Latent Defects Insurance likely to be a game-changer in NSW

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At a glance

- A new insurance product, Latent Defects Insurance (LDI), is set to transform the insurance framework for high-rise residential buildings – especially if it becomes mandatory in New South Wales.
- This is a major development being considered by the NSW Government, which is aimed at restoring consumer confidence in the state's residential construction industry.
- The introduction of LDI is also intended to help address any disconnect between the government's legislative reform agenda and the very stark commercial realities of the insurance market.
- The continuing legislative reforms in the NSW construction industry, coupled with the greater use of rating systems, are likely to produce the market conditions for LDI to evolve.

The building compliance crisis

Serious building defects in high-rise residential developments have become commonplace since the privatisation of the certifying role in the 1990s. Subsequent decades of deregulation in the pursuit of productivity resulted in a consumer confidence crisis in the NSW construction industry. The most dramatic examples of how this crisis has played out are the evacuations of Sydney's Opal Tower (December 2018) and Mascot Towers (June 2019), and the resulting public and legal disputes that followed.

NSW building reforms

The ongoing media focus on the confidence crisis, combined with the ever-increasing rate of high-rise residential construction (particularly in Sydney), put pressure on the NSW Government to intervene. The government's response was to implement wide-ranging reforms of the construction industry, which included the *Design and Building Practitioners Act 2020 (NSW)* (DBP Act) and the *Residential Apartments Building (Compliance and Enforcement Powers) Act 2020 (NSW)* (RAB Act).

The NSW construction industry has now moved into a highly regulated phase. This will continue as the NSW Government's objective is to "change the culture of the NSW construction industry" and rebuild consumer confidence. While the focus of the first wave of reforms was on the high-rise residential sector, further law reform will expand to cover other sectors.

The NSW Government reforms are intended to rebuild consumer confidence by:

- increasing the liability of building professionals
- requiring mandatory insurance for building professionals
- enhancing the construction industry's compliance and licensing regimes, and
- enhancing enforcement powers to ensure compliance.

The NSW Government reforms have changed the liability landscape for insurers of building professionals. However, some insurers think that law reform should attempt to complement existing insurance arrangements or, at least, try to ensure some coordination with the insurance industry. A common sentiment among commercial insurers is that the government has simply pushed the problems associated with defective residential building works onto the insurance industry, and particularly onto professional indemnity insurers.

The introduction of LDI is intended to help address any disconnect between the government's legislative reform agenda and the very stark commercial realities of the insurance market.

What is LDI?

LDI is first party cover for building owners. It is intended to provide insurance of first resort that allows owners, and subsequent owners, to make claims regarding latent building defects under the LDI policy rather than against the building professionals responsible.

The common features of LDI are shown in the following table:

Feature	Commentary
Building type	Class 2 (high-rise residential)
Insured property	All major elements (including structural, fire safety systems and waterproofing)
Insured	Owners and subsequent owners
Policy purchaser	Developer
Premium	1.5% to 2% of construction value
Trigger	• manifestation of defect, or • physical damage, and/or • imminent threat of physical damage
Excluded property	Equipment, fixtures and fittings, and non-structural works
Excluded perils	Fire, storm, corrosion, gradual deterioration and accidental damage (i.e. all those risks that are usually covered by strata insurance)
Period of insurance	10 years from issue of occupation certificate

LDI will typically be taken out by the developer before construction commences and will attach to the building rather than any particular person or entity. This means it will cover subsequent owners for 10 years.

To obtain LDI, developers will need a sufficient Independent Construction Industry Rating Tool (iCERT) score.

iCERT

iCERT is a developer/builder rating tool operated by Equifax. The rating tool uses past performance, financial viability and corporate governance to assess a developer's ability to deliver trustworthy buildings.

The theory is that the use of iCERT, coupled with the government's reforms, will provide the favourable conditions necessary for LDI products to develop in NSW. The objective is to provide all participants in the high-rise residential construction space, including lenders, insurers and consumers, with confidence that the end product meets all the relevant codes and standards – in other words, high quality, safe and fit-for-purpose buildings.

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The existing insurance landscape for high-rise residential buildings

The government's view is that LDI will plug gaps in consumer protection for apartment owners. The primary insurance products currently used during the construction and occupation phases of high-rise residential buildings are professional indemnity, contract works and strata property insurances. In the following table, we compare these covers with LDI cover at a high level.

Insurance	Cover	LDI benefits
Professional indemnity	Third party claims insurance for breach of professional duty	LDI is first party claims insurance that provides cover over and above breach of professional duty – it does not require the building owner to make a claim against any building professional said to be responsible for a defect
Contract works	First party insurance for damage to building works during the construction phase	LDI extends over a 10 year period after the occupation certificate is issued and after any defects liability period has expired
Strata	Mandatory first party insurance for damage to buildings – excludes latent building defects	LDI covers latent building defects

This comparison highlights the benefits LDI products are expected to deliver for residential high-rise owners.

Currently, the *Home Building Act 1989 (NSW)* (HBA) is the primary consumer protection feature in the residential space. The main objective of the HBA is to incorporate statutory warranties into every residential building contract so that work can be done in a proper and workmanlike manner, and in line with plans and specifications. The HBA imposes those warranties on developers and builders. The warranties "run with the building" for six years after practical completion for major defects (e.g. structural defects) and two years for minor defects (i.e. non-structural defects).

However, recovery problems arise when developers and builders become insolvent or use project-specific (shell) companies to undertake developments. The *Home Building Compensation Fund* (HBFC) was set up to deal with that risk. However, the HBFC:

- is a policy of last resort underwritten by the NSW Government – it operates only if the developer and/or builder is no longer in existence
- buildings of more than three storeys are exempt from requiring cover – in other words, the HBCF is essentially limited to class 1 buildings, leaving high-rise residential buildings unprotected by the scheme, and
- HBFC coverage is capped, so the insurance payouts may not represent the full value of the loss incurred by building owners.

The other main consumer protection feature is the 2% (of contract price) strata building bond required to be paid by developers. However, this bond is only held for two years.

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Government intervention

The options currently being considered by the NSW Government are:

- repeal of the strata building bond scheme and the introduction of mandatory LDI – this would mean that developers would not need to provide a 2% bond, but would need to obtain LDI from the commercial insurance market, or
- the encouragement of a viable commercial market for LDI by increasing the strata building bond from 2% to 5% and extending it from two years to six years – the rationale is that economic and market forces will encourage the development of LDI products in NSW.

Whichever way the government goes, it seems intent on making LDI a central feature of insurance arrangements for high-rise residential buildings in NSW. This is unsurprising given that 39% of apartment buildings have serious building defects, and the average remediation cost to owners' corporations is about $300,000.

Benefits of LDI

The benefits of LDI include:

- ensuring only developers with adequate iCERT ratings will be able to obtain LDI – this will provide greater
    a) consumer protection for purchasers (i.e. an insurance safety net), and
    b) confidence in the ability of the developer to construct a trustworthy building
- greatly diminishing the risks associated with phoenixing
- avoiding the need for owners' corporations to litigate regarding latent building defects, in turn meaning they will not incur the legal costs associated with multi-party litigation against building professionals and others (noting there may be an increase in subrogated recovery actions against building professionals by LDI insurers), and
- protecting current and subsequent owners as the policy will "run with the building".

There's no doubt the LDI will impose a cost on construction businesses. However, developers are likely to obtain a better price from consumers by offering the added confidence of LDI.

Industry improvements will benefit insurers too

Commercial insurers will not cover risks that they cannot accurately assess and price. The NSW Building Commissioner, David Chandler, has said that "… once insurers trust developers and builders, they would come back to the industry, provided that there are profits to be made at a reasonable level of risk."

The ability of insurers to assess and price risk in the NSW construction industry is likely to strengthen as the legislative reforms change the culture of the industry and rating systems like iCERT provide greater transparency and certainty about developer performance.

These improvements will give LDI insurers the ability to accurately assess, rate and price the risk associated with a particular building. LDI policies, and the associated iCERT rating, are also likely to help the government deliver its objective of restoring consumer confidence in the high-rise apartment sector.

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