommodate claims than private insurers are more conducive to a greater incidence of insurance claims for subsidence. However it could also be the case that deficiencies in the regulatory arrangements for engineers or soil testers combined with an interpretation that builders clearly have no responsibility if they have followed engineering specifications are important factors in explaining the large proportion of subsidence claims in Queensland. Differences in the weather and soil conditions may also be relevant. It is not clear as to the extent to which the difference is primarily attributable to a more generous scheme or a deficiency in the contracting and regulatory arrangements or environmental conditions or some combination. It is beyond the scope of this study to explain the difference. However it is noted that the BSA is now proposing the licensing of persons providing design and related services for residential building foundation work by the BSA as a means of developing more effective regulatory arrangements.

Queensland is also the only State that provides cover for uninsured consumers for cases where the premium payment is avoided.

Until the recent changes in New South Wales and Victoria, Queensland appears to have had the most effective mechanism for managing disputes in relation to insurance claims

Until the recent changes in New South Wales and Victoria, Queensland appears to have had the most effective mechanism for managing disputes in relation to insurance claims. The Building Services Authority deals with disputes about workmanship issues, while disputes of a contractual nature are dealt with by the Queensland Building Tribunal. The Tribunal also has the power to review decisions of the Building Services Authority. The dispute resolution system within the Tribunal only costs $200 for all claimants. Decisions of the Tribunal can be appealed to the District Court.

Until recently, Victoria and New South Wales had very similar dispute resolution systems, as in both states application to the relevant Tribunal was the first formal step in the dispute settlement process. This made the resolution of disputes costly and time consuming. In addition, it was claimed that the processes were too legalistic and complex, creating confusion for the parties involved. The new systems provide simpler means of resolving disputes in a less expensive and faster manner.

Queensland had a superior, dispute management system, as it had a formal mediation process in place without Tribunal involvement

Prior to the recent changes in New South Wales and Victoria, Queensland had a superior system, as it had a formal mediation process in place without Tribunal involvement. The BSA offers a mediation mechanism that allows many disputes to be resolved quickly and at least cost to the parties involved. Once a consumer has submitted a Dispute Notification to the BSA, a technical expert meets the parties on site to inspect the work. If the BSA is satisfied that the work is defective, it issues the builder with a Direction to Rectify. If the builder does not comply, prosecution action follows. Disputes that cannot be resolved by the BSA mediation process are referred to the Queensland Building Tribunal. However, as most disputes are successfully resolved by the BSA, the Tribunal can be used more efficiently to deal with major disputes which could not be resolved by the BSA and with contractual disputes.

Evidence suggests that the BSA mediation process has been successful. In 2000-2001, 64 per cent of the 3,787 disputes received by the BSA (excluding cases outside the BSA jurisdiction and straight insurance claims) were able to be satisfactorily resolved through the BSA dispute mediation process. As a result, only 1,348 directions were issued. This represents a 10 per cent reduction from the previous year, indicating that the 21-day policy (allowing contractors 21 days to remedy complaints prior to BSA intervention) has helped reduce the number of directions issued. The percentage of disputes satisfactorily resolved has increased each year for the past 5 years and the target level is 70 per cent.

New South Wales and Victoria have both developed formal mediation mechanisms that do not involve the Tribunals

New South Wales and Victoria have both recognised the importance of early intervention in the dispute resolution process and have developed formal mediation mechanisms that do not involve the Tribunals. As noted, this will ensure a less costly, legalistic and time consuming process and it will free up the Tribunals to deal with larger disputes that could not be resolved at mediation.

In New South Wales consumers in dispute with their builders can contact the Building Dispute Unit of the Consumer, Trader and Tenancy Tribunal. An independent expert will then engage the parties in informal discussions in an attempt to reach settlement. Only where the dispute cannot be resolved during this mediation phase will it be referred to the Consumer, Trader and Tenancy Tribunal.

In Victoria, the Director of Consumer and Business Affairs Victoria will refer the dispute to conciliation or institute proceedings. The Building Commission may appoint an inspector to examine the disputed work and to make a recommendation as to what should be done to rectify the defect. Annex J provides further details about the dispute resolution procedures in place in New South Wales and Victoria.

Those States with a more basic product also tend to have no formal dispute mechanism in place. However, they generally allow for private arbitration in relation to building contracts.

It is notable that disputes in relation to home warranty do not fall under the terms of reference of the insurance industry's self regulation mechanism for dealing with insurance disputes. The basic features of this mechanism are outlined later to help an assessment of whether it could be adapted for home warranty insurance.

In terms of the criteria that must be met to obtain insurance, the Queensland insurance requirements are integrated with the licensing requirements

In terms of the criteria that must be met to obtain insurance, the Queensland insurance requirements are integrated with the licensing requirements. In addition to technical criteria, there are a number of specific financial criteria in Queensland including minimum net assets based on minimum net asset/turnover ratios, a liquidity ratio of 0.8, internal financial monitoring and independent reports. However self-assessment applies for entities with a turnover of less than $250,000.

In interstate markets there are generally no formal regulated criteria but insurers undertake technical and financial assessments

In interstate markets there are generally no formal regulated criteria but insurers undertake technical and financial assessments (with most weight being on the financial component) and require certain standards to be met in terms of minimum net asset/turnover ratios and profit margins. The assessments used to set different premiums depend on an overall assessment of risk of insolvency and potential loss. The major insurer advised that premiums depend on contract value, allowable turnover increments, financial capacity, past performance and location. The turnover category of $2.5-15 million is considered to be the highest risk. Turnover of less than $1 million is considered to be the lowest risk. The major insurer advised that for this category, financial assessments are less demanding but premiums are above average. Concerns about rapid expansion are addressed through the setting of re-assessment requirements when 85 per cent of allowable turnover is likely to be exceeded in the forthcoming year. The other insurer also applies a number of financial and business tests.

These assessments have become more demanding since the HIH failure because prior to the failure it seems that HIH was undertaking quite limited assessments compared to the other major insurer, Homeowners Warranty (underwritten by Royal Sun

Alliance). However insurers claim that their requirements do not greatly restrict the ability of builders to expand provided they have the basic business capacity.

It is important to recognise that the assessment of financial solvency risk is a very demanding technical exercise that is not capable of being reflected in simple formulas or rules

It is important to recognise that the assessment of financial solvency risk is a very demanding technical exercise that is not capable of being reflected in simple formulas or rules. Effective assessment will need to be quite demanding and rigorous irrespective of whether the insurance is provided by private or public insurers. We consider that public enterprises, particularly ones without a clear and non-conflicting commercial objective, are not well suited to this task.

According to insurers the incidence of refusals is very low (around 1 per cent) with most being related to companies or individuals who are already insolvent.

We also consider that it is likely to be the case that the legislative restrictions that prevent individuals associated with bankrupt businesses from holding a building contractor's license to be more effective than the BSA's financial solvency tests in reducing the incidence of insolvency in the building industry in Queensland.

Until early 2002, premiums across Australia for a $150,000 house were reported to average around $350 per annum

Until early 2002, premiums across Australia (except for Queensland and the Northern Territory) for a $150,000 house were reported by the main insurer to average around $350 per annum. This compared at the time with a premium in Queensland of $900 and at least $564 in the Northern Territory where a much more basic insurance product is provided.

Recently, average premiums have more than doubled in some states. Average premiums in New South Wales are now almost twice the average premium in Queensland

Premiums in all States have subsequently increased dramatically except in Western Australia and South Australia (refer to Annex D). Average premiums for all houses in New South Wales have increased to $830, while average premiums in Victoria increased to $630 (as of May 2002). In the Australian Capital Territory and Tasmania average premiums increased to $500 and $700 respectively. Average premiums in Western Australia and South Australia only increased by 15 per cent in 2002 over 2001. In Queensland average premiums for all houses are currently $431.

For a $150,000 house, premiums in Queensland are currently $900 and they will rise to $930 on 1 July 2002. In New South Wales the premiums range from $1,080 to $2,870 depending on the risk rating of the builder. Similarly, in Victoria the premiums for a $150,000 house range from $660 to $1,430. Currently premiums for a $150,000 house in the Australian Capital Territory and Tasmania range from $563 to $1,196.

Queensland provides a much more comprehensive and consumer friendly product

Clearly, interstate premiums are now more expensive than for Queensland. However, Queensland provides a much more comprehensive and consumer friendly product, so that on a like-for-like basis the difference is much greater.

It is relevant to make adjustments to interstate premiums to determine a like-for-like comparison

Despite the information constraints, it is relevant to attempt to make some adjustments to the interstate premiums to establish a broad like-for-like comparison.

The single most important factor in terms of product difference in Queensland compared to other jurisdictions is the coverage for subsidence. As noted earlier it is not possible to determine the extent to which the difference can be explained by a more generous product, a deficiency in the regulatory and contractual arrangements or differences in environmental circumstances.

Based on indicative estimates of the BSA the cost of subsidence cover would add about $200 to the premium

Based on indicative estimates of the Building Services Authority the cost of subsidence cover as per the Queensland arrangements would add about $200 to the premium.[7] This is quite a substantial estimate and some entities have questioned the scale of it. However we will assume it is reasonable for the purposes of obtaining a broad like-for-like comparison.

The scope of work that is covered is also greater in Queensland since it extends to paving, driveways, fences, retaining structures, swimming pools and other work provided these are under a building contract. This adds around an additional $95 to the premium.[8] The absence of an excess charge would add about $25 and the provision of insurance to uninsured consumers could add an additional $15 to the premium.

There are several other factors that imply that the Queensland product has greater value and that would require additional cost components to be added to interstate premiums to allow a like-for-like comparison.

Soon Queensland will be the only state with a termination clause. This will make the Queensland product more valuable

From 1 July 2002, Queensland will be the only state with a termination clause in its home warranty insurance scheme. This additional coverage for early termination of the contract for the work either because of the contractor's wrongful failure or refusal to complete the work is likely to make the insurance product offered in Queensland more valuable.

The low minimum insured value also adds value to the Queensland product

The fact that Queensland has the lowest minimum insured value also adds value to the product. With the recent changes in New South Wales and Victoria, those States will only provide cover for non-structural defects of a period of two years. This also implies additional value for the Queensland product. It has not been possible to attribute an absolute value to these features but it is clear that they would imply higher interstate premiums in establishing a like-for-like comparison.

There are however three notable factors that make premiums more expensive in Queensland on a like-for-like basis. Firstly, in Queensland the Building Services Authority is able to pursue builders to recover insurance claims more effectively because of its licensing powers. The recovery is estimated to be in the order of 3-5

[7] Based on claims costs of $6 million, engineering costs of $1 million, a loss ratio of 80 per cent and 50,000 homes.

[8] Based on an average additional cost of $10,000 per non-completion claim.

per cent of gross premiums. There is some scope to recover claims from builders interstate but not of this order. Without the scope to use licensing powers, premiums would have to be higher in Queensland. Assuming the upper end of the range would imply an adjustment of around $20.

It is clear that insurance premiums in Queensland would be higher if licensing resources involved in checking financial requirements were replaced by insurance resources

Secondly, in Queensland the cost of undertaking financial checks is covered by the licensing area of the BSA that is funded by license fees (because financial checks are part of licensing and not insurance, and the Insurance Fund does not pay for any of the costs incurred by the BSA in administering licenses). Yet such costs are covered by private insurers in other jurisdictions. We are unable to identify the share of license fees (which totalled $9.3 million in 2000-01), which could be interpreted as a recovery of insurance costs (for the purposes of like-for-like comparisons). But it is clear that insurance premiums in Queensland would be higher if licensing resources involved in checking financial requirements were replaced by insurance resources.

Thirdly, the Queensland scheme does not have to comply with APRA guidelines and is not required to earn a normal risk-adjusted rate of return on capital. We consider that this is a weakness and that an adjustment to establish a like-for-like comparison would mean a higher premium. However, given the BSA is now on target for achieving a claims loss ratio of around 70 per cent (and combined claims loss and operating ratio of around 100 per cent), we consider that the adjustment would be relatively small.

In Queensland, the dispute resolution system at the BSA is funded by license fees and insurance.

Until the recent changes in New South Wales and Victoria, funding of the dispute resolution system in Queensland was another factor that needed to be adjusted for when comparing Queensland premiums to premiums in New South Wales and Victoria. However, with the changes in New South Wales and Victoria, the systems will be sufficiently similar to allow like-for-like comparison. In Queensland the dispute resolution system at the Building Services Authority is partially funded by license fees (60 per cent) and partially by insurance (40 per cent). The Queensland Building Tribunal is being separately funded from general government revenue from 1 July 2001. According to the Housing Industry Association, insurers in interstate markets have funded their own dispute resolution services out of premiums until the recent changes occurred. The new dispute resolution procedures in New South Wales are funded by a 10 per cent increase in licence fees in January 2002. Funding for the new dispute resolution procedures in Victoria will be obtained through an additional building permit levy.

The new dispute resolution procedures in New South Wales and Victoria are funded by a 10% increase in license fees and an additional building permit levy respectively

While it is not possible to assign values to all the factors which affect the value of the product offered in Queensland, we consider that by adding an additional component of at least $295 to the new average premiums of each state, a broad like-for-like comparison is possible.

By adding an additional component of $295 to interstate premiums to recognise the greater coverage of the Queensland scheme, the average price would range from $615 to $1,125

These adjustments would result in average interstate premiums ranging from $615 to $1,125 compared with the current average premium in Queensland of $431. Clearly,

average premiums in all other states are currently significantly higher than in Queensland on a like-for-like basis.

Given the high claims costs, poor profitability of the schemes in recent years, the highly concentrated nature of the home warranty insurance market and the scope for continued instability in insurance markets, it may take some time for impacts of the recent reforms to become evident in lower premiums

It is clear that currently interstate premiums are high relative to Queensland. To a large extent this appears to reflect several years of very large loss ratios for direct insurers and re-insurers. It is possible that premiums could rise further to ensure adequate coverage of claims and to reflect rising reinsurance costs and relatively limited competition. However there have been significant changes to the nature of the product and the dispute resolution process in interstate markets that will lead to lower claims costs which should in turn impact on premiums. In New South Wales and Victoria premiums have the potential to fall significantly in the future, reflecting the more effective dispute resolution processes and the more basic nature of the product. However, given the high claims costs, poor profitability of the schemes in recent years, the highly concentrated nature of the home warranty insurance market and the scope for continued instability in insurance markets, it may take some time for impacts of recent reforms to become evident in lower premiums.

A final point worth reiterating is that in other jurisdictions that provide more than just basic coverage, the major problem for consumers has been the performance of the claims management process and formal dispute mechanisms

A final point worth reiterating is that in other jurisdictions that provide more than just basic coverage, the major problem for consumers has been the performance of the claims management process and formal dispute mechanisms. This has been addressed in New South Wales in January 2002. The Victorian system is also being streamlined and made more effective. Only time will tell whether the reforms in New South Wales and Victoria will be as effective as the arrangements in Queensland. Based on experience with compulsory third party and worker compensation insurance and the General Insurance Code of Practice we consider that claims management problems in other insurance markets do tend to be resolved over time with the combination of an intervention by government and the co-operation of industry.

3.7 KEY FEATURES OF THE QUEENSLAND HOME WARRANTY INSURANCE SCHEME

As shown in the preceding section, the Queensland home warranty insurance scheme is the most comprehensive in Australia. On a like-for-like basis the Queensland scheme is also currently the best value for money. However recent and prospective changes to the products in the key interstate home warranty insurance markets are in time likely to lower the costs of these schemes. If the new products and dispute resolution procedures prove effective and insurance markets generally become more competitive the cost of the more comprehensive product in Queensland could become more of a concern in the future.

It is worth examining in more detail a number of key features of the Queensland scheme that differentiate it from those in other States. These are the one-stop shop nature of licensing and insurance arrangements in Queensland, the absence of pricing for risk, the absence of an excess charge and the no fault nature of subsidence insurance.

One-Stop Shop Nature of the Arrangements and Potential for Conflict of Interest

The one-stop shop nature of the arrangements in Queensland is considered by some entities as a key advantage

An important aspect of the Queensland arrangements that some advocates argue can enhance the consumer protection aspects of home warranty insurance is the one-stop shop nature of the arrangements. The Building Services Authority is responsible for licensing, building advice, home warranty insurance and dispute resolution in relation to workmanship issues. In contrast to other jurisdictions the Building Services Authority claims that it advises consumers on how to access a claim and gives an indication of claims acceptability before lodgement and assessment. Consultations have confirmed that the Queensland product has proved more consumer-friendly than in other States.

However the argument against the one-stop shop concept is that it entails a potentially very important conflict of interest

However the argument against the one-stop shop concept is that it entails a potentially very important conflict of interest. This is essentially because the Building Services Authority has both regulatory and commercial responsibilities that can be in conflict. The main problem is that there is potential for the Building Services Authority to use its licensing powers to induce builders to resolve disputes and reduce its insurance liabilities. It is generally well accepted by legal, commercial and economic principles that conflicts of interest of this form are a serious problem.

Current arrangements are very effective for consumers who make claims but this may be at the undue expense of builders

It may well be that the current arrangements are very effective for consumers who make claims but this may be at the undue expense of builders. Consultation confirmed that builders perceived that the licensing powers of the Building Services Authority were used to resolve claims and thereby reduce insurance liabilities. The Building Services Authority confirmed that for about 3-5 per cent of total insurance claims it recovers costs from builders who were responsible for the defect and that it would recover a much smaller proportion without its licensing powers. This is a factor that means that premiums for the Queensland product would have to be slightly higher than in the absence of the one-stop shop arrangements.

An essential component of an effective commercialisation or corporatisation policy is the clear separation of regulatory, policy making and commercial responsibilities

For government enterprises that have commercial functions it is normally well accepted that such functions should be formally commercialised or corporatised. An essential component of an effective commercialisation or corporatisation policy is the clear separation of regulatory, policy making and commercial responsibilities. The importance of this issue was clearly recognised in the recent NCP review of the *WorkCover Queensland Act 1996* that relates to the provision of workers compensation insurance in Queensland. The review recommended that WorkCover's commercial and regulatory functions be legally separated in order to ensure fully independent and more transparent regulation of the market for workers compensation as well as improving confidence in the system. This recommendation has been implemented.

We consider that there is clearly an inherent and important conflict in the Building Services Authority undertaking licensing, insurance and workmanship dispute functions in relation to home building. We also consider that effective

We consider that there is clearly an inherent and important conflict in the BSA undertaking licensing, insurance and workmanship dispute functions in relation to home building

commercialisation or corporatisation of the Building Services Authority cannot proceed unless the functions are legally separated. Moves to increase the degree of commercialisation without legal separation of these functions is likely to worsen the conflict of interest by placing consumer protection in more direct conflict with heightened commercial objectives. However under the current arrangements the conflict would remain and still be potentially important. Separate reporting arrangements under the one organisation are also considered to be inadequate for redressing the conflict effectively. This suggests that corporatisation which entails legal separation would be preferred to commercialisation which normally just means that commercial functions are undertaken in a commercial manner but which does not legally separate those functions from the parent entity. Commercialisation is a policy that is designed to apply to commercial functions within a government department not to major commercial functions of a public enterprise.

It is considered that legal separation and full commercialisation of the insurance functions of the BSA would provide a clear public benefit relative to the current arrangements

It is well established that commercial and regulatory conflicts of interest of the sort inherent in the BSA's current functions need to be addressed by legal separation and full commercialisation of the insurance functions of the BSA. Such a change could also facilitate the introduction of other primary insurers who could compete with the public provider. Without separation of the licensing functions, potential private primary insurers would be disadvantaged by the scope of the Building Services Authority to exploit the conflict of interest.

However we also note that in the event of any separation of the licensing and insurance functions it would be important to ensure the licensing functions were still focussed on ensuring that defective work was effectively rectified for builders who were still trading.

Uniform Pricing

The Queensland premium is currently 0.6 per cent of the contract value. This will increase to 0.62 per cent of the contract value on the 1 July 2002. In other jurisdictions premiums depend on contract value and the assessed solvency risk of builders. For example premiums can vary from $660 to $1,430 (and higher for extreme risks that are difficult and unlikely to be insured) depending on risk for a $150,000-$200,000 house in New South Wales.

It is well accepted in insurance markets that pricing to reflect risk is fundamental to ensure that premiums are related to risk

It is well accepted in insurance markets that pricing to reflect risk is a fundamental aspect of the insurance product. In voluntary schemes where premiums are not related to risk, entities with low risk will at some stage decide that premiums are too high and this will affect the viability of the product (the problem of adverse selection). In a compulsory scheme where premiums are not related to risk and there is only one supplier of insurance, the product will remain viable but there are likely to be significant cross subsidies from low risk entities to high risk entities.

An additional aspect of pricing to reflect risk is that it has the likely impact of inducing high risk entities to take action to reduce their risks

An additional aspect of pricing to reflect risk is that it has the likely impact of inducing high risk entities to take action to reduce their risks. With premiums reflecting the extent of solvency risk, licensees would have a stronger incentive to take action to reduce the likelihood of insolvency. Concern about the solvency problems of builders is a key concern of both homeowners and subcontractors and is the main concern of private insurers when providing the product in interstate markets. Uniform pricing irrespective of solvency risk ignores the scope for premiums to help ensure more responsible behaviour.

We have been advised by interstate insurers that builders in the highest risk scheme are in the turnover range of $2.5-15 million. The BSA also considers builders in this range to be of above average risk and builders below $1 million in turnover to be low risk. However there are a number of factors, besides this general observation, relevant to assessing risk as well as non-risk factors such as savings in administration costs in dealing with larger builders that will affect premiums. So it is not clear what the final outcome would be in terms of premium differentiation. However it is clear that premium differentiation is a normal feature of insurance markets that can affect behaviour.

The Building Services Authority has argued that its system restricts activities in line with the financial resources of an entity and that there are no contractors who are deemed better performers than others so that differences in premiums are not justified.

However it should be noted that private insurers will also effectively restrict activities in line with financial resources through their financial assessment process and that the motivation for premium differentiation is to reflect differential risk that also still exists under the Queensland scheme. In other words the Queensland scheme only eliminates extreme risk as do the private interstate schemes but the Queensland scheme entails a large cross subsidy element from high risk to low risk operators and there is no financial incentive provided through the premium structure to reduce risk.

In our view the uniform pricing arrangements associated with the Queensland scheme do not constitute a net public benefit

In our view the uniform pricing arrangements associated with the Queensland scheme do not constitute a net public benefit since real financial risk is not being effectively addressed by the premium structure and there is no strong equity or non-economic argument to justify the uniform pricing approach.

No Excess

Homeowners do not pay an excess in Queensland. In most other States excesses are at least $500. As noted above this contributes to higher premiums in Queensland but is considered by some to be an advantage of the scheme in Queensland relative to other States.

The rationale for excesses is to have claimants bear some part of the cost of a claim to avoid any tendency to make minor claims where the cost to society of dealing with the claim are in excess of the cost of the damage and to better target the total expense of a policy where risks are higher

The absence of an excess is clearly a benefit to someone who is making a claim but it involves a transfer from all policy holders to claimants and from a transfer perspective there is no benefit.

The rationale for excesses is to have claimants bear some part of the cost of a claim to avoid any tendency to make minor claims where the costs to society of dealing with the claim are in excess of the cost of the damage and to better target the total expense of a policy where risks are higher.

Excesses are a standard feature of insurance policies in many markets so that their absence in a statutory scheme is unusual and should be questioned.

No Fault Subsidence

No fault subsidence cover is unique to Queensland

No fault subsidence cover is unique to Queensland. In other jurisdictions that provide some form of subsidence cover, the cover is only applied where a defect in construction or other breach of warranty can be proven. In practice subsidence claims in other jurisdictions have been relatively few.

In Queensland, provided a builder follows the specification of the engineer and soil tester the builder has no responsibility for subsidence problems. From consultations we understand that engineers may at times give some discretion to builders in relation to the type of fill and extent of compaction which if not followed in accordance with the engineer's specifications may lead to subsidence problems. In our view the scope for such discretion, the difficulty of demonstrating variation from required specifications, the potential for ineffective certification and regulation of engineering and soil testing, and the no fault nature of the contract create a poorly defined accountability framework. However as noted earlier, it is not clear as to the extent to which the difference between Queensland and other jurisdictions is primarily attributable to a more generous scheme or a deficiency in the contracting and regulatory arrangements or environmental conditions or some combination.

Subsidence represented about one-third of the claims in 2000-01

The increase in subsidence claims in 2000-01 was around 35 per cent. This is likely to be considered unacceptably high

Subsidence represented about one-third of the claims in 2000-01 when the absolute level of subsidence claims reached its highest level at $6.6 million. The following quote from the 1998-99 Annual Report is relevant (BSA 1999, p. 46): *"The $4.5m expended on subsidence claims remains unacceptably high."* The report noted successful legal actions against engineers in that year ensured an improved net claims experience and that a new policy was being developed to be implemented in 1999-00. The 1999-00 report noted that (BSA 2000, p. 41): *"The $4.9m expended on subsidence claims continues to be of concern."* The increase in 2000-01 was around 35 per cent and given the concern expressed in previous annual reports it is reasonable to conclude that the level would still be considered unacceptably high.

As subsidence claims have a long tail, the high level of subsidence claims in 2000-01 reflected the effects of a building boom in the mid-1990s and an increase in the maximum cover from $50,000 to $100,000. It is possible that subsidence claims

could continue to be an issue in coming years following the impact of the pre-GST and current housing booms and the increase in maximum cover. As with other insurance schemes it is also often the case that claims escalate once the process becomes more familiar and individuals learn to take better advantage of and in some cases exploit the scheme. However it is noted that the Queensland scheme has been in operation for some 20 years and the BSA has been prominent in providing information to improve consumer awareness of the scheme. This suggests that the scheme may not be that vulnerable to further escalation of claims. However the impact of raising the limit on subsidence claims from $50,000 to $100,000 in January 1997 may still take time to be reflected in subsidence claims.

To address concerns about subsidence claims and the role of engineers, the BSA has developed a proposal for it to have responsibility for licensing and disciplining engineers involved in building work

To address concerns about subsidence claims and the role of engineers, the BSA has developed a proposal for it to have responsibility for licensing of persons providing design and related services for residential building foundation work. This would be in addition to any other registration requirements such as for engineers under the Professional Engineers Act 1988. The proposal is for the BSA to have the power to take action to have defective work rectified including the power to suspend or cancel licenses. We consider this proposal has merit.

We consider there is a strong risk of continuing high claims and claims escalation in subsidence in the Queensland scheme given the nature of the current arrangements. We consider that such an escalation could put pressure on the financial stability of the scheme and require further premium increases or capital support from the State Government budget. However we consider that currently the risk is manageable and could be made more manageable if the proposal for the BSA to license and discipline persons providing design and related services for residential building foundation work was approved.

Given concerns about subsidence, the scope for further escalation in subsidence claims and the risk it poses for the Queensland Government, this aspect of the scheme is considered to entail a public detriment in its present form

However given concerns about subsidence expressed in previous annual reports and the scope for further escalation in subsidence claims, this aspect of the scheme and the risk it poses for the Queensland government is considered to entail a public detriment in its present form.

3.8 PERFORMANCE OF THE BUILDING SERVICES AUTHORITY INSURANCE FUNCTIONS

It is very difficult to determine the effectiveness of interstate schemes as there are minimal reporting requirements in other States

It is very difficult to determine the effectiveness of interstate schemes as there are minimal reporting requirements placed by other State governments on insurers so that there are no comprehensive and reliable data to assess consumer satisfaction.

The interstate review identified a number of problems with interstate schemes and in particular complaints about the clarity and effectiveness of the claims and dispute resolution processes. These problems and the flow-on effects of the failure of HIH have led to a number of reforms that have recently been implemented or that are proposed for implementation in interstate markets. Further reforms are also likely

following the finalisation of the National Review by Professor Percy Allan (expected by mid-2002 at the time of writing).

A finding from the interstate review process was that in those States where there is a much simpler product, namely South Australia and Western Australia, there appear to be less problems for consumers. Although in Western Australia it is notable that a recent review recommended including home warranty insurance under the terms of reference of the Insurance Council of Australia's self regulatory General Insurance Code of Practice.

The BSA provides information on customer satisfaction

The Building Services Authority provides considerable information relevant to assessing its performance on customer satisfaction through the use of annual surveys. The results of two key measures of service performance in relation to insurance are provided in Table 3.2.

In 2001, 39 per cent of those surveyed rated the quality of service as above average

In 2001, 39 per cent of those surveyed rated the quality of service in relation to insurance as above average. It is notable that performance on this measure has deteriorated significantly in the past three years and is well below the target level of 75 per cent. Much of the deterioration in 2000-01 could reflect the escalation in claims.

TABLE 3.2 INDICATORS OF BSA CUSTOMER SERVICE IN RELATION TO INSURANCE

	94-95	95-96	96-97	97-98	98-99	99-00	00-01	Target
				Per cent of total				
Claimants who rated quality of service as above average		68	70	74	51	56	39	> 75
BSA position affirmed in reviews	86	87	89	88	82	89	74	> 90

Source: BSA Annual Reports, various and 2001 BSA customer survey

The BSA has achieved a good record in terms of the proportion of decisions that are affirmed in reviews

The BSA has achieved a consistently good record in terms of the proportion of decisions that are affirmed in reviews, with the proportion in most years being close to the target of 90 per cent. However there was also a noticeable deterioration in this measure in 2000-01.

In terms of dispute management, 55 per cent of consumers rated quality of service as above average. Only 39 per cent of contractors rated quality of service as above average

Indicators of BSA customer service in relation to dispute management are shown in Table 3.3. In terms of dispute management, 55 per cent of consumers rated quality of service as above average in 2000-01 compared with a target of 75 per cent. Performance on this measure has been around this level for several years. In contrast only 39 per cent of contractors rated quality of service as above average in 2000-01, well below the target level and considerably less than in recent years.

TABLE 3.3 INDICATORS OF BSA CUSTOMER SERVICE IN RELATION TO DISPUTE MANAGEMENT

	94-95	95-96	96-97	97-98	98-99	99-00	00-01	Target
				Per cent of total				
Consumers who rated quality of service as above average	68	60	54	47	55	48	55	> 75
Contractors who rated quality of service as above average	31	65	61	50	63	70	39	> 75
Disputes within ambit of dispute resolution service able to be satisfactorily resolved	56	49	51	54	57	58	64	> 70

Source: BSA Annual Reports, various and 2001 BSA customer survey

In terms of the resolution of disputes, performance has steadily improved since the mid-1990s

In terms of the resolution of disputes, performance has steadily improved since the mid-1990s with 64 per cent of disputes within the ambit of the dispute resolution service being able to be satisfactorily resolved in 2000-01 compared with a target of 70 per cent. These figures accord with the impressions gained from the interstate review that the Queensland dispute mechanism appears to have been the most effective for a comprehensive product. However it is worth noting that this measure is an internal BSA measure whereas the ratings are survey based.

It is also possible to assess the financial performance of the BSA insurance scheme and compare it to the performance for all direct insurers in Australia. Table 3.4 contains indicators of financial performance for the BSA since 1993-94.

From an economic perspective the rate of return is the most critical indicator of financial performance. As noted the BSA does not have a strong profit objective although it does have an objective of no more than 80 per cent loss ratio (the ratio of accumulated claims to written premium in respect of the policy year). The rate of return implied by such a ratio would depend on the operating costs and investment income.

The overall financial performance of the BSA over the past 8 years is of concern

The overall financial performance of the BSA over the past 8 years is of concern. Rates of return have been highly variable and the overall average return has been strongly negative, largely as a result of a major loss in 2000-01. The average geometric (compound) rate of return of the insurance fund from 1994-95 to 2000-01 has been –21 per cent. The rate of return on the general fund over the same period has been –10.3 per cent. However it is relevant to recognise that for all of the period reviewed, the insurance fund funded the Queensland Building Tribunal and from 1 October 1999 also cross subsidised the general fund which is used to fund the general licensing and other non-insurance functions of the BSA. From 1 July 2001 the cross subsidies were eliminated. and the general taxpayer will be directly funding the Queensland Building Tribunal. It is also relevant to note that the main contributor to the poor overall financial performance in this period was the very large loss that occurred in 2000-01, for which a key contributing factor was the boom and subsequent bust situation associated with the introduction of the GST.

The financial performance for the year 2001-02 is expected to improve dramatically as premium income will be much higher reflecting both the building boom and higher premiums while total claims are projected to be significantly lower than in 2000-01. At the time of writing premium income for the year 2001-02 is expected to be in excess of approved claims with the actual loss ratio being around 90 per cent. The new premium structure is consistent with achieving a loss ratio of 70 percent based on the last 7 policy years (NSP Buck 2002) and current reserves are considered by the BSA to be more than adequate to deal with unexpected claims.

TABLE 3.4 INDICATORS OF BSA FINANCIAL PERFORMANCE

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Insurance Fund								
Operating profit after abnormals	3498	655	-3526	-588	-643	1374	1497	-6924
Net assets	10189	10829	7306	6718	6075	7449	8946	2022
Rate of return on start-of-period net assets		6.4	-34.8	-8.0	-9.6	22.6	20.1	-77.4
Average compound rate of return								-21.0
General Fund								
Operating profit after abnormals	266	840	-296	-1220	-1239	-1647	1008	
Net assets	5181	5512	5216	3996	3366	1719	2658	2636
Rate of return on start-of-period net assets		16.2	-5.4	-23.4	-31.0	-48.9	58.6	-1.1
Average compound rate of return								-10.3

Source: BSA Annual Reports, various

From an economic perspective losses of this order of magnitude cannot be justified unless there are major external benefits generated by the arrangements

From an economic perspective losses of the order of magnitude indicated in Table 3.4 cannot be justified unless there are major external benefits generated by the arrangements or there is a well defined community service obligations policy. However there is no evidence to suggest that such external benefits exist or that there is a clear community service obligation to justify such losses. The net capital that the BSA has is owned by the government and if that capital fails to earn a rate of return consistent with its opportunity cost (value in the next best alternative use) the wealth of the community is effectively diminished.

Despite these concerns, as indicated there is good evidence that the scheme is well on the way to achieving better profitability. Nevertheless the financial situation of the BSA needs continual monitoring given the comprehensive nature of the scheme, the history of escalation of subsidence claims and recent experience with the aftermath of the GST. As the current building boom ends premium income will likely decline while claims could remain relatively high or increase and investment income growth could be lower than in recent years.

The removal of cross subsidies from the insurance functions to the non-insurance functions and the removal of direct funding of the Queensland Building Tribunal by the BSA will assist in improving financial performance of the BSA

The removal of cross subsidies from the insurance functions to the non-insurance functions and the removal of direct funding of the Queensland Building Tribunal by the BSA will also assist in improving the financial performance of the BSA. However we consider that the comprehensive nature of the insurance arrangements, the policy change in 1997 to increase the cap on subsidence claims from $50,000 to $100,000, the pre-GST boom and the effective assumption of builder-of-last-resort functions by the BSA collectively entail a substantial risk of an escalation of claims in the future, beyond what is anticipated.

From consultation with the BSA and the actuary who advises the BSA we understand that the underlying methodology for estimating future claims relies on a rolling 5 year average of claims experience, adjusted by judgement about the impact of policy changes, special analysis of large claims and other key developments that would affect the evolution of claims for past policy years. Box 3.1 summarises BSA advice about the methodology.

BOX 3.1 SUMMARY OF BSA ADVICE ON ACTUARIAL METHODOLOGY FOR ESTIMATING CLAIMS LIABILITIES FOR HOME WARRANTY INSURANCE IN QUEENSLAND

The financial management of the Scheme is conducted by the Board of the BSA based on advice from the actuary. The actuary carries out the following tasks to assist the Board:

- Assessment of the value of outstanding claims in respect of policies that have already been written by the BSA; this assessment is conducted as at 30 June each year and is also updated at least once during each year;
- Projection of forward estimates of claims arising from policies that are yet to be written;
- Advice as requested by the Board from time to time on the level of premiums to be applied by the BSA on new policies.

Outstanding Claims

In calculating the outstanding claims liability the actuary must comply with the accounting standard AAS26 and the Institute of Actuaries of Australia's Professional Standard on the valuation of general insurance companies. These standards have to date required the actuary to calculate a single central estimate for the outstanding claims liability.

With effect from the current year, Federal government legislation and revised actuarial professional standards will require actuaries appointed to general insurance companies to calculate solvency liabilities on a more conservative basis than the central estimates approach. While the BSA is not regulated by Federal legislation and is therefore not subject to the same legislative requirements as general insurers, the BSA actuary has advised that the same solvency tests will be applied to the insurance fund as required for other general insurers.

The underlying methodology for estimating future claims relies on a rolling 5 year average of claims experience, adjusted by judgement about the impact of policy changes, special analysis of large claims and other key developments that would affect the evolution of claims for past policy years. The methodology was modified in 2001 to improve its predictive capability for claims. The enhancement allows for outstanding claims liabilities to be calculated for each of the three (3) types of cover provided under the BSA's policies.

In calculating the outstanding claims liability, the methodology includes adjustments for large claims, impact of known policy changes, professional judgement and a contingency margin. The contingency margin is included to allow for uncertainty of the liability estimates.

In estimating the development of the claims, the methodology prior to 2001 was based on the aggregate claims data across all three claim types. The methodology was modified in 2001 to analyse the three main elements of insurance cover separately. It is expected that this will improve the predictive capability of the methodology.

Forward Estimates

The actuary also advised that forward estimate provisions are provided separately from the outstanding claims liability calculation. The forward estimate provisions provide estimates of the outstanding claims liability for up to 5 years into the future. In providing the forward estimate provisions, the actuary provides the Board with a sensitivity analysis of different levels of future claims.

The forward estimates are prepared to assist in determining appropriate premiums.

BOX 3.1 CONTINUED

Premium Adjustments

BSA has increased premiums on two occasions in recent years. These increases have been made to take account of changes in policy conditions and the larger than expected claims experience.

The component of the premiums that covers the insurance risk was increased by 15% in 1999 at the time of an increase in the maximum insurance benefit to $200,000. This increase took account of an anticipated increase in claims costs due to the introduction of the higher limit as well as the then recent experience of the Insurance Fund.

On 1 July 2001 BSA again increased premiums as a result of adverse developments in loss ratios. An additional factor which created pressure on the scheme in 2000/01 was the pre-GST building boom and the financial failure of many contractors once the market retracted. This fact, whilst recognised as a one-off event, impacted heavily on the projected loss ratios for the scheme. The current premiums charged by BSA have been set to achieve a loss ratio of no more than 80% and provide for both the future and to partially offset the deterioration of existing periods.

BSA pro-actively monitors its claims experience and modifies its insurance policy to reduce exposure from unnecessary risks. In 2001 it identified three areas of risk:

1. Non-completion claims by developers.
2. Deposit claims in excess of deposits limited by other legislation.
3. Escalating non-completion benefits.

Analysis of the effect of removing the risk associated with 1 and 2 was anticipated to impact positively on loss ratios by 5%-7%. BSA further recognised that by limiting 3 to a claim maximum of 20% of contract price, a further 5% reduction in loss ratios could be achieved. Changes have been made to the current Insurance Policy to remove the risks identified in 1 and 2. However Government rejected a proposal to limit non-completion benefits.

BSA is currently reviewing the basis against which it protects consumers and contractors for subsidence losses. This element of the policy coverage ultimately results in 1/3 of the claim expense and is regarded by BSA as its most critical exposure.

The BSA recognises there are risks associated with the operation of this insurance scheme and to diversify risk offsets 75% of the claims liability through reinsurance. The remaining 25% is self-insured creating a limited risk that relies on insurance fund reserves if loss ratios exceed 100%. The exposure is however only 25% of the expense that ultimately exceeds 100% of the premium pool plus interest earnings.

With revision of the actuarial analysis methodology, modifications to insurance policy parameters and increase in underwriting premium, BSA and its actuaries are confident the scheme will return profitable years and build its free reserves. This philosophy is independently endorsed by the actuaries of the reinsurance companies backing BSA.

Source: Building Services Authority advice.

The methodology was modified in 2001 to improve its predictive capability for claims. A key modification was the analysis of the three main elements of cover separately. In the 2000/01 actuarial report the outcome for that year's claims against 10 underwriting years from 1990 to 2000 was 34 per cent in excess of that anticipated. The BSA has attributed this negative result to the combined effect of the GST and the introduction of more stringent financial requirements for licence renewal. The overall average projected loss ratio for these 10 underwriting years is 104 per cent.

We note that a more conservative approach has subsequently been adopted and also that the BSA is taking a pro-active approach in trying to identify and control risk. We also have been advised that the BSA and its actuaries are confident that, with the revision of the actuarial methodology, modifications to insurance policy parameters and the recent increase in the underwriting premium, the profitability of the scheme will improve and reserves will be built up.

However given the recent history of the scheme, the pre-GST building boom and the comprehensive nature of the scheme we think it is reasonable to express a concern about the risk of further claims escalation.

One concern we have is that it is important to recognise that the use of a 5-year rolling average supplemented by judgement may not be sufficient to take account of a substantial escalation of claims in the last 1-2 years of the rolling average unless a substantial judgemental adjustment is made. Other key aspects of the methodology include the use of a contingency margin and the assumption that the experience of the scheme will not worsen in the future. The contingency margin is applied to the central estimates of the liabilities to provide for outcomes within a certain confidence interval (usually up to 90 per cent), i.e. to allow for a particularly bad outcome in a specific year. The contingency margin has been similar for several years. This is not unreasonable provided the central estimates are robust but we cannot determine the reliability of the central estimate based on the information provided and in particular the extent to which judgemental factors have been applied. This is particularly important given the assumption that the experience of the scheme will not worsen. In this respect, it is important to recognise the apparent paradox that as the BSA does a better job of informing consumers this can induce a higher incidence of claims.

Taking all of the above into account we are concerned that there is a substantial risk of further escalation in claims that will place pressure on net assets and/or premiums

It is also relevant to recognise that an additional factor that will create pressure on financial returns or future premiums is that the pre-GST building boom was interpreted to be a one-off factor in terms of the likely future escalation of claims. The inclusion of the immediate GST-related experience in the actuarial analysis results used for the projection of claims means that projections have proportionately increased due to the use of compounding claims development factors in the analysis. We have been advised by the BSA that this would mean that the ultimate outcome will be within predictions. We do not have sufficient information or the expertise to assess fully the reliability of the actuarial methodology but, based on the information we have had access to, we consider that it is reasonable to express a concern that there may be a substantial risk of further escalation in claims that will place further pressure on net assets and/or premiums. Although the scheme is expected to achieve good profitability in 2001-02 we consider that the prospect of a weakening in building activity needs to be monitored along with claims experience over the next two years.

Due to the lack of data, it is not possible to make direct comparisons of the financial performance of the Queensland home warranty insurance scheme with interstate schemes. However, it is well known that interstate schemes have recorded poor profitability over recent years and this is a contributing factor to recent premium increases.

For example, in the Sydney Morning Herald (3/12/2001, p. 4) it was reported that —

"The Deputy Chairman of Aon Risk Services, David Farrell, says premiums are far too low in NSW, given the level of benefit. Over the last four years, for every $100 we have taken $142 is paid out," he said.

Mr Farrell predicts "significant price increases in 2002 which could range up to 100 per cent".

Others in the industry say 100 per cent for increases will not go close to covering the real risk".

Informal advice from representatives of the insurance industry confirmed high loss ratios for home warranty direct insurers and reinsurers in recent years. As a result premiums more than doubled in major interstate markets in early 2002. The context of these increases and impacts of recent changes to the statutory product were discussed in section 3.6 above.

Although direct comparisons with interstate home warranty insurance providers cannot be made it is possible to make comparisons with the financial performance of direct insurers for all insurance products in the Australian market. This can give an approximate guide as to industry standards and expectations in insurance generally.

Table 3.5 compares estimates of loss ratios, operating expense ratios and rates of return for the BSA to the same measures for direct insurers in Australia (i.e. all direct insurers for all forms of insurance products).

TABLE 3.5 AVERAGE LOSS RATIO, OPERATING EXPENSE RATIO AND RATE OF RETURN

	Direct Insurers (all insurance categories in Australia)	Building Services Authority
6 year average loss ratio (1995-2000)	82	125
2 year operating expense ratio (1999-2000)	26.5	31.5[a]
6 year geometric average after tax rate of return based on start of period net assets (1995–2000)	8.8	-21.0[b]

a 2000 and 2001 for BSA

b 7-year average for BSA for 1994-95 to 2000-01

Source: BSA various annual reports and advice, NSP Buck (2001) and APRA (2000)

The six-year average claims to written premiums ratio (loss ratio) for direct insurers is 82 per cent compared with 125 per cent for the BSA

The six-year average claims to written premiums ratio (loss ratio) for direct insurers is 82 per cent compared with 125 per cent for the BSA. It is noted that when allowance is made for the recent premium increase for the BSA, the average loss ratio would have been around 70 per cent. However this is not of much comfort as the premium did not apply, significant losses have already been incurred and we consider there is a prospect of claims growing in excess of those projected.

The two-year average operating expense to gross premium income ratio for direct insurers was 26.5 per cent compared with 31.5 per cent for the BSA. It is noted that a proportion of the BSA shop front services would be included in the expenses but this is also reflected in the revenue and the revenue is also inflated by the subsidy paid to the Queensland Building Tribunal and the General Fund of the BSA in this period. Adjusting for these factors would suggest a higher operating expense ratio for the BSA on a like-for-like basis and that there is room for efficiency improvements.

The six-year after-tax rate of return for direct insurers for all products in the Australian market was 8.8 per cent

The six-year after-tax rate of return for direct insurers for all products in the Australian market was 8.8 per cent. This compares with a return of –21 per cent for the BSA (note the BSA does not pay any corporate income tax or tax equivalent so the BSA return is effectively on an after-tax basis).

3.9 GENERAL INSURANCE CODE OF PRACTICE

To help evaluate interstate experience and reform options it is useful to provide a brief review of the General Insurance Code of Practice.

The Insurance Council of Australia has established a General Insurance Code of Practice

The Insurance Council of Australia has established a General Insurance Code of Practice that is administered by the industry-established Insurance Enquiries and Complaints Ltd. The General Insurance Code of Practice entails improving customer service standards and providing for a low cost non-litigious mechanism for handling disputes. The code covers all products covered by the *Insurance Contracts Act 1984*.

The dispute resolution mechanism is a free, national two-tiered service. The first tier is an enquiry and advisory service where consumer consultants liaise with policyholders and insurers to try to resolve disputes. The second tier involves determination by an Adjudicator, Claims Review Panel or Referee depending on the nature and complexity of the claim. Determinations are binding on the insurer but not the consumer who still has recourse to the legal system if they are dissatisfied with the determination. The scheme is fully funded by participating insurers.

The scheme is widely considered to be a very effective form of self-regulation but the terms of reference currently do not cover home warranty insurance

The scheme is widely considered to be a very effective form of self-regulation (Tasman Asia Pacific 2000), However currently its terms of reference do not cover home warranty insurance. It is noted that a recent review of the home warranty insurance scheme in Western Australia recommended including home warranty insurance in the terms of reference. This is a matter for the Insurance Council of Australia to decide and it is likely to be raised as part of the current national review of home warranty insurance schemes.

4 LICENSING

4.1 NATURE OF THE LICENSING SYSTEM

A licence is required to undertake building work worth more than $1,100

Under the Building Services Authority Act a license is required by an individual or company seeking to undertake building construction work in excess of $1,100 (ie any building construction work in excess of $1,100 must be undertaken by a licensed individual or company). The term 'building construction' is broadly defined and includes, for example, new construction, renovations, alterations, extensions, improvements or repair, provision of lighting, water supply, air conditioning, sewerage and drainage, any site work including retaining structures, installation and maintenance of fire protection and the preparation of plans.

There are two types of licenses: (1) for contractors who wish to contract directly with the public or other contractors; and (2) for supervisors, who can supervise but not carry out building work. Licensed supervisors cannot contract but can do the physical work while employed by another licensee. Applicants must meet two requirements to qualify for one of the classes of higher skilled licenses: (1) technical qualifications – an appropriate trade or degree course; and (2) experience – two years of suitable practical and supervisory experience. Some lesser skilled license classes do not require technical qualifications.

All builders, trade contractors and subcontractors undertaking work above the minimum value must be licensed. The only exemption from licensing is provided to employees who can only be engaged on building work by a licensee.

There are more than 100 license categories

There are more than 100 license categories that differ in their skill requirements and associated allowable work. There are a number of broad license categories that typically would be held by tradespeople that have completed their apprenticeship and can cover most tasks of the trade. There are also a series of narrower categories within a trade that are intended to provide access to lesser skilled individuals. For example, a fully qualified painter and decorator would normally qualify for a Painting license. But someone with 2 years of appropriate on-the-job training could, upon certification at a recognised training agency, qualify for a Painting Restricted to New Domestic Buildings license, or perhaps a Painting Restricted to Repainting Domestic Buildings license.

The BSA has proposed a number of licensing reforms

The BSA has recently completed a license review and is understood to favour a collapsing of the current number of license classes from 106 to 57. One of the motivations for the reduction in license numbers is the need to align the licensing framework with the formal training regime overseen at a national level by the Australian National Training Authority. An expected reduction in the future availability of training courses is one factor behind the proposed rationalisation. Implementation of the BSA recommended reforms is proposed for mid-2002.

Limits are placed on the allowable turnover

The license restricts the allowable maximum turnover of the licensee to pre-set turnover categories. The BSA has advised that around 70 per cent of license holders are in the two lowest categories of $0 to $75,000 and more than $75,000 to $250,000. The subsequent thresholds for other license categories are $0.5 million, $2.5 million, $10 million, $25 million, $50 million, $100 million and $200 million, where the allowable maximum turnover of an individual licensee can fall within these thresholds. Sales up to 10 per cent more than the allowable maximum turnover are allowable but the BSA must be notified of any sales over the 10 per cent mark with an adjustment sought to the license category.

Targets are set for net tangible assets and liquidity

Target levels of net tangible assets and liquidity ratios apply. Contractors (other than builders) with a turnover of less than $75,000 per annum must have at least $5,000 in net assets. Trade contractors and building designers with a turnover of between $75,000 and $250,000 per annum and builders with a turnover of less than $250,000 per annum must have a minimum of $15,000 in net assets. Builders/contractors and building designers with a turnover of less than $250,000 can satisfy the financial requirements by signing a statutory declaration that they satisfy the requirements.

Financial reporting is tighter for larger licensees

Larger builders and trade contractors must hold a prescribed level of net tangible assets based on a formula. This sets the ratio of net tangible assets to maximum allowable turnover from around 2 to 7 per cent. Financial monitoring is to be conducted and reported on annually for the smaller of these builders and trade contractors (ie those with an allowable annual turnover of between $250,000 and $500,000), where the reporting increases in frequency such that quarterly reports are required for the largest operators. For licensees with an annual allowable turnover of up to $10 million independent review reports are required (eg as prepared by an accountant), with audit reports required for larger operators. A liquidity ratio of at least 0.8 to 1 must also be met by licensees with an allowable annual turnover of more than $250,000.

A number of additional financial conditions also apply. In particular, a reduction of 10 per cent or more in net tangible assets must be notified within 10 days of the reduction occurring and most licensees must also hold professional indemnity insurance (or similar).

Annual license fees apply

Licenses must be renewed annually with the level of annual allowable turnover determining the initial application fee and annual license fees. License application fees range from $210 to $450 for an individual contractor's license, and from $350 to $750 for companies. Annual renewal fees range from $160 to $360 for an individual contractor's license, and from $320 to $720 for companies. Both the application fee and the annual fee for a supervisor's license is $120. Owner-builders require a permit, which costs $114 for work valued below $11,000 and $229 for work above this value. Various minor fees also apply.

Licensing also provides for dispute management

There are two other features of the licensing system of note. Firstly, all licensees undertaking domestic building work for a fee must have in place the statutory home warranty insurance provided by the BSA. Secondly, the licensing system is backed-up by a dispute resolution system. This provides the buyer the right to seek BSA assistance in correcting defective work undertaken by a licensee within a period of 6 years and 3 months from the date of completion. This dispute resolution system is integrated with the insurance system and the management of contractual issues through the Queensland Building Tribunal (see Annex J for a summary).

4.2 RATIONALE FOR THE LICENSING SYSTEM

Information on failures are the main rationale

The main economic rationale for licensing is the need to overcome the information failures facing consumers. Homeowners face problems in gaining an understanding of the quality of work of a builder or contractor. They may address this problem by seeking references for a contractor or learning from the experience of friends or acquaintances. Homeowners may also make their own personal assessment of the integrity of a supplier or rely upon quality shown at displays.

However this may not provide sufficient information to ensure they engage a supplier that can provide adequate quality or enable them to monitor the quality of work undertaken. Home owners may not know enough people with relevant past experience, and in providing references the supplier may hide the poor quality jobs. And there are also limits on the value of information on past performance. A supplier may have previously supplied a good quality product, but may be lax on one job or intentionally seek to cut quality on one job (eg so as to provide a short term boost to profits during a cash crisis). There are also technical aspects of building that can be difficult for a non-expert to assess and some problems may only become apparent after considerable time has passed.

Licensing provides a signal of quality

It is likely to be the case that some form of licensing will be required to effectively address the problem faced by consumers in obtaining adequate information. Licensing provides a signal of quality, an indication that a supplier has been confirmed as holding the skills required to undertake certain work. This helps a buyer choose between good and poor quality service providers. The licensing arrangement in Queensland has the added benefit of providing a low cost dispute resolution process. This means that a homeowner can have some confidence that the licensee will be required to meet reasonable quality standards even if work is initially below standard.

In summary, the transactions costs of identifying quality and rectifying problems can reduce the effectiveness of market mechanisms and provide an important efficiency argument for the use of licensing as a signal of quality.

Both homeowners and commercial buyers benefit

Commercial buyers of building services can also benefit from the improved information available from licensing on the technical quality of suppliers. However

the need for licensing is unlikely to be as strong for commercial buyers. Such buyers are more likely to hold relevant technical expertise, or have the funds to engage expert advice, and are likely to be engaged in the market more frequently such that they are better placed to obtain information. They are also likely to be more commercially astute and take better actions to safeguard their interests.

Better licensees benefit from quality standards

The better quality builders, trade contractors and subcontractors benefit from the improved information as buyers will be better able to distinguish and reward good quality work. This can help prevent the erosion of quality standards and an undue focus on price in decision making — factors that can, under certain conditions, lead to inefficient market outcomes.

There are also information problems faced by builders and trade contractors in dealing with subcontractors. Licensing may help the selection of appropriately skilled subcontractors by reducing the costs incurred in obtaining information on capacity and avoiding the cost of correcting poor quality work. This would tend to benefit builders, trade contractors and appropriately skilled subcontractors.

Some assurance of financial standing is also provided by licensing

Licensing can also provide buyers, both homeowners and commercial buyers, some assurance on the financial standing of licensees. A buyer would tend to have even less information about the financial capacity of a supplier to complete a project than they have on technical capacity. Financial standing can change rapidly and generally cannot be assessed by a buyer because the information is confidential or hard to obtain. For example, a builder could develop a good reputation but then face problems as a result of over-commitment, unexpected costs or a general downturn in the market. The financial conditions of licensing may help in this regard by ensuring a minimum financial standing is met. The information problem addressed by the financial conditions may be even more important than the technical quality problem.

This may help ease the security of payment problem

The financial conditions have also been presented by some parties as a means of dealing with the security of payment issue. A subcontractor or supplier can face similar problems to buyers in assessing the financial standing of a builder or contractor and their ability to pay for goods and services provided. Specifying minimum financial standards can be seen as an assurance that there is at least some capacity to pay such that suppliers need not seek out financial information. It may also be argued that the market failure of externalities is corrected by such financial standards. In this case the externality is a cost imposed on a third party arising from the failure of a builder or contractor to pay.[9]

[9] Note however there is no externality if the risk of non-payment is adequately factored into prices. It would be very surprising if the market had consistently failed to learn from past experience and failed to make any allowance for risk in its pricing.

4.3 KEY MESSAGES FROM THE INTERSTATE COMPARISON OF LICENSING SYSTEMS

There is considerable variability across jurisdictions

The requirements for the licensing or registration[10] of builders vary considerably between the states and territories of Australia. In the small markets of Tasmania and the Northern Territory there are no license requirements, although Tasmania has draft legislation in place to require licensing of builders. There are, however, certain legislative controls on the industry in each state and territory. The various Acts and Regulations in each jurisdiction are listed in Annex E. Most jurisdictions are changing their legislation, regulations and building control practices, in some cases as a result of the National Competition Policy (NCP) and its application to the building industry. Consequently, a review and comparison between jurisdictions is made difficult by the changing regulatory and administrative landscape.[11]

Licenses and License Classes

There are up to 240 license classes interstate

The number of license classes varies from more than 240 in New South Wales to none in Tasmania (presently) and the Northern Territory. It is generally recognised that there is a need to move to fewer license classes where there are currently many. For example, New South Wales is in the process of reducing the number of license classes to the 30-40 range.

A high number of license classes can impose costs on buyers and sellers

The arguments against a large number of licenses include that it results in an excessive level of specialisation that might be anti-competitive if skills are narrowly defined. The costs confronted by contractors will also be increased if they are required to adhere to a plethora of licenses. Many license categories might also increase consumer costs because a greater array of tradespeople are required for any construction task. Consumers are also likely to find such a system confusing and lacking in transparency.

Conversely, some degree of license categorisation provides consumers with protection because building tasks are performed by tradespeople with the requisite skills. This relates also to the grading of licenses according to skill that does not occur in some jurisdictions. But it is generally felt in these states that grading would support quality through, for example, separating specialist commercial builders from specialised home builders.

[10] The legislation in some states refers to 'licensing', while in others it refers to 'registration'. 'Licensing' is used as the generic term in the remainder of this section.

[11] While every effort has been made to gather the most recent and up-to-date information, a caveat on the material presented on the interstate review is that some might go quickly out-of-date, and some changes may have been implemented about which we were not informed. In some instances personnel from various government and industry bodies were reluctant to provide information because it was still in the preparation phase and/or was considered confidential.

Quality Assurance

Quality assurance is normally a prime reason given for the development and implementation of a licensing system for building contractors. Yet participants in some states suggest that such an outcome is not necessarily achieved simply as a result of having a licensing system. That is, poor outcomes occur even with regulation. A number of reasons underlie the failure of such systems to ensure quality outcomes.

First, the relationship between warranty insurance, provided by private insurers, and licensing is seen by some as tenuous. They argue along the following lines. Insurers are focused on the financial position of builders and apply a number of tests to ensure the viability of the business when assessing an insurance application. In some states provided the insurance is approved it is relatively easy to gain a building license. Consequently, there can be a problem when consumers believe that a building license ensures a certain level of technical competence, which it may not.

There may be poor links between licensing and other forms of regulation

Second, there may be little or no linkage between those responsible for building inspections – such as local Council inspectors – and the licensing authority. Feedback to the authority on the capability of individual builders is compromised in this situation and there may be no challenge to the renewal of the license of those who regularly do poor quality work.

Consumers need more information on performance

Third, detailed information on the performance of individual builders is generally not available to consumers. However, some states have foreshadowed the establishment of database systems that allow consumers to check the record of builders.

Fourth, and related to the above two points, the level of checking of builder's qualifications, experience and training to stay abreast of new developments at the time of license renewal – as distinct from the original application for a license – is minimal to non-existent in a number of cases.

Monitoring of licensees needs to be upgraded

Finally, it was argued there was insufficient monitoring of the performance of licensees by the licensing authorities once a license is granted. This is usually related to a lack of resources, both financial and human. In Western Australia this problem is now being addressed by charging a $30 levy on every building approval, with all but a $5 collection fee transferred to the Builder's Registration Board to support monitoring and dispute resolution.

Quality can be adequate in the absence of licensing

In Tasmania and the Northern Territory building licenses are not required and it might be concluded that quality will suffer accordingly. However, this is not necessarily the case for two reasons. First, the small size of the markets means that there is social pressure to perform well. And secondly, in the Northern Territory Building Certifiers are responsible for ensuring buildings comply with the Building Act and Regulations. Nonetheless, the focus of Certifiers is structural integrity, (through five separate inspections during construction), so the problem of overall

quality is not specifically addressed. But this does indicate that it might be possible to have a system where builders are not licensed but nonetheless are required to meet quality guidelines.

Licensing Criteria

Financial checks are best done by insurers

The key criteria relate to financial status and technical competence. Because warranty or indemnity insurance in all states and territories other than Queensland and the Northern Territory is provided by private sector insurers, financial scrutiny is undertaken by insurers. Feedback from other jurisdictions indicated that the assessments applied by insurers were more comprehensive and rigorous than those likely to be applied by government agencies. In some states there is also an element of financial testing applied by the licensing/registration authority, but the criteria tend to be undefined and the tests not particularly stringent. A common statement was that the insurance companies are the specialists in this area and financial status assessments should be left to them.

Rigid accounting ratios have their limitations

A perceived weakness of the financial criteria, where applied as a requirement of licensing, is that the ratios applied tend to be accounting ratios that are normally simply used as a guide to the financial status of a company at a particular moment in time. They do not take account of matters such as past and expected cash flow or business performance over a period of years. Insurance companies again are seen to be more proficient in applying meaningful financial tests to building contractors.

In all jurisdictions where licenses are required evidence of technical competence is listed as a criterion to obtain a license. This can take the form of certain formal qualifications, trade references and/or competency assessment and interview. Notwithstanding such requirements, the stringency with which they are applied was reported as highly variable. Building quality is similarly variable, with some states apparently applying the criteria in a quite lenient manner. The upgrading of skills and license renewal is related to technical competence and, as previously noted, is often not subject to meaningful scrutiny. But as a result of the national training agenda, there will be a shift to nationally recognised competencies and more formal competency-based accreditation processes which should help lift performance in this area.

The separation of licensing and insurance is important

The separation of powers for licensing, financial assessment and policing of performance was emphasised by some personnel from other states. The potential for conflict of interest was highlighted as the main concern when such separation does not exist.

Dispute Resolution

The provision of low cost mediation is important

All jurisdictions have a mechanism for the resolution of disputes between builders and consumers. In some jurisdictions this has been through a building tribunal although consumers and builders alike express unhappiness about this system. The

main reasons are that it tends to be slow, expensive and to deliver outcomes that suit neither party. Consequently, those states that do have a tribunal are now in the process of (or have recently introduced) a prior mediation step before taking a dispute to the tribunal. Normally this is similar to the Queensland approach of mediation in an attempt to quickly and cheaply resolve disputes, the majority of which appear to be relatively minor.

Mediation could be undertaken by the private sector

It was suggested that a mediation system could be undertaken without reliance on a government agency, perhaps in the way that the Insurance Council of Australia's Insurance Enquiries and Complaints system works for general insurance. An alternative suggested was to accredit a number of individuals or organisations with building industry skills and experience to act as mediators. The potential application of the General Insurance Code of Practice was discussed above.

Other Issues

Jurisdictional matters within states were identified as a constraint on the ability of a licensing system to operate smoothly and provide benefits to both builders and consumers. For example, in one state there are four government bodies with involvement in some aspect of the administration and monitoring of licensing. Consequently, problems of coordination arise that might be avoided if fewer agencies were involved.

Owner-builder provisions can create problems

Home-building practices were raised as a matter of concern in some jurisdictions. For example, in Tasmania some builders enticed owners into signing the warranty insurance as an owner-builder, relieving the builder of liability. The move to licensing is expected to help prevent such activities in the future.

4.4 AN ASSESSMENT OF KEY FEATURES OF THE LICENSING SYSTEM

Consumer Protection

The BSA dispute resolution process is a major benefit

One of the features of the *Building Services Authority Act* is the generally high level of consumer support provided by the dispute resolution process. The mediation process rests on a mediation overseen by the BSA with consumers provided the option of taking unresolved disputes to the Queensland Building Tribunal. Our in-principle appraisal of the BSA system suggests it is both comprehensive and relatively inexpensive for the consumer to access. This interpretation is supported by the consultation we have undertaken with the building industry and a small number of homeowners that have accessed the BSA process.

The benefits of the Queensland mediation process have also been recognised interstate. Both New South Wales and Victoria have now reformed their dispute resolution processes along the lines of the Queensland model (see Annex J).

Each year the BSA's annual report presents the results from consumer surveys of their customers' satisfaction with the agency's overall performance. Over the last 5 years at least 93 per cent of customers rated their overall personal treatment as acceptable, the figure rising above 96 per cent in 2000-01. The BSA surveys also ask customers whether they rate the service as above average. In the four years to 1999-00, more than 65 per cent rated the service as above average, although this fell to 54 per cent in 2000-01. Despite the decline in this statistic in the latest year, we consider the customer ratings of the agency's overall performance as positive.

The high usage of BSA services indicates an accessible service

A limitation of the BSA customer ratings is that they are based on a survey of only those home builders that have been though the BSA system. They do not identify how many consumers are unaware of the BSA and through ignorance have not sought the assistance of the BSA or those that have been deterred from seeking assistance by the perceived cost (broadly defined to include time spent, emotional strain, etc). The BSA system may actually be 'user unfriendly' to some consumers. The comprehensive data that can be used to explore this issue do not exist. However, the data we have collected from other states/territories on the incidence of complaints regarding defects points to a high usage of BSA services relative to its counterparts in other jurisdictions (the data and alternative interpretations are presented in Annex I and discussed further below). This suggests that the BSA service is readily accessible and widely known.

Some doubts were experienced in consultation as to the extent to which consumers rely on the information provided by licensing (ie the certification of quality that licensing provides). Builders consulted routinely reported that they are only occasionally asked by homeowners to show their license. This may suggest that homeowners do not use the license as a sign of quality and instead prefer to rely on recommendations, an examination of a licensees past work etc. But it is also possible that homeowners ascertain from advertising whether a builder or trade contractor is licensed (a licensee is required to record their license details when advertising) or from a contractors quote (a letterhead will normally show the license number) and therefore may have no need to request this information from the licensee.

Consumers could be provided more information to assist in their decisions

An important issue is whether the system provides enough information to consumers. Consumers can conduct a search of BSA records of the number of directions issued against a license holder. But a direction is only issued when the builder cannot or refuses to correct a defect. A builder can for example record a very high incidence of defects but as long as these are corrected before a direction is issued there will no adverse record against the builder. As a general principle a good builder will have less complaints (ie dispute notification forms) than a bad builder (per unit of work done), but information on the number of complaints is not made available to

consumers by the BSA. It is understood that other jurisdictions are considering ways of providing consumers more information on licensee performance.[12]

The system probably favours consumers

During consultation building industry representatives routinely argued that the BSA system is weighted in favour of consumers. They argue that a BSA inspector faced with a complaint and a potentially anxious consumer will be inclined to favour the consumer. The builder or licensee on the other hand faces the prospect of: being diverted from other work to respond to complaints; a direction being issued which becomes a 'black' mark against a licensee; the potential suspension or loss of their licence for not correcting a defect upon the BSA's direction; and, if they wish to object to a BSA decision through the Queensland Building Tribunal, a $200 application fee plus costs. Building representatives argue that the least cost solution is often to comply with any direction from a BSA inspector even if it is considered unreasonable. It appears that some builders adopt the policy of automatically correcting any complaint made by a home builder even before it reaches the BSA. We see the industry arguments that there is a bias in favour of consumers as plausible.

We conclude the BSA provides a high level of consumer protection

Our overall assessment is that the BSA system provides a high level of consumer protection by Australian standards and this system is probably the main strength of the BSA Act. The benefits for consumers appear to arise largely from the provision of a low cost dispute resolution system rather than from the use by consumers of licenses as a signal of quality. Nonetheless, there are opportunities to further improve the effectiveness of consumer protection in particular by reducing the incidence of problems in the first instance through improved information flows.

Maintaining the Technical Quality of Work

An assessment of the effectiveness of the licensing regime in maintaining adequate technical standards is hindered by the very limited data available on the technical performance of the Queensland or interstate building industries. Nonetheless some useful observations can be made.

Defects are spread across many trades

One important observation in favour of the BSA system is that defects in Queensland are spread across a range of tasks and there is no obvious concentration of defects within a particular trade (see Table 4.1). It is reasonable to expect at least some examples of poor workmanship even when technical standards are set correctly. The broad distribution of defects across trades gives some confidence that there isn't a systematic failure to set reasonable minimum technical standards for a particular skill.[13]

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[12] Some industry representatives argued against providing more information on complaints as it could lead to a licensee's reputation being damaged by unfair accusations (and potentially be defamatory). However it is difficult to see how this would be the case if information was only provided by complaints heard by the BSA, and information was also provided on the number decided in favour of the licensee, the home builder or those that were withdrawn.

[13] A potential cause for concern is the apparently high incidence of subsidence problems in Queensland. This may suggest there is a failure to ensure that acceptable standards are in place for work on footings, slabs, etc (ie. work of a type that is likely to lead to

There is a relatively high incidence of complaints in Queensland

A second observation that is not so encouraging is that we have been unable to find clear evidence either through consultation, from the work of others or industry data that the Queensland system has been successful in raising technical standards. One way relative performance can be assessed is by examining the number of complaints made to the BSA and its counterparts in other jurisdictions relative to the level of building activity. If the incidence of complaint was low in Queensland compared to other jurisdictions, it would be reasonable to conclude that technical standards are relatively high in Queensland.[14] However, comparisons we have been able to make point to the opposite. That is, there is a relatively high incidence of complaints in Queensland (see Annex I).

It is unclear whether technical standards are relatively high in Queensland

There are two possible explanations for this finding of a high incidence of complaints. One is that technical standards are relatively poor in Queensland. A second explanation is that the Queensland dispute resolution system is more effective than those available interstate and hence attracts a higher incidence of complaint. As our assessment is that the Queensland dispute resolution system is relatively effective, this is a plausible explanation. But it could also be that technical standards are low in Queensland.

Rising insurance claims are a concern

In this respect, of concern is the upward trend in the value of claims made under the BSA insurance system (as discussed in Section 3). In part this can be explained by an expanding and comprehensive coverage of the insurance system. But it is also consistent with the presence of poor and deteriorating technical standards.[15]

subsidence when below standard). However, the subsidence issue is a complex, detailed matter and we are unable to form a firm opinion as to whether the incidence is unreasonably high and whether poor technical standards are a contributing factor.

[14] It is possible that the number of complaints can be low if the process for making complaints is weak and either prevents or deters complaints being made. However our assessment is that the Queensland system performs well in this regard. As discussed in Annex I, a high incidence of complaint can be attributable to either easier access to the complaints mechanism or a high 'real' incidence of poor workmanship. For this reason, it is not possible to conclude that high incidence of complaints necessarily indicates an overall low standard of workmanship.

[15] It may be possible to explore the potential contribution of declining technical standards by examining the record with respect to particular defects. However the detailed data required for such an examination were not available.

TABLE 4.1 THE TOP 20 DEFECTS OF 2000-01

	Defect	Number	Percentage of total
1	Wall/ceiling internal plasterboard (clad/lining)	154	4.8
2	Shower recess (w/proof)	141	4.4
3	Roof flashings (R/W plumbing)	118	3.7
4	Floor ceramic (tiling)	114	3.6
5	Driveway/path - concrete (l/scaping)	105	3.3
6	Paint external - application (painting)	100	3.1
7	Window/door timber - install (joint/fin)	91	2.9
8	Paint internal – applications (painting)	90	2.8
9	Window/door Alum - install (joint/fin)	88	2.8
10	Stairs and balustrade (joint/fin)	71	2.2
11	Steel sheet (roof cover)	66	2.1
12	Footings (foundations)	65	2.0
13	Other (waterproofing)	65	2.0
14	Guttering – eaves	64	2.0
15	Termites - chemical barrier	57	1.8
16	Floor slab (foundations)	56	1.8
17	Other (misc)	53	1.7
18	Strip (flooring)	51	1.6
19	Wall installation	50	1.6
20	Downpipes (R/W plumbing)	43	1.3
	Other	1,547	48.5
	Total	**3,189**	**100.0**

Note: Based on defects as identified in directions issued

Source: BSA

It is worth noting that the BSA Act is not the only piece of legislation seeking to maintain building standards in Queensland. In particular, compliance with the Building Code is dealt with under the Building Act by parties other than the BSA. Local authorities or (in some cases) private certifiers are responsible for inspecting building work in progress and ensuring that work is structurally sound. A weakness in technical standards in Queensland could be attributable to a weakness in the implementation of the Building Code (which is outside the scope of this PBT). However, the main defects assessed by the BSA appear to be non-structural suggesting there is not a high occurrence of problems arising from poor structural work.

The BSA is concerned at the level of unlicensed contracting

A third important observation is that the licensing system appears to allow a significant level of non-licensed activity. The BSA conducts around 2,000 site visits a year to check the operation of unlicensed operators. In around 10 per cent of cases

unlicensed contractors are identified.[16] As summarised in the BSA's 2000-01 annual report –

> *"Unlicensed contracting remains a significant industry issue because of the adverse consequences for those that contract with unlicensed operators. BSA believes that a typical unlicensed contractor is often inexperienced, unable to demonstrate basic technical competencies or meet the financial criteria required to hold a license." (p. 19)*

Our survey found substantial competitive pressures from unlicensed operators

For the purposes of this review we conducted a survey of 100 licence holders. Almost half of those interviewed reported that the industry is subject to substantial competitive pressures from unlicensed operators (see Annex G). A slightly lower share reported that they themselves are subject to substantial competitive pressures from unlicensed operators. This is further confirmation that there is substantial activity from unlicensed operators.

Unlicensed operators may erode quality standards

There are two important implications of what appears to be a relatively high incidence of unlicensed operators. Firstly, complaints to the BSA are focused on licensed operators – a large number of building problems may go unrecorded and unaddressed. So the favourable assessment of the BSA outlined above may be too optimistic. The second is that the price competition from lesser trained and cheaper operators may over time erode the technical standards of even licensed operators (eg as they seek to cut costs in order to compete). It is not necessarily the case that unlicensed operators are poor quality service providers.[17] But it is reasonable to expect that they are more likely to cause problems than licensed operators.

The licensing system appears to allow considerable activity from unlicensed operators, and this suggests that there is a significant level of building activity unconstrained by the BSA technical standards. This demonstrates the limits on the effectiveness of licensing in the building industry.

Industry regulation needs to be designed with the assumption that it cannot effectively control all building activity. An attempt to control all levels of activity is likely to ensure the better operators comply, particularly those operators that feel obliged to abide by legislative obligations. But such an operator is actually disadvantaged by extensive regulation because their non-complying competitors are not constrained. The poor operator is actually favoured and will tend to expand at the expense of the better operator. In this way, extensive regulation can actually undermine technical standards. This is a perverse side effect of regulation that should be guarded against.

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[16] A number of industry participants consulted advised of their concern that the BSA does not do enough to identify and stop unlicensed operators. They point out, for example, that it has been previously suggested to the BSA that they could more effectively identify such operators by examining those advertising in local papers, but the BSA has not acted on this advice.

[17] For example, personal relationships, social pressures or the personal commitment of the unlicensed operator may provide sufficient incentives to perform.

There may be a case for licensing engineers under the BSA Act

One of the advantages of the licensing system is that it provides a mechanism for excluding poor operators from the building industry (for work above a certain level). This helps maintain technical standards in the industry. However this mechanism is not present for engineers despite the substantial insurance liability that may be created through their role in dealing with matters that may contribute to subsidence. In Queensland engineers are not licensed by the BSA and instead are registered through the *Professional Engineers Act 1988*. The BSA has no standing under this Act and cannot take direct action to prevent the operation of a poorly performing engineer. It is also recognised by the Board of Engineers that it is difficult to take action under the Act against poor performers (and this is being addressed via legislative amendment). This has the potential to contribute to a deterioration in technical standards. In Victoria and the Northern Territory, engineers involved in building are overseen by the equivalent of the BSA, and it appears likely that similar arrangements need to be considered for Queensland such that engineers are treated on a similar basis to most other skills used in building. It is understood that the BSA is now developing proposals for the licensing of persons providing design and related services for residential building foundations.

Ensuring the Financial Standing of Licensees

Strict financial criteria only applies to Queensland licenses

The Queensland licensing system has the most extensive financial requirements of all Australian jurisdictions. Australia-wide the industry norm is that the financial standing of those undertaking residential work are dealt with by the providers of home warranty insurance and little attention is paid to those operators engaged in commercial work. In Queensland, the financial requirements of the license act as the financial check on those operators seeking home warranty insurance from the BSA.

But the system is inflexible

There are five important weaknesses of the financial criteria set out in the Queensland license. The first weakness is that the rules based approach of licensing does not provide adequate flexibility to target the financial assessment on the individual circumstances of an operator. For example, the same test is applied to both a low risk and high risk operator of a given size. Some of the important lessons from the interstate review are that private insurers: tend to more risk-based in their assessment of financial standing; adopt a more comprehensive assessment than does the BSA when risk is high and a less comprehensive assessment when risk is low; and are generally able to apply a more flexible approach than the BSA given that they are not constrained by fixed, legislative based rules. Our assessment is that the more flexible approach adds to effectiveness.

And does not impose the highest restrictions on the highest risk licensees

The second important weakness is that the financial requirements set out under licensing do not place the tightest restrictions on the most risky licensees. The BSA has described the financial risk profile in the building industry in the following terms.

The licensee of highest risk is the rapidly growing builder. This class of builder tends to start small, provide a good product and build up their cash flow and business opportunities. They tend to reach a point where they are able to quickly secure

substantially more work. But as they expand rapidly, supervision tends to be insufficient, they have to carry the cost of correcting more defects, cash flow becomes tighter and they tend to purchase extra or more expensive equipment they had previously managed without. They also have a tendency not to expand their administrative capacity in line with the extra work. It is when they have grown rapidly to building around 30 to 50 homes a year at an annual turnover in the order of $5 million a year that the risk of failure is generally highest. In contrast the risk of failure of the more stable smaller builders and better capitalised and managed larger builders is much lower.

However, the ratio of net tangible assets to allowable annual turnover for this risky class of builder identified by the BSA is actually declining and below that for some lower risk licensees (see Table 4.2 and Figure 4.1).[18] This means the Queensland systems does not penalise risk adequately. In contrast we understand that interstate financial checks are toughest on these high risk builders.

And can create a ceiling on business expansion

The third important weakness is that the financial requirements have the potential to create a ceiling on business expansion for many license holders. Self-assessment is allowed up to an annual allowable turnover of $250,000. A number of industry participants consulted advised that self-assessment is not taken seriously by a substantial share of licensees and amounts to 'no-rules'. It is understood that around 70 per cent of license holders are within this $250,000 level, such that a large share of licensee holders may in effect be operating free of any financial restriction. But once the annual turnover exceeds this $250,000 level the operator is much more accountable. They must have their financial standing independently assessed, which means they really must have the required level of net assets and the license holder would be exposing themselves more to the scrutiny and rules of the BSA. This shift in scrutiny can create a ceiling on expansion, deterring licensees from growing their turnover above $250,000. Even the perception of closer scrutiny can create a tight ceiling on expansion above $250,000.

The problem with such a ceiling is that we understand that the small licensees are low risk.[19] This means there are few potential benefits offered by the financial controls on the smaller licensees, but at the same time the costs are potentially significant.

[18] The BSA does have the authority to instigate audits on selected licensees but we are not aware of a systematic targeting of these high risk builders.

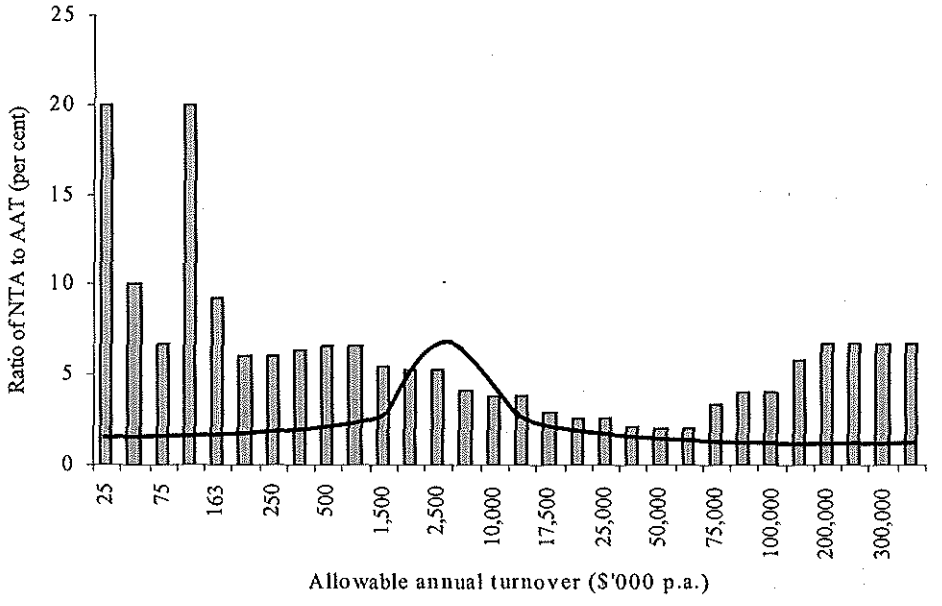
[19] Note that there are no data available to assess the level of risk of such licensees. Our understanding is based on consultation with the BSA and interstate industry participants.

TABLE 4.2 THE REQUIRED LEVEL OF NET TANGIBLE ASSETS AND ALLOWABLE TURNOVER

Licence Category	Annual Allowable Turnover (AAT)	Minimum of Required Net Tangible Assets (NTA)	Ratio of Net Tangible Assets to AAT (per cent)
SG1	25,000	5,000	20.0
	50,000	5,000	10.0
	75,000	5,000	6.7
SG2	75,001	15,000	20.0
	162,501	15,000	9.2
	250,000	15,000	6.0
1	250,001	15,000	6.0
	375,001	24,000	6.4
	500,000	33,000	6.6
2	500,001	33,000	6.6
	1,500,001	81,500	5.4
	2,500,000	130,000	5.2
3	2,500,001	130,000	5.2
	6,250,001	255,000	4.1
	10,000,000	380,000	3.8
4	10,000,001	380,000	3.8
	17,500,001	505,000	2.9
	25,000,000	630,000	2.5
5	25,000,001	630,000	2.5
	37,500,001	815,000	2.2
	50,000,000	1,000,000	2.0
6	50,000,001	1,000,000	2.0
	75,000,001	2,500,000	3.3
	100,000,000	4,000,000	4.0
7	100,000,001	4,000,000	4.0
	150,000,001	8,650,000	5.8
	200,000,000	13,300,000	6.7
8	200,000,001	13,333,333	6.7
	300,000,001	20,000,000	6.7
	400,000,000	26,666,667	6.7

Source: Consultants estimates based on BSA Policies on the Financial Requirements of Licensing

FIGURE 4.1 THE REQUIRED LEVEL OF NET TANGIBLE ASSETS



Note: The line shows our stylised representation of how the ratio of net tangible assets to allowable annual turnover should vary to match the risk profile facing the industry (as indicated through consultation with the BSA and interstate insurers). Note that the profile is stylised and average ratio has not been specifically determined. This means that attention should be focussed on the profile rather than the level of the line.

Source: Consultants estimates based on BSA Policies on the Financial Requirements of Licensing

A sense of the extent of the 'ceiling' problem can be seen from our survey of 100 license holders. It was found that that the cost and time required to meet the BSA requirements is a more important constraint to expanding their business than normal business constraints (eg finding work, managing extra people). This was shown by the 36 per cent of respondents, with an annual allowable turnover of less than $250,000 that reported the time and cost involved in meeting the BSA rules as the main barrier to moving up a licence category. We see this as an unnecessary barrier given the available information suggesting that licensees at such low turnovers are low risk. Based on the survey results it may affect more than 10,000 licensees in Queensland.

Self-assessment penalises the better operator

A fourth weakness with the financial requirements is that, for the majority of licensees with an annual turnover of less than $250,000 per annum, the operator that pays little regard to the rules is advantaged over the operator that does actually closely follows the rules. That is, the good operator is penalised. This can actually contribute to a deterioration in the financial standards of the industry.

A fifth weakness is that the ceiling can lead builders to avoid certain projects that require substantial raw materials (to avoid higher turnover) or a licensee may be deterred from undertaking small incidental work on a project, such as variations, when they are close to the ceiling. These effects may limit the scope for competition

above the ceiling, where such effects may be of most concern in regional areas where the supply of builders is small.

There are no data to confirm that the higher financial restrictions have been effective

We have been unable to obtain adequate data on the extent to which the tighter financial requirements introduced in 1999 have reduced the incidence of business failure. A reduction in the incidence of failure would be an important benefit to be considered in light of the above weaknesses of the financial restrictions. The available data paint a negative picture of the performance of the financial restrictions. We are particularly concerned at the near doubling to more than $6 million of insurance claims for non-completion in 2000-01. A key contributing factor cited by the BSA for this rise was the introduction of the GST.[20] The tighter financial requirements adopted in mid-1999 were seen to contribute to the non-renewal of a significant number of licences, perhaps as many as 900.[21] But even so it appears the tighter restrictions were unable to prevent a substantial number of financially vulnerable businesses from continuing.

The extent of the security of payment issue is unclear

One of the motivations presented by some industry participants for the financial restrictions was the need to enhance security of payment. However, we have been unable to obtain data on the extent of the security of payment problem or if it has reduced under the tighter financial requirements. The difficulty of obtaining this information was confirmed by consultation with the previous General Manager of the BSA who also led the 1997 Implementation Steering Committee on Security of Payment in the Building and Construction Industry. A recent review of the Victorian industry by the Security of Payment Taskforce, which examined both domestic and non-domestic building, commented on the data shortage in the following terms —

> *The Taskforce was advised in its initial discussion paper of earlier attempts to quantify the security of payment problem. Taskforce members concluded, however, as did the 1993/4 Economic Development Committee of the Victorian Parliament, that an accurate statistical measure of payment problems is not possible. The chief reason is that payment difficulties most commonly appear to result in contractors and subcontractors carrying bad debts. Occasionally the burden of this debt leads to the company folding, and/or a personal bankruptcy. At that point the payment problem translates itself into a statistical form but the Taskforce could not identify any means by which it was possible to extract from the general records of bankruptcies and receiverships how many could be attributed to a building and construction industry payment problem. In this way, conventional statistical measures fail to identify the significance of payment difficulties.*
>
> *Nevertheless, the Taskforce believes that its collective experience points strongly at security of payment issues being a major concern which urgently*

[20] BSA 2000-01 Annual Report, p.16

[21] The BSA's 1999-00 Annual Report (p. 18) cited 59 licenses as not being renewed as a result of licensees failing to meet the new financial requirements, and an increase in the number of licensees not paying their licence fees (an increase of 247 from 1,374 to 1,621) or cancelling their licence (an increase of 419 from 402 to 821).

needs to be addressed. And while it would be of assistance to formulate a precise measure of the problem, Taskforce members did not believe any effort in this directly is likely to achieve meaningful success in the short term (Victorian Government (2001), p.3).

The absence of data on the extent of the security of payment issue is a further impediment to identifying with confidence any potential benefits of the financial conditions.

As a final point we consider that it is likely to be the case that the legislated provisions that exclude individuals who have been associated with bankruptcy from holding a building contractor's licence are likely to have been more effective than the financial solvency tests in reducing the incidence of insolvency in the building industry in Queensland.

Technical Criteria as a Barrier to Entry

Licensing can impose unnecessary costs

One potential problem with licensing is that it can lead to undue demarcation arrangements for relatively minor tasks. This can unduly restrict competition and raise costs. For example, a situation can potentially arise where a tradesperson must be specifically brought into a project to undertake a relatively simple task simply because it is outside the formal scope of the licence of those already on site.

Or provide the right to work to the wrong people

There can also be problems when inappropriately qualified individuals are allowed to undertake a task. For example, in submissions to the PBT, a number of representatives of the fire protection industry pointed to this problem arising in their area of work.

These issues were not raised as significant concerns during consultation

It has not been possible to systematically investigate the extent to which existing arrangements may impose such inefficiencies. However, the infrequency with which the issue was raised in consultation, even after prompting, suggests it is not of major concern. Possible explanations include that: the formal requirements of the legislation that only certain activities are undertaken by prescribed trades are potentially routinely breached (a point noted by the BSA in its licensing review (BSA (2001), p.37); that skills and licensing are generally aligned reasonably well; or that the cost of any inefficiency is generally passed onto the buyer such that contractors may not be overly concerned by its presence.

Reforms proposed by the BSA will help avoid problems

1. A number of the proposed reforms to the licensing system following from the BSA's licensing review appear likely to lessen the scope for the technical criteria to act as an unreasonable barrier to entry. Particularly encouraging are the proposals that: those industry participants who only subcontract to a principal trade contractor will not be required to be licensed (but they would be unable to trade directly with the public); that in future licensees will be allowed to carry out the incidental work of another class (to a value of $1,100); and that it will be

possible for a trade to engage an occupational licensee when fundamental to the trade calling (see BSA (2001).[22]

The proposals are not without their critics. For example, the Environmental Pest Managers Association pointed out that in future even those pest controllers that do not deal with pesticides (such as those that install physical barriers or inspect for the presence of pests) will be required to hold a Pest Controllers Licence issued by the Department of Health. This license is issued with a view to minimising the risk to public health of the use of pesticides and requires the conduct of a $3000 TAFE course lasting 15 weeks (2 days a week) and 150 hours of practical experience. The total cost to a firm of training a staff member to meet these requirements is calculated as $13,500. But the skills acquired in using pesticides may never be called upon by the licensee.

Under the BSA proposals, this cost can be avoided by engaging a person to undertake non-pesticide work as either a subcontractor (to a principal trade contractor) or an employee. Even so, for the case of pest control there will remain for some an unreasonable barrier to obtaining a license.

It is probably inevitable that tighter restrictions will create some problems

It is possible that there will be other instances where the proposed reduction in the number of licences or the imposition of higher skill levels (as license classes are aligned with the courses made available through the national training program) could impose unreasonable restrictions on some individuals or trades.[23]

But there will be benefits

But the tighter restrictions may also help remove the poorly qualified suppliers from the industry. BISCOQ, the lead subcontractor association, advised that a substantial share of subcontractors lack basic literacy and language skills, yet are able to be licensed and work independently under the current licensing system. There may be some value in raising the technical requirements so as to either limit such individuals to either smaller tasks or to work only under an appropriately educated trade contractor (under the BSA's proposals they could work as unlicensed subcontractors but only for other trade contractors).

On balance we would anticipate significant benefits from the proposal to remove the compulsory licensing of subcontractors working to a licensed contractor and allowing more flexibility for trades to undertake incidental work of another class. Such relaxations of the current rules should help minimise any costs of the expected

[22] At present a small number of license classes formally allow the licensee to undertake incidental work of another class. The BSA's licensee review proposes that this provision be extended to cover a broader range of licensees for work up to a value of $1,100 with the exception of the occupationally licensed trades (and that all licensed trade contractors have the right to engage occupationally licensed contractors, and not just builders as at present) (BSA (2001), pp. 37-38). In a sense, the right to carry out incidental work is already authorised by the provisions of the BSA Act that allow work up to $1,100 to be carried out without a license (with the exception of occupationally licensed activities). The revisions proposed by the BSA would formalise this 'back door' approach of a right to carry out incidental work.

[23] It appears that some tightening of entry standards is unavoidable as Queensland complies with its requirements under the National Vocational Education and Training System (see BSA (2001), p.15-16).

tightening of technical requirements over time (as tighter national training rules come into force) while ensuring reasonable technical standards are upheld.

The Financial Cost of Licensing

The most obvious financial cost of licensing arises from the payment of licence fees. But licensees must also pay for accounting and administrative support and cover the cost of their time and the disruption to their business of obtaining a license and continuing compliance.

The total financial cost of licensing is estimated at $40 million per annum

Taking into account the full range of financial costs, the total financial cost of licensing in Queensland is estimated to be approximately $40 million each year. This total cost figure was derived by using data from the licensee survey which collected information from each respondent on the total cost incurred each year for the renewal of their license. Average costs were calculated for each group of licence holders (i.e. contractors, subcontractors, contractors/subcontractors, builders and others). The average cost for each group was subsequently multiplied by the number of licence holders in that group. This in turn was based on their estimated share (derived from the survey) of the approximately 50,000 licences in Queensland. The sum of the total costs for each licence holder group provided us with an estimate for the overall cost of licensing in Queensland.

We interpret most of these costs as arising from the financial requirements and not from the technical requirements (as there is no need to re-establish a person's qualifications or skills every year).

The Requirement to Undertake Management Training

Applicants for a license are required to conduct a management course before being issued a license. The courses are conducted by eight different service providers being the TAFEs, four industry associations (the HIA, QMBA, Master Painters Association and Master Plumbers Association) and three other training organisations. The intention is to provide license holders certain basic management skills including bookkeeping, taxation, budgeting and cash management, health and safety and basic statutory requirements.

A substantial share of licensees seem to have poor literary skills, but can satisfy the management criteria

Both the subcontractor representative, BISCOQ and the HIA noted the low levels of literacy of some subcontractors. BISCOQ estimates that around 20 per cent of subcontractors do not adequately understand English, and of the remainder, a substantial share has low levels of reading, writing and numerical literacy. However, at present there are no tests conducted as part of the management course. For those courses based on lectures, a person can satisfy the course requirements simply by attending 24 hours of teaching — there is no requirement to actually prove an understanding of the content of the course or, it appears, even the language of instruction. We are concerned that it will be even easier to satisfy the requirements of those courses offered by correspondence.

This will tend to erode industry standards

It is inappropriate to set a mandatory requirement that fails to ensure minimum standards are met. While those with a genuine intention to learn from the course will benefit, it is reasonable to expect that these benefits could be realised without the imposition of a mandatory requirement. This is because they can be expected to search for the training voluntarily, and in a form that best suits their needs. For others a false impression of competency is created by not ruling out those that lack basic skills, and the objective of licensing of maintaining quality is negated.

The BSA has indicated its intention to revise the course content and introduce an assessment as part of the course so as to ensure a minimum acceptable standard is met by each participant. It is understood the BSA has also proposed that the assessment will be conducted via the internet. It appears unlikely that such an unsupervised assessment will amount to an improvement as an internet assessment is open to manipulation by participants. The potential conflict of interest faced by the industry organisations in assessing whether potential members meet the requirements also needs to be kept in mind.

5 EVALUATION OF INSURANCE REFORM OPTIONS

This section provides an evaluation of the main options with respect to the provision of home warranty insurance. The public benefit test plan outlined four alternatives to the current arrangements. These were: no compulsory insurance; non-compulsory schemes provided by private insurers; legislation based schemes defining the product but provided by private insurers; and legislation based schemes defining the product, with private provision but a role for the BSA in handling claims and supervision of the industry.

There is also merit in considering an option where the BSA licensing and insurance functions are separated but a public monopoly in insurance continues. Another option to consider is where compulsory insurance is required for a more basic product and voluntary arrangements can be developed for more comprehensive products.

Given the recent instability in the Australian insurance market and the scope for these uncertain market conditions to continue, consideration is also given to the worth of delaying a decision until there is more clarity about the performance in the main interstate markets.

It is considered that the following six options cover the key variants (although they are not exhaustive of the potential policy options).

Option 1 No Compulsory Insurance

There seems to be a widespread perception that consumers are not capable of meaningful assessments of the risks and costs they face in relation to home warranty insurance issues

There seems to be a widespread perception that consumers are not capable of making meaningful assessments of the risks and costs they face in relation to home warranty insurance issues. There also seems to be a strong view that this problem cannot be effectively addressed with the compulsory provision of information.

There is a community expectation for the government to resolve the problem

We are not convinced by these arguments. However we do recognise that if there is a major problem in relation to builder insolvency or home building defects, that there will be a community expectation for the government to resolve the problem. This implies an inevitable and significant risk for government and the general taxpayer.

We also recognise that the scale of the potential costs and the extent of the transactions costs required to resolve problems through the normal legal process are likely to justify a role for the government in specifying a well defined statutory scheme with effective dispute resolution processes.

We conclude that voluntary arrangements would not be justified at this stage

We conclude that voluntary arrangements would not be justified at this stage.

Option 2 Current Arrangements

The current arrangements entail the combination of licensing, information, certain dispute resolution services and insurance provision and claims handling in a public monopoly. The rationale for these arrangements was considered earlier in this report.

There is an important potential conflict of interest with the one stop shop concept and there would be a clear public benefit from legal separation of the licensing, information and certain dispute resolution mechanisms from the insurance functions

The main argument that is advanced to support the current arrangements is the efficiency and effectiveness of the one-stop shop concept. However in assessing the key feature of the home warranty insurance arrangements in Queensland, we concluded that there is an important potential conflict of interest with the one stop shop concept and that there would be a clear public benefit from legal separation of the licensing, information and certain dispute resolution mechanisms from the insurance functions. Such a reform would also facilitate the introduction of competition from direct private insurers, although this would not necessarily have to occur.

We also understand that under the current arrangements an appropriate exemption from the Trade Practices Act has not been obtained to protect from legal action the current public monopoly in home warranty insurance of the BSA. If this is correct it would leave the BSA exposed to a challenge under the Trade Practices Act. If the monopoly is to be retained it would be relevant to subject it to a public benefit test to justify an exemption under the Trade Practices Act.

We consider that there is a net public detriment associated with the current arrangements and that other options are superior.

Option 3 Corporatised Public Monopoly Providing Current Product

If the insurance functions of the BSA are legally separated into a public enterprise providing home warranty insurance in Queensland, that entity should ideally be formally corporatised

If the insurance functions of the BSA are legally separated into a public enterprise providing home warranty insurance in Queensland, that entity should ideally be formally corporatised. It is well accepted that major public enterprises that are undertaking primarily commercial functions should be formally corporatised or commercialised. This is considered to be the best means of achieving effective performance if the entity is to remain a public enterprise.

The question of whether corporatisation or commercialisation is appropriate has been raised. Commercialisation is normally implemented in government agencies that are undertaking a mix of commercial and non-commercial functions and does not normally imply formal legal separation of the commercial functions from the parent entity. Corporatisation is considered to be a more appropriate policy for a public enterprise with a major commercial function.

The issue of the costs of corporatisation has also been raised. We note that corporatisation is a well-established policy in Queensland with a well-established legal and administrative framework, so that the corporatisation of the insurance functions of the BSA should not be a major cost. We also note that the costs of

corporatisation have not been considered a major barrier to the corporatisation of a wide range of public enterprises in Queensland and that the benefits from corporatisation have generally been perceived to exceed the implementation cost and the costs of not proceeding with corporatisation. We also note that the costs of corporatisation were not considered to be prohibitive in the corporatisation of the insurance functions of WorkCover Queensland.

In raising this issue it is important to recognise that any options that entail substantial changes relative to the current situation will entail a range of additional implementation costs. Options that involve the introduction of competition from primary insurers, whether or not there is still public provision of home warranty insurance are likely to entail similar implementation costs to corporatisation. So the issue is whether the conflict of interest consideration is important enough in its own right for effective action to be taken. We consider that it is and that the minimum (but not optimal) effective action would be full corporatisation as discussed extensively in the main body of the report.

As the public insurance entity would be a monopoly under this option, it would be necessary to have effective monitoring and regulatory arrangements. A key option that would need to be considered is to declare it to be a government monopoly business activity under the Queensland Competition Authority Act 1997 for the purposes of determining and monitoring pricing practices. From a shareholder perspective effective monitoring arrangements would also have to be established by the Queensland Treasury.

Another important issue in implementing these options would be to make sure the insurance was a 'last resort' and not a 'first resort' function in dealing with defects. This would entail ensuring that the BSA's licensing process was used to ensure effective attention to defects if a builder was still trading.

We consider that this option is superior to options 1 and 2 but is still very restrictive in terms of facilitating competition

We consider that this option is superior to options 1 and 2 but is still very restrictive in terms of facilitating competition.

Option 4 Legislation Based Scheme for Standardised Product with Only Private Provision of Insurance, BSA to be Responsible for Representing Consumer Interests in Claims Management Supplemented by Queensland Building Tribunal Dispute Process

There are several variants of this option that could be considered.

Under the **first variant** of this option, the BSA would be responsible for licensing and claims management but not insurance. Private insurers would be responsible for primary insurance underwriting. The BSA would also undertake its current mediation functions for matters relating to workmanship and the Queensland Building Tribunal would continue to play its current role.

The problem with the first variant of option 4 is that the management of claims is a commercial and competitive process and primary insurers would not likely to be willing to hand the management of claims to a third party over which they have no control

The problem with this variant is that the management of claims is a commercial and competitive process and primary insurers would not likely to be willing to hand the management of claims to a third party over which they have no control.

Under this option the BSA would have no commercial incentive to minimise claims or even avoid excessive claims. Insurers would need to have some fair and efficient mechanism to present their position. If the BSA was responsible for approving claims it would effectively be taking on the role of tribunal or a court. This does not apply in any other markets for comparable insurance products.

This variant of this option is considered to be unworkable and not attractive to private insurers.

Under the **second variant** of this option, the BSA would retain its current role except that it would re-insure all of its claims liabilities.

If option 4 was interpreted as the BSA retaining its current role except that it re-insures all of its claims liabilities, the arrangements would still entail a conflict of interest

The arrangements would still entail a conflict of interest as it is not clear whether the BSA will protect consumers at the expense of builders or vice a versa. It would still be beneficial from a financial perspective to reduce claims liabilities even if all liabilities are re-insured, since the BSA would retain ultimate liability above a certain loss ratio specification. However, a complication is that reinsurers may not agree to the BSA having such a low share of the risk as it could diminish the incentive to contain costs.

In addition, the most vigorous competition occurs in the market for primary insurance rather than in re-insurance. And we consider that the BSA, as a State-based public entity offering a single insurance product, would not be likely to be able to negotiate and shop around in the re-insurance market as effectively as a large private insurer with a substantial portfolio of various insurance products.

The process would also mean that there was no competition in claims management.

This variant of option 4 is considered to be likely to offer little benefit relative to the current arrangements in terms of increased competition.

Option 4 could be very effective if the BSA played a role of representing consumer interests in claims management but insurance was provided only by private primary insurers

Under the **third variant** of this option, the BSA would not be responsible for decisions with respect to claims management but would play a role in ensuring that consumers get a "fair" deal when making claims. Private insurers would be responsible for primary insurance underwriting. It is not clear as to the extent to which the BSA would also undertake its current mediation functions for matters relating to workmanship since mediation ideally needs to be facilitated by a party that does not represent a particular interest.

The arrangements for mediation would have to be worked out in consultation with the insurance industry and consumer representatives. The Queensland Building Tribunal could continue to play its current role. Payment for this function could be from a levy

on insurance premiums and the arrangements could be specified in the legislation specifying a standardised product.

Also relevant to the development and implementation of this option is the role of the General Insurance Code in dealing with disputes in relation to home warranty insurance and the outcome of the national review on home warranty insurance.

Careful consideration needs to be given to legislating for only a basic product to be compulsory with additional features to be subject to market forces

As with several other options, this option could be implemented by legislating that the current comprehensive product must continue. However we consider that there is not a public benefit from making such a comprehensive product compulsory. There is a real risk of continued escalation of claims and instability in the scheme. Careful consideration needs to be given to legislating for only a basic product to be compulsory with additional features to be subject to market forces.

The provision of insurance for a basic product similar to New South Wales, Victoria, Western Australia and South Australia would be considerably cheaper and reduce the scope for contrivance of claims and scheme instability.

An issue that would have to be addressed in defining the product is whether there should be scope for builders who are not able to obtain private insurance to be either insured by the government as a last resort or given a temporary and conditional exemption

An issue that would have to be addressed in defining the product is whether there should be scope for builders who are not able to obtain private insurance to be either insured by the government as a last resort or given a temporary and conditional exemption. It could be expected that such entities would be generally high risk in terms of either solvency or quality of work and so in most cases it would not be appropriate to provide an exemption. However there could be some exceptions or anomalies where there is a limited role for an insurer of last resort or temporary exemptions. This role could be undertaken by the BSA in its new role or specified as a community service obligation.

In summary, this variant of option 4 would entail the introduction of private insurers competing to provide a more basic statutory product than currently exists but with the BSA playing a role in facilitating claims and representing the interests of consumers. The arrangements for mediation would have to be worked out in consultation with insurers and consumer representatives.

We consider that this option is far less restrictive than the current arrangements and has considerable potential for success

This option is considered to entail: the maximum scope for effective competition in the provision of a basic standardised statutory product; the effective representation of consumer interests; and reasonable protection in terms of the security of payment issue given the financial checks insurers are likely to undertake. Given these characteristics and other considerations outlined for other options, this variant of option 4 is considered to have considerable potential for success.

We consider that normally private entities will deliver a superior commercial performance to public entities in an otherwise similar competitive or effectively regulated environment. Under both options 4 and 5 we are assuming a similar level of competition and similar regulatory arrangements in making this assessment.

Given recent developments in interstate insurance markets and associated regulatory arrangements we consider that it would not be feasible to implement this option at this stage

Given recent developments in interstate insurance markets and associated regulatory arrangements we consider that it would not be feasible to implement this option at this stage. This conclusion is based on our assessment that private sector insurers are unlikely to be interested in supplying direct insurance in Queensland until they become confident with the recent changes in interstate markets. It is expected that such a situation is likely to continue for at least a year. From a public policy perspective it would also be justified to wait until the new arrangements interstate had been shown to be effective before contemplating the introduction of competition between direct insurers in Queensland.

Option 5 *Legislation Based Scheme for a Basic Product with Public and Private Provision of Insurance and Claims Management Supplemented by BSA Consumer Representation and Queensland Building Tribunal Dispute Process*

Option 5 would entail the legal separation of the insurance functions of the BSA into a new public enterprise providing home warranty insurance that would compete directly with private insurers

This option would be similar to the third variant of option 4 with the exception that the insurance functions of the BSA would be undertaken by a new public enterprise providing home warranty insurance that would compete directly with private insurers. Both the new public insurer and the private insurers would compete in the provision of claims management and the Queensland Building Tribunal would continue in its current role.

As with the third variant of option 4, the BSA would not be responsible for decisions with respect to claims management but would play a role in ensuring that consumers get a "fair" deal when making claims.

This option introduces more competition than option 3 although it is not clear as to the extent to which private insurers would be willing to enter the market if there is also a public insurer with perceived links to the BSA (even though there may be formal separation of the insurance functions from other functions of the BSA). This reluctance would also depend on the perceived and actual outcome of the proposed national review of home warranty insurance. There would also be considerable ongoing difficulties in meeting competitive neutrality and other requirements for corporatised entities competing with private enterprises.

However, option 5 could be preferred to option 4 (variant 3) if it was considered that the current statutory comprehensive product was justified and would deter private insurers so that there was a need to have a public insurer fill the void or if our view about the performance of private entities in an otherwise similar environment was not accepted. However, as with option 4, given recent developments in interstate insurance markets we consider that it would not be feasible to implement this option at this stage. The main concern is that private sector insurers would be reluctant to enter the market until the profitability in interstate home warranty insurance markets improved considerably.

Option 6 Legislation Based Scheme for a Basic Product with Only Private Provision of Insurance and Claims Management

Option 6 entails privatisation and deregulation of the existing arrangements with the exception of legislation of a basic product. This option is considered to be less restrictive than options 2 to 5 but vulnerable to ineffectiveness in the claims management and dispute resolution process

This option entails privatisation and deregulation of the existing arrangements with the exception of legislation of a basic product.

This option is considered to be less restrictive than options 2 to 5 but vulnerable to ineffectiveness in the claims management and dispute resolution process. This option is considered to be inferior to options that retain the Queensland Building Tribunal and the BSA mediation process.

The Implications of Ongoing National Insurance Reviews

As noted at several places in this report, the home warranty insurance market is in a state of flux. The recent increases in premiums and the withdrawal of Dexta (and its subsequent re-entry in New South Wales and Victoria) have created much uncertainty in interstate insurance markets. The fact that different home warranty insurance regimes operate in every state and territory and that there is no national home warranty insurance market further complicates the situation. In addition, the recent and proposed reforms in the other states, most notably in New South Wales and Victoria, will clearly require a period of experience to demonstrate their effectiveness and may require further adjustments.

In addition the national review of home warranty insurance and the Royal Commission inquiry into the failure of HIH are also likely to identify a range of improvements that should be considered for Queensland.

We consider that major changes are not justified at the present time due to the uncertainties. A decision should be postponed until there is more clarity about performance in main interstate markets

We consider that major changes are not justified at the present time due to the above-mentioned uncertainties and that a decision should be postponed until there is more clarity about performance in main interstate markets. It this respect we consider that it would be valuable to undertake another review of home warranty insurance schemes in mid-2004 when the BSA is next negotiating its reinsurance contracts.

However, in the mean time consideration could be given as to whether the Queensland arrangements are too generous in terms of the product that is specified, whether better financial assessments and risk-based pricing could be adopted and whether it is necessary to seek an exemption for the public monopoly status of the BSA.

6 EVALUATION OF LICENSING REFORM OPTIONS

This section provides an evaluation of key options with respect to the licensing of the industry (note that the options considered are not exhaustive and additional policy options could have been considered). We consider the options for the technical and financial requirements separately.

The public benefit test plan outlined four alternatives to the current technical requirements. These were no licensing, negative licensing, legislation based accreditation and industry self-regulation. In addition to these options there is value in considering an option that provides for more targeted technical requirements.

The alternatives we consider to the current financial requirements are: the complete removal of financial requirements with the BSA remaining the sole provider of home warranty insurance; improved financial requirements with the BSA remaining the sole provider of home warranty insurance; and the removal of financial requirements with the BSA no longer providing home warranty insurance.

Technical Requirements of Licensing

Option 1 *No technical requirements in licensing, with protection to be provided for industry participants via the Queensland Building Tribunal Act, the Trade Practices Act 1974 and Fair Trading Act 1989 and certain technical requirements to be enforced by other legislation.*

Other legislation will still protect basic building standards

The Building Services Authority Act is not the only piece of legislation seeking to maintain technical standards in the building industry. In particular, compliance with the Building Code is dealt with under the Building Act by parties other than the BSA. Local authorities or private certifiers are responsible for inspecting building work in progress and ensuring that work is structurally sound. Certain occupations would also remain subject to licensing established by other legislation. These are mainly occupations that pose a risk to public health (eg electricians, pest controllers) or some of the professions (eg engineers, architects). So under this option it is relevant to note that potentially unsafe building practices and to a lesser extent technical standards will remain controlled even in the absence of the Building Services Authority Act.

There will be some recourse via occupation-based legislation to remove from operation those poor performers in occupations that remain regulated. But in general there will not be the potential to do this for other skills. It is likely that this weakness, combined the higher cost of obtaining information on the quality of potential suppliers, will result in technical standards tending to decline in the industry.

Insurers, builders and trade contractors would develop alternative screening arrangements

In the absence of the BSA license, it is reasonable to expect insurers to introduce replacement assessment procedures of the technical standing of those taking out home warranty insurance. This is necessary so as to manage risk effectively. The builder and trade contractor involved in house building in turn would probably also need to pay more attention to the screening of trade contractors and subcontractors. Builders and trade contractors involved in commercial work would likewise be expected to develop alternative screening arrangements. Both developments can be expected to lead to more transaction costs than incurred under the current licensing system.

But low cost mediation would be lost

Under this option there would no longer be an agency specifically responsible for overseeing the corrections of non-structural defects, or for correcting those structural defects that only become apparent after construction. Those buyers in dispute with builders or contractors would be required to seek correction and/or compensation via the Queensland Building Tribunal, the Small Claims Tribunal etc. The low-cost mediation process currently provided by the BSA would no longer exist and more expensive options would need to be routinely adopted. This will add to transactions costs incurred in the industry.

This would disadvantage consumers

We anticipate that this option would reduce the level of consumer protection by requiring consumers to seek redress through more expensive and difficult dispute resolution processes. More time and costs would need to be spent selecting a builder or contractor in part because the cost of redress would be higher. But it is likely that most consumers will lack sufficient skills to make an adequately informed decision. And the incidence of building problems is likely to increase as information problems make it easier for lower quality suppliers to operate. It is concluded that consumers would be expected to bear significant costs under this option.

Commercial buyers may also find it harder to select appropriate builders or trade contractors and seek redress for poor workmanship. This would add to the costs incurred by commercial buyers.

Industry costs may decline slightly

The main potential benefit for consumers and commercial buyers would be a potential reduction in building costs. There will be small financial savings for builders and contractors as licence compliance costs regarding technical criteria would no longer be incurred. These can be expected to flow through into lower building costs. But most of the financial cost of licensing is attributed to the financial conditions so the potential saving is expected to be very small.

Better quality builders and contractors would tend to bear costs as it becomes easier for lower quality operators to obtain work. The low quality operators are the main potential beneficiaries of this option.

The scope for market failure in the absence of licensing and associated high transaction costs under this option provides a strong rationale to reject it. It is concluded that there would be net costs from this option relative to the current arrangements.

Option 2 *Option 1 but with negative licensing with respect to technical requirements, which would exclude from the industry those found to undertake sub-standard work.*

Basic technical standards would be protected

Technical standards would be protected as under Option 1, but there would be the added benefit of potentially excluding poor performers from the industry. The process employed by buyers to check operators would be very similar to that described for Option 1.

Finding poor performers may be difficult

However, buyers of building services will find it more difficult to seek redress than at present, so instances of poor workmanship being corrected through the action of consumers or commercial buyers would become less frequent than at present. A further issue is the extent to which operators could be effectively excluded from the industry. In the absence of the BSA there would be very little monitoring of the industry and excluded individuals could probably continue to operate, possibly shielded via a new business structure. These factors suggest that negative licensing would not be very effective in maintaining technical standards.

The main weakness of this option is the absence of the cheap dispute resolution process offered by the BSA.

We see the outcome under this option to be very close to Option 1. It is concluded that there would be net costs from this option relative to the current arrangements.

Option 3 *Option 1 but with legislation based accreditation with respect to technical matters, where legislation specifies industry experience of educational requirements that if met enable someone to undertake specified work without a license being issued.*

This would place more emphasis on a buyer's skills than at present

Buyers could select suppliers as per the process described for Option 1. However, this option would also allow a buyer seeking verification of the suitability of a potential supplier to examine the training of that individual and their experience. They would examine the legislation to see what tasks the individual was capable of undertaking given their background.

Adding to transaction costs

Educated buyers making frequent purchases, such as commercial buyers (eg the Government) and some homeowners, may find such an enhanced selection process satisfactory. But in general home owners are unlikely to have the required skills to make their own assessment and this will tend to weaken the process buyers use to select suppliers. In effect buyers would be required to undertake a process that is currently undertaken by the BSA. The BSA currently undertakes this checking process once on behalf of the market (perhaps rechecked as appropriate). Under this scenario the checking process would be undertaken repeatedly and potentially on a frequent basis (ie the checks would be undertaken separately by different buyers), adding to overall transaction costs in the market.

The BSA is a better interpreter of suitability

The additional checks made possible under this option means that is considered superior to Options 1 and 2. However it is seen as inferior to the current arrangements. It is preferable that a skilled agency such as the BSA be the 'interpreter' of qualifications and experience. Transaction costs will also be higher than at present.

The absence of the BSA would mean a dispute resolution process as per Option 1, and this is a major shortcoming of the option.

It is concluded that there would be net costs from this option relative to the current arrangements.

Option 4 *Option 1 but with industry self-regulation of technical matters, perhaps via an industry Code of Conduct with supporting legislation developed to cover circumstances where the Code was not followed. Dispute mediation processes would also be supplied by industry.*

The presence of many small operators makes building a difficult industry to self-regulate

At present the industry appears to be exposed to substantial competition from unlicensed operators, at least at the lower end of the market. We expect that this competition has the potential to erode quality standards in the industry over time, although we cannot be certain of this. It is difficult to see why industry self-regulation would be more effective than the BSA in ruling such suppliers out of the market. Consequently we see industry-based licensing as less effective than the current BSA-based licensing.

The main monitoring problem is the difficulty and costs incurred in ensuring poor performers are locked out of the industry. The small operator in particular is not as readily tracked or controlled as a very visible and stationary corporation, such that the building industry is not as well suited to self-regulation as others. Poor performers could readily move to a new area or re-establish under alternative business arrangements. Considerable time and effort is required to regulate the industry and the incentive for the industry to monitor is probably too weak.

The conflict of interest faced by industry would be difficult to control

Consumer protection would probably be eroded under this option as the industry has a conflict of interest in this aspect that the BSA does not. The same level of independence and impartiality as currently offered by the BSA may be difficult to secure. Such problems would probably be greatest in regional areas where industry participants may be required to implement the self regulation. If for example builders know each other on a professional and perhaps social basis, they may be reluctant to judge each other.

An independent dispute resolution process is preferred

While broad checks could probably be put in place to guard against this conflict of interest, the government would be required to oversee the process in some way so as to ensure accountability. Funding is probably best allocated to a government-run dispute resolution process.

It is concluded that this option would be inferior to the current arrangements. The main concern is that it is very likely that the effectiveness of the dispute resolution process provided for consumers would fall under this option.

Option 5 Enhanced Licensing Provided Through the Adoption of More Focused Technical Criteria and Improved Consumer Information and Education

The BSA has proposed a number of important improvements

A number of options have been identified through the BSA licensing review to improve the efficiency of the current system. Of particular note are proposals to remove the compulsory licensing of those subcontractors working to a licensed contractor and allowing most trades to undertake incidental work of another class.

And others are possible

Other improvements are also possible, such as removing the requirement for applicants for a license to undertake a management course. It may also be sensible to raise the maximum level of work that can be undertaken without a license.

There appears to be the potential to enhance the worth of a license by providing more information to consumers on a licensee's record and by better educating the public as to the benefits of engaging a licensed contractor (e.g.. because it provides access to a low cost dispute resolution process).

To reduce costs and increase the benefits of licensing

We anticipate that these proposals would reduce the financial cost of licensing (broadly defined) and offer other benefits in terms of ensuring better informed consumers and providing more flexibility in operating practices. There may also be a general improvement in technical standards arising from the increased training requirement proposed by the BSA as this would raise skills and reduce the extent to which less skilled and/or educated workers would deal directly with home owners (and instead work via better skilled trade contractors that would be responsible for enforcing quality standards).

This option would retain the high level of consumer protection offered by the current, low-cost dispute resolution process. And homeowners commissioning a substantial building project would continue only to deal with licensed operators, where this is considered important in helping maintain industry standards.

The suggestion that licensing restrictions could be relaxed for lower value work and work undertaken directly by trade contractors may seem at odds with the objective of ensuring consumer protection. But in this respect a number of points are worth keeping in mind —

- The option of employing licensed contractors for small work would remain. We expect that consumers with limited building experience would tend to favour licensed operators even for small work.
- We expect that the incidence of problems is relatively low for low value work, likely contributing factors being the relative simplicity of smaller jobs and the

relative ease with which a consumer can assess quality and withhold payment.[24] Our expectation is that consumer protection is most critical for larger jobs and there is probably little downside from a relaxation of restrictions on lower valued work.

- The difficulty of policing smaller operators means that licensing is not very effective for lower valued work. There is a very real risk that an attempt to license at the lower end actually penalises the better operator that feels obliged to abide by all rules in contrast to the poor operator that will ignore the rules. In this way the current licensing system may actually be contributing to an erosion of quality standards because they can favour the poor quality operator.
- Improved consumer education of the benefits of the BSA dispute resolution process (which of course is only available to a consumer when a licensed operator is engaged) could act as a useful 'branding device' for better operators and help secure their place in the market. By better distinguishing the value of engaging a licensed operator, consumers will be prepared to pay more and this would help offset the extra costs incurred by licensed operators relative to an unlicensed operator. This would help maintain industry standards.

This option would see a reduction in license revenue for the BSA as the number of license holders declines. Options for making up this revenue include increased budget support for the BSA or a greater reliance on user charging. User charging (subject to subsidies where inequities are seen as a potential problem) would make an important contribution to correctly rationing the use of the BSA's resources and could be used to create incentives for both contractors and buyers to reduce the rate of defective work.

It is concluded that there would be net benefits from this option relative to the current arrangements.

Financial Requirements of Licensing

Option 1 *Complete removal of financial requirements with the BSA remaining the sole provider of home warranty insurance. The technical requirements of licensing would apply as at present.*

If the BSA is to continue to be the sole provider of insurance, it will need to have financial checks in place. Complete removal of financial checks would be untenable as it would mean home warranty insurance would be provided without any assurance of a licensee's financial standing.

There would be net costs from this option relative to the current arrangements.

[24] Unfortunately the BSA was unable to provide data that could be used to identify the incidence of claims for small versus large jobs.

Option 2 *Improved financial requirements with the BSA remaining the sole provider of home warranty insurance. The technical requirements of licensing would apply as at present.*

Current arrangements impose costs but benefits cannot be identified

There is a lack of data on the performance of the financial criteria. In particular, there are no data available to assess whether the incidence of business failure has decreased since the financial requirements were tightened (either in total or for high risk groups) or the incidence of business failure in Queensland relative to other jurisdictions. We conclude that there is insufficient information to allow a robust opinion to be formed as to the extent of the benefits offered by the financial requirements. Nonetheless it is clear that there are some benefits generated through the imposition of the financial checks on industry as they help prevent the operation of financially insecure builders.

It is also clear that the financial requirements impose significant costs in terms of the financial cost of meeting licensing requirements (license fees plus accounting and other compliance costs), the ceiling they may placed on business expansion and the effective penalty they impose on better operators (at low turnover levels).

It would be possible to reduce these costs

It would be possible to reduce these costs of licensing through improved financial requirements. For example, the $250,000 threshold level at which more stringent financial standards apply could be raised to reduce the ceiling on business expansion. Given the perceived low risk at this level, this is expected to have little effect on the BSA's exposure while easing the ceiling. Self-assessment could be removed for builders that grow quickly.[25] And the financial checks that remained could be more closely attuned to risk and applied in a more flexible manner, and premiums could vary with risk so as to provide an incentive to reduce risk.

It appears unlikely that such initiatives, if implemented sensibly, would significantly erode the financial standing of the industry. That is, under this option costs would be reduced with the loss of few if any of benefits generated by the current financial requirements. So, for example, this option can be expected to do as much as current arrangements to ensure security of payment.

We conclude there would be net benefits from this option relative to the current arrangements.

[25] A builder that grew quickly could be identified through the monitoring of a licensee's insurance premium (for those builders involved in house building) or an obligation could be imposed on licensees to advise the BSA when sales increase above a prescribed rate (eg. 100 per cent a year).

Option 3 *Removal of financial requirements with the BSA no longer providing home warranty insurance. The technical requirements of licensing would apply as at present.*

This option is untenable

Due to a lack of data we have been unable to confirm the extent of the benefits generated by the current financial requirements. However it is clear that they do impose unnecessary costs in terms of the financial cost of licensing, the ceiling they may place on business expansion and the effective penalty they impose on better operators (at low turnover levels).

A key concern under this option is the nature of the alternative financial checks that would be adopted by the industry on high risk operators. Data do not exist to identify with precision which operators are at most risk of financial failure and which impose the greatest costs (on buyers, subcontractors and suppliers) when they do fail. However, based on consultation with the BSA and industry participants, our assessment is that there is minimal risk associated with trade contractors and small builders (contract size is small, they employ few people if any and tend to be financially stable), but there is significant risk associated with medium to large home builders.

Home warranty insurance providers would review financial standing

Such builders would require home warranty insurance. As discussed in previous sections, private providers of home warranty insurance impose more appropriate financial checks than are imposed under the current BSA licensing system. This option would see a higher standard of financial checks applying to the higher risk operators than apply at present.

But what share of the industry would these insurance-based checks cover? Our survey of licensees found that the majority of license holders operate in the residential market, with the survey finding around 80 per cent of licensees are involved in residential work (ie. 60 per cent are only involved in residential work and 20 per cent undertake mixed residential/commercial work). Assuming this same figure applies to builders, perhaps 20 per cent of builders would operate outside the scope of these insurance-based financial checks. And we expect that many trade contractors and subcontractors, even those that operate in the residential market, would operate free of these insurance-based checks as they would not undertake work requiring insurance (as they would tend to work for builders and only undertake smaller tasks direct for homeowners).

Of the builders that only undertake commercial work, a substantial portion would be subject to financial checks by the State Government as a buyer, and these are

understood to be more rigorous than those applied by the BSA.[26] Other commercial buyers can also be expected to have reasonable checks in place.

There are limited data available to fully assess the level of risk

It is unclear whether the absence of checks on trade contractors and subcontractors would present a potential problem. Most of these trade contractors would be small and fall under the $250,000 self-assessment ceiling. We understand that smaller operators are at a low risk of insolvency. Furthermore, it is expected that the existing financial checks are not binding on a substantial share of subcontractors (given the current self-assessment option), so for these operators there may be little change in the effective level of oversight. It is significant that the interstate review failed to find any evidence that there is a problem with the limited checks on trade contractors and subcontractors that apply interstate.

This option is expected to mean that more comprehensive, more rigorous and more flexible financial checks would be put in place on high risk operators and offer a reduction in unnecessary costs on lower risk operators (eg the ceiling on expansion, a requirement that low risk operators meet financial conditions). Our assessment is that the option would improve risk management by focusing on the areas of greatest risk and relax those restrictions that offer little value in terms of risk management. So, for example, this option can be expected to do as much as current arrangements to ensure security of payment but do so at least cost (broadly defined).

We conclude there would be net benefits from this option relative to the current arrangements.

[26] They add to the checks made by the BSA and a licensee can pass the BSA test but not the State Government tests. We assume the State Government would, in the absence of the BSA tests, introduce replacement tests that and continue to impose more stringent controls than the BSA.

7 CONCLUSIONS

The components of the regulatory regime are clearly sensible

It is found that a clear case can be made for the following components of the regulatory regime that restrict competition —

- The specification of technical criteria in licensing.
- A compulsory requirement to obtain home warranty insurance.
- Retention of a public monopoly in home warranty insurance at least until new arrangements in interstate markets demonstrate their effectiveness.

There is a particularly strong argument for setting technical criteria via licensing, mainly because this provides the basis for a low cost dispute resolution mechanism that offers a good standard of consumer protection in an efficient manner. A number of opportunities to further enhance these components of the regulatory regime have also been identified.

In relation to financial requirements, it is considered that these should be retained in the short term but modified to raise the threshold for self-assessment and be closely and flexibly attuned to better reflect and manage risk. However, in the longer term, it is considered that formal statutory financial requirements would not be necessary if private insurance was introduced.

In principle, licensing and associated regulatory arrangements should make it possible to make home warranty insurance voluntary

In principle we consider that over time it should be possible to enhance the licensing and associated regulatory arrangements (including via improved arrangements for the provision of readily available information about the performance of builders) such that it would no longer be necessary to specify that home warranty insurance should be mandatory. And in principle it should be possible at some point to relax the requirement that home warranty insurance be provided only by a public monopoly.

However, given recent developments in interstate home warranty markets and associated regulatory arrangements it would not be sensible to make major changes to the insurance arrangements in Queensland at this stage. In particular, the experience of New South Wales and Victoria suggests that a cautious approach to reform be adopted. In these states, the performance of home warranty schemes has been a problem as a result of ineffective scheme design, the insolvency of HIH and general difficulties in certain insurance markets.

The current instability in insurance markets means that it is not feasible to make major changes to the insurance arrangements in Queensland at this stage

In short, the current instability in the insurance industry and uncertainty about the new interstate home warranty insurance schemes lead to an environment that is not conducive to the introduction of competition in the provision of home warranty insurance in Queensland. It is expected to take an extended period of time before new insurance providers would be prepared to enter the Queensland market and to establish if the new arrangements recently adopted interstate are effective and whether further changes are required.

It is not feasible to introduce competition in Queensland at this stage

Although it is not feasible to introduce competition into the Queensland market at this stage, we expect it would be sensible to do so at a later stage. We consider that it would be worthwhile to undertake a further review of the potential to introduce competition into the Queensland home warranty insurance scheme before mid-2004 when the BSA is next negotiating its reinsurance contracts.

There is merit in considering improving current arrangements by separating the licensing and insurance functions of the BSA

Despite our conclusion that any major reforms be approached with caution, some immediate improvements in home warranty insurance appear achievable through minor revisions. In particular, we consider there is merit in improving the current arrangements by separating the licensing and the insurance functions of the BSA. Furthermore, we believe that consideration should be given as to whether the Queensland arrangements are too generous in terms of the product that is specified, and whether risk-based pricing could be adopted and whether it is necessary to seek an exemption under the Trade Practices Act for the public monopoly status of the BSA.

Summary impact matrices of the current system and preferred alternatives for the short term and the long term are provided in Tables 7.1 to 7.3.

TABLE 7.1 IMPACT MATRIX FOR CURRENT SYSTEM

	Effects on Competition	Impact on Key Groups				Overall Assessment
		Homeowner	Builders/trade contractors	Subcontractors	Taxpayer	
Current System						
- Technical requirements of licensing as at present. Continuation of existing low-cost dispute resolution system and the right to enforce the correction of defective work of licensees.	Restricts entry of operators that do not meet basic skill or experience requirements.	Provides good protection at low cost. Most of these benefits arise from the presence of a low cost dispute resolution system. This system is acknowledged as superior to that in place interstate.	Provides a sign of quality to home owners that helps better operators get work. In this way it helps prevent the operation of poor quality operators.	Beneficial for those selling to consumers but imposes unnecessary costs as must be licensed even when working for an 'educated' buyer.	No impact at present as all costs are funded by licensees.	Benefits can be expected to exceed the costs. There is a large saving in transaction costs in the market and enhanced information flows support the development of better quality standards.
- Financial requirements of licensing as at present.	For larger operators, restricts entry of operators of inadequate financial standing. It is unclear how effective the restrictions are in reducing the entry of unsuitable, smaller operators as compliance with the self-assessment regime is unclear.	The protection for home owners is mainly provided by the home warranty insurance. Nonetheless there is a potential benefit if the arrangements generally add to the financial stability of the industry.	Imposes significant financial costs on a large number of low risk operators, ceilings on growth (particularly above the $250,000 level) and penalises good performers that abide by the rules (while their competitors may not).	As for builders/trade contractors.	No impact at present as all costs are funded by licensees	There are little data available to help establish the extent of benefits of the current arrangements. However it is established that the costs are substantial.
- Statutory monopoly for the provision of home warranty insurance	There is no competition allowed in primary insurance because private providers are excluded. But there are provide providers of re-insurance operating.	The current system provides a high degree of protection. But it may be overly generous and actually erode the standard of work and create too many defects. On average, premiums are now low relative to other jurisdictions, but there is the potential for this price advantage to decline or be removed over time.	Automatic provision of insurance means administrative costs for licensees are kept to a bare minimum.	Little impact as subcontractors are unlikely to be heavy users of insurance (as they would be unlikely to undertake much work directly for home owners). As for builders/trade contractors for those subcontractors that undertake residential work for home owners.	Taxpayer is exposed to losses of BSA if current capital reserves are completely eroded. There is a real risk that this exposure may be substantial as claims appear to be on an upward trend.	Instability in the interstate insurance markets and the relatively low premiums in Queensland at present mean that it is not feasible to introduce competition. However improvements could be made to further enhance performance as outlined in the following matrix.

TABLE 7.2 IMPACT MATRIX FOR PREFERRED ALTERNATIVE FOR THE SHORT TERM

MORE FLEXIBLE AND FOCUSED TECHNICAL AND FINANCIAL REQUIREMENTS FOR LICENSING, SEPARATE PUBLIC INSURANCE FOR A STATUTORY PRODUCT

	Effects on Competition	Impact on Key Groups				Overall Assessment
		Homeowner	Builders/trade contractors	Subcontractors	Taxpayer	
Preferred Short Term Alternative						
- More flexible and focused technical requirements (including BSA proposals) and improved consumer information. Continuation of existing low-cost dispute resolution system and the right to enforce the correction of defective work of licensees.	Restricts entry of operators, but less so than under the current system. This is mainly because restrictions are relaxed for those subcontractors working for other contractors and because the exemptions are more generous.	Provides better protection than current system because homeowners are better informed while retaining the protection of licensing and the low cost dispute resolution system of the BSA. The cost of building would be slightly lower than at present.	Provides additional benefits over current system by doing more to help eliminate poor performers and providing more flexibility for licensees.	Relaxes the obligation to obtain a licence when working for a trade contractor. This will provide more flexibility for new entrants while ensuring a continuing oversight of technical standards.	No adverse impact relative to current arrangements.	Preferred alternative as it enhances benefits of the current system (with respect to consumer protection and preventing the entry of poor operators) while reducing compliance costs for industry.
- For financial requirements, raise the threshold for self-assessment, focus financial checks more closely on risk characteristics.	Makes it easier for small to medium firms to expand, creates better incentives to manage risk and has a positive impact on competition.	The protection for home owners is mainly provided by the home warranty insurance but enhanced competition will provide benefits to consumers in terms of greater price and service competition and less risk of disruption associated with financial failure.	Lowers financial costs for most licensees, provides greater scope for expansion.	Increases business opportunities and reduces risks for subcontractors.	No adverse impact relative to current arrangements.	Preferred to current arrangements but may not be necessary in the long term if private insurance was introduced.
- Public monopoly for statutory home warranty insurance but with separation from BSA licensing and any industry development functions and greater focus on pricing for risk.	There would be no impact on competition compared with the current arrangements. However the separation of licensing and insurance functions removes a conflict of interest and would facilitate the introduction of competition over the longer term.	Continues to offer a high degree of protection provided BSA licensing process is used to ensure effective attention to defects.	Will benefit good performers and penalise poor performers because of an improved focus on risk management. This will help improve industry standards. Removal of conflict of interest between regulatory and insurance functions is beneficial.	Greater focus on pricing for risk will reduce risks for subcontractors. Removal of conflict of interest between regulatory and insurance functions is beneficial.	No adverse impact relative to current arrangements.	Instability in the interstate insurance markets, the relatively low premiums in Queensland at present and the likely reluctance of private insurers to enter the market until their confidence is restored in interstate markets mean that this option is clearly preferred in the short term (for at least 2 years). Over the long term, the option outlined in the following matrix is considered to be likely to be superior.