

Home building compensation premium guidelines

Discussion paper

August 2017

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Minister's foreword



In June the NSW Government passed legislation to overhaul the current Home Building Compensation Scheme.

The *Home Building Amendment (Compensation Reform) Act 2017* creates a pathway for private insurers to re-enter the scheme and will assist to put it on a sustainable financial footing.

The future HBC Scheme will enable competition through product differentiation, market specialisation and risk-based pricing. The new scheme will also encourage innovation and best practice claims handling.

More than 55,000 homes built and renovated each year are covered by this scheme. Importantly the new legislation retains the same high level of protection for homeowners undertaking new builds and renovations.

The NSW Government undertook extensive industry consultation prior to embarking on legislative reform. In a similar vein, the State Insurance Regulatory Authority (SIRA) will consult with the industry on the design of the premium guidelines.

This discussion paper provides an opportunity for industry and community input regarding the regulation of premium setting in the scheme. This is the first step in building a fair and affordable premium system, which adequately covers the risks faced by home owners, while also supporting sustainable participation of a range of new providers and innovative products.

Central to the success of the new scheme is data collection and data analytics. Better use and sharing of data, in real-time, will ensure the scheme operates effectively. It will encourage innovation, increase accountability and transparency and drive greater innovation and competition.

I encourage you to comment on the questions raised in this discussion paper. With your help, the NSW Government can deliver a system that continues to protect homeowners, while achieving a system that provides greater choice and is easier to navigate for the building industry.

A handwritten signature in black ink, appearing to read 'Victor Dominello', with a small dot at the end.

Victor Dominello MP
Minister for Finance, Services and Property

Introduction

The role of SIRA

The State Insurance Regulatory Authority (SIRA) is the NSW Government organisation responsible for regulating home building compensation, motor accidents compulsory third party (CTP) insurance and workers compensation insurance in NSW.

What is home building compensation?

The Home Building Compensation (HBC) Scheme provides a safety net for homeowners. It is designed to reduce the impact of a financial loss if their contractor fails to complete or fix defective work. Since 2002 it has been a 'last resort' scheme focused on losses due to contractor insolvency, death or disappearance.

By law, any contractor (a licensed builder or tradesperson) must buy HBC insurance for residential building work valued at more than \$20,000 inclusive of GST, such as new home constructions (including multi-unit buildings of three storeys or less) or home renovations.

The NSW Government provider, icare Home Building Compensation Fund (HBCF), has been the sole provider of HBC insurance since private insurers left the market in 2010. Contractors can only buy HBC insurance from icare hbcf if they pass an eligibility assessment, and may be restricted in the type, value and number of projects for which they may buy insurance cover. This makes access to eligibility critical for any contractor wanting to do work that requires HBC insurance.

The current HBC Scheme has not been financially sustainable, and as a monopoly product, builders and consumers have had no choice of product or provider to suit their needs.

What's changing?

On 20 June 2017 the NSW Parliament passed legislation¹ to overhaul the HBC Scheme. The changes will allow competition into the market, ensuring the scheme's financial sustainability and maintaining high levels of consumer protection.

Private providers will be able to enter the market alongside icare hbcf in 2018. They will also be able to offer new HBC products that can cover additional risks (such as 'first resort' cover) or that include additional services for contractors and homeowners. SIRA will be responsible for licensing and regulating HBC providers (insurers and alternative indemnity providers), and will set the standards HBC providers must use, such as for contractor eligibility, premiums, and claims.

¹ *Home Building Amendment (Compensation Reform) Act 2017*

How you can get involved

SIRA will consult on the key design features of the new HBC Scheme before it commences in 2018. We're seeking input from industry, consumers and other interested stakeholders.

We will consult about the following topics in three phases between August and December 2017:

- Phase 1: Eligibility and premiums
- Phase 2: Business planning, prudential regulation, claims handling, HBC provider licensing and market practices
- Phase 3: Regulations.

We will publish discussion papers and other documents about each topic you can respond to. We will also meet with industry and other associations to seek their input.

Executive summary

Purpose of premium guidelines

The NSW Government's legislative reforms to the HBC Scheme include making SIRA responsible for licensing HBC providers and regulating the premiums these providers may charge for HBC products. Licensed providers will need to file any proposed premiums for their products with SIRA. The legislation gives SIRA the power to set insurance guidelines² for premiums (premium guidelines) that licensed HBC providers must comply with, such as:

- specifying the manner in which premiums are to be determined and the factors to be taken into account in determining premiums
- requiring licensed HBC providers to specify how they have determined premiums
- specify the nature of the additional information and reports that SIRA may require the licensed insurers to provide with filings or to justify their premiums
- specify the maximum fee payable to the agents of licensed HBC providers and other expenses that may be included in the determination of premiums
- setting the period allowed for rejecting a premium.

SIRA will be able to reject an insurance premium if SIRA determines that it:

- is excessive or inadequate, having regard to actuarial advice and to other relevant financial information available to the Authority, or
- does not conform to the relevant provisions of the insurance guidelines.

The purpose of this discussion paper is to seek input about what SIRA should prescribe in the premium guidelines and related matters. We're seeking input from the building and insurance industries, related professions who act as intermediaries or advisors to these industries, consumer representatives and other interested stakeholders.

² This is provided for by the insertion of new sections 103EC and 103BD-103BG in the *Home Building Act 1989*

How to have your say about the premium guidelines

This discussion paper includes a series of focus questions and explanatory material. We invite you to read this paper and provide comments. You may wish to comment on only one or two questions of particular interest or all of the issues in this discussion paper. You can also comment on additional matters if you want to. Send your submission in an email to hbcreform@sira.nsw.gov.au by COB on Friday 15 September 2017.

Important note: All submissions will be made publicly available. If you don't want your personal details or any part of your submission published, please indicate this clearly in your submission together with your reasons. Automatically generated confidentiality statements in emails are not sufficient. You should also be you aware that, even if you state that you don't wish certain information to be published, there may be circumstances in which the government is required by law to release that information (for example, in accordance with the requirements of the *Government Information (Public Access) Act 2009*).

Current icare hbcf premiums

In November 2016 the NSW Government announced that the premiums charged by its insurance provider, icare hbcf would increase to ensure the scheme's sustainability. SIRA has approved a premium filing from icare hbcf, under which the first premium changes took place on 3 April 2017. icare hbcf will implement a second round of premium changes on 2 October 2017. Any further premium changes proposed by icare hbcf will require a new premium filing for SIRA to consider.

icare hbcf currently charges premiums based on a percentage of the contract price, with a minimum premium of at least \$200. Premiums vary depending on the type and location of the project. Base premiums for projects in regional NSW are set at a lower rate than those located in metropolitan areas.

Contractors also receive an individual loading or discount of up to 30 per cent of the base premium. This is based on their insurance risk profile, which is assessed using actuarial guidelines. These are not a reflection of the quality of the contractor's work.

A 10 per cent GST and a 9 per cent stamp duty applies to icare hbcf premiums. Where the contract price for a residential construction project is not known, the reasonable market cost of the labour and materials involved in the project is used to calculate the applicable premium.

Premium principles

Premium guidelines will apply to all licensed HBC providers, including icare hbcf. They will require licensed HBC providers to provide a premium filing to SIRA prior to issuing policies to eligible contractors.

The premium guidelines will make it mandatory for licensed providers to file their premium rates with SIRA for approval within a specific timeframe, allowing the provider to use new rates if SIRA does not reject the filing.

The filed premium must provide enough information and evidence for SIRA to assess it against the premium principles, requirements and special requirements.

icare hbcf is now only able to charge premiums that have been approved by SIRA.³ As the basis of approving icare hbcf's premiums, SIRA has used the following principles to assess icare hbcf premium filings. These are similar to the principles that SIRA uses to assess premiums under the workers compensation scheme⁴:

- Principle 1: Premiums are fair and reflective of risk
- Principle 2: Premiums should not be unreasonably volatile or excessive
- Principle 3: Incentives for risk management and good business practices
- Principle 4: The premium basis needs to be consistent with the insurer's capital requirements.

SIRA applies different guidelines to the motor accidents insurance scheme, which includes detailed requirements and equations for the calculations of some matters that are part of insurance premiums under that scheme.⁵

We propose to adopt a similar set of principles in the HBC Scheme to the workers compensation premium principles set out above.

Focus questions

1. What premium principles should apply to the HBC Scheme?
2. Are there particular principles applied in the workers compensation or motor accidents insurance regimes that should apply or not apply in the HBC Scheme?
3. How detailed or prescriptive should the premium principles be about how they will be interpreted or applied?

Premium filings

Premium filings will need to provide sufficient evidence to be assessed against the premium principles, requirements and special requirements for the policy renewal year.

³ Section 12A (2A) of the *NSW Self Insurance Corporation Act 2004*

⁴ SIRA's Workers Compensation Market Practice and Premiums Guidelines

⁵ SIRA's Green Slip Premium Guidelines

Focus questions

4. What should the premium guidelines require for filings by licensed HBC providers to ensure that premiums are not excessive or inadequate?
5. Is there any additional information or other matters that the premium guidelines should require that licensed HBC providers submit with a premium filing?
6. What, if any, matters should the premium guidelines prescribe about maximum fees payable to the agents of licensed HBC providers and other expenses that may be included in the determination of premiums?
7. Should SIRA publish a standard premium filing template and information to support the premium filing process?
8. What information should be required in a standard template?
9. Are there any other issues or risks that SIRA should be addressing through the premium guidelines?
10. Is there information or data from premium filing documentation that should be published by SIRA or that SIRA should require that licensed HBC providers publish?
11. What period should the premium guidelines allow for rejecting a premium filing?

Risk-based premiums

The introduction of risk-based pricing by icare hbcf in April 2017 means contractors are now being offered premium prices that are intended to reflect their individual level of risk.

This approach is aimed at providing an incentive for contractors to reduce their risk in return for lower insurance premiums.

A key question for SIRA is how the premium guidelines should provide for future risk-based approaches to premiums that may be proposed by licensed HBC providers. For example, SIRA's motor accidents premiums determination guidelines require for that scheme, that each risk rating factor proposed by an insurer must be objective and evidence based. It requires that a risk rating factor must not be used unless approved by SIRA and expressly prohibits the use of certain risk rating factors. It also prescribes certain calculations and limits in respect of the 'bonus-malus' (positive-negative) that applies to premiums under the motor accidents scheme.

To support the HBC Scheme being sustainable and fairly priced, SIRA may consider introducing a mechanism to share or equalise risks across different providers. A risk equalisation model is currently used as part of national private health insurance arrangements in Australia, and SIRA is introducing a risk equalisation model (REM) to the CTP Scheme in NSW. The REM works in the background so it's not visible to the purchaser of the insurance. The advantage is that the REM can remove the likelihood of an insurer attracting either too many high risk or low risk (i.e. 'cherry picking') customers by spreading the risks across all insurers. As a result, profits and losses from either end of the risk spectrum can be more equally shared across insurers.

Focus questions

12. How should the relative riskiness of contractors be assessed?
13. What approach should SIRA take to location-based pricing of premiums?
14. Are there any issues with the current risk-based pricing model?
15. Should SIRA regulate risk-rating criteria that must be considered, or should individual HBC providers be able to determine their own risk rating methodologies for the purpose of pricing their products?
16. How can SIRA best support evidence-based risk-ratings that support best practice in the building industry (e.g. through giving licensed HBC providers better access to data or data analytics services)?
17. Should SIRA place controls or limits on how providers apply risk loadings or discounts to contractors? If so, why and what should they be?
18. What, if any requirements should SIRA impose on licensed HBC providers to ensure that risk-based pricing is done in a clear and transparent fashion that ensures contractors understand why ratings have been applied and how contractors can improve their rating?
19. Should risk-based pricing accommodate more flexible eligibility standards, (e.g. to allow contractors to pay a premium loading or surcharge to take on work beyond their current eligibility limit without the need for it to be reviewed)? What issues would such arrangements need to address?
 - Note: we have asked related questions in our discussion paper about contractor eligibility standards.
20. How should SIRA approach managing the sharing or equalisation of risks across different HBC providers in the HBC Scheme?

Premiums for new HBC products

The NSW Government's reforms are designed to enable and encourage product innovation by HBC providers.

The legislation passed by the NSW Parliament includes provisions to put beyond doubt that HBC products *can* provide for additional matters that are not inconsistent with the requirements of the *Home Building Act 1989* or its regulations.⁶ Regulations can also be made to provide examples of additional matters that may be provided for as part of HBC products. This is intended to enable the bundling of related services and options for contractors or homeowners as part of HBC products.

The legislation also includes provisions to specifically enable products to be offered that cover risks or losses that are additional to the minimum standards prescribed in the *Home Building Act 1989* and regulations. This is intended to allow products such as 'first resort' cover where a home owner can claim in some circumstances where the contractor is still solvent and trading.⁷

⁶ This is provided for by the insertion of new Section 102 (5A) in the Home Building Act.

⁷ This is provided for by the insertion of new Section 102 (8) in the Home Building Act.

The legislation also enables HBC cover to be provided in the form of two separate products (currently all insurance must be in one contract that provides a minimum of \$340,000 of cover against all the risks required to be insured). These two 'split cover' products are:

- a **construction period insurance contract**, to provide a minimum of \$340,000 of cover for home owners against a risk of loss due to non-completion and associated breaches of statutory warranty during the construction period, and
- a **warranty period insurance contract** to provide a minimum of \$340,000 of cover for home owners against the risk of loss after the work is complete for the duration of the statutory warranty period.

Focus questions

21. Are there ways that the premium guidelines could facilitate licensed HBC providers to offer innovative products?
22. How should the premium guidelines assess the pricing of split cover products, products that indemnify other risks or losses, or products that include additional services or options?
23. Should SIRA assess premiums only in respect of the component relating to the minimum standards required for HBC cover, or the total price inclusive of any innovative features that exceed minimum requirements?
24. How can the premium guidelines support transparency for contractors and home owners about the cost of HBC products, including product innovations that exceed minimum requirements?
25. What, if any, controls should SIRA place on HBC product policy wording and conditions that relate to premiums or other fees or charges associated with HBC products?
26. What if any requirements for premiums should SIRA apply to support the entry of new providers in a competitive market, but also support sustainability?
27. What if any controls should SIRA place on licensed providers offering premium discounts for bundling HBC cover with other separate products that SIRA does not regulate?

Next steps

SIRA will review all submissions and prepare a summary of the feedback received. The feedback summary will be published on the SIRA website. Information provided through this consultation process will be used to develop regulatory options for consideration by the government.

Any questions or enquiries regarding this discussion paper should be emailed to hbcreform@sira.nsw.gov.au

Disclaimer

This publication may contain information that relates to the regulation of workers compensation insurance, motor accident third party (CTP) insurance and home building compensation in NSW. It may include details of some of your obligations under the various schemes that the State Insurance Regulatory Authority (SIRA) administers.

However to ensure you comply with your legal obligations you must refer to the appropriate legislation as currently in force. Up to date legislation can be found at the NSW Legislation website legislation.nsw.gov.au

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