

Capital Management Plan

Background

Until the start of this Fund in 2013, the Northern Territory of Australia (NTA) had a first-resort scheme, the Home Building Certification Fund (HBCF), covering non-compliance with building standards. That scheme provided unlimited cover for a period of ten years from completion of work. There was no protection against non-completion.

Following a number of insolvencies over the previous two years, the NTA government introduced legislation, to:

- tighten the licensing requirements for builders;
- control contractual arrangements, with particular emphasis on progress payments;
- introduce compulsory residential building insurance (RBI); and
- provide for a residential building fidelity fund (FF), to be managed by the MBA.

The legislation to introduce RBI and provide for a fidelity fund is the Building Amendment (Residential Building Consumer Protection) Act 2012 (the Act), assented to on 27 April 2012, and amending the Building Act. The associated regulations are the Building (RBI and Fidelity Fund Schemes) Regulations. In accordance with Section 79 of those Regulations, as soon as practicable after the end of the first year of approval and each financial year of the scheme, the trustees must review the capital management plan and, if necessary, amend the plan and submit the plan (whether amended or not) to the Minister for approval.

The RBI provides last-resort protection against both non-compliance and non-completion. It covers houses (BC1) and units (BC2), but not external work, such as landscaping, pools and driveways, nor renovations that do not change the building's floor area. In order to claim, the builder must be unable to fix or complete the work, as a result of insolvency, death, disability or disqualification. Non-completion (insolvency) requests are limited to the lesser of \$200,000 and 20% of the contract value. Non-compliance (warranty) cover runs from completion for one year for non-structural defects and six years for structural defects, subject to a maximum claim of \$200,000, less any amount paid under non-completion.

RBI is open to licensed insurers and, while the Act envisages multiple FFs, I understand: that the consensus is that the market is too small to support more than one FF; and that no insurers will be participating. The FF currently underwrites all the market. This is likely to constrain the ability of the FF to refuse to provide certificates to builders that do not meet its criteria for financial stability and quality of work.

Sources of capital

The principal sources of capital for the Fund are:

- A loan of \$750,000 provided by DIPL with the principal repayable on 30 June 2025 but subject to extension if the Fund does not then have sufficient reserves;
- A guarantee by the NTA to pay any cash shortfall on payment of requests, for 5 years but subject to annual extensions if the Fund does not then have sufficient reserves;
- An explicit capital contribution, built into the contribution rate scale;
- The allowance, within the contribution rate scale, for adverse levels of claim.

This last allowance calls for some explanation. Builders warranty insurance is highly sensitive to the health of the economy generally and of the building industry in particular. Valid requests can only arise under specific conditions, the most important of which is the insolvency of the builder. If the building industry is healthy, then insolvencies are likely to be infrequent and requests to be low. This level of requests comprises "working" claims. In times of economic turmoil, however, a very much higher ("adverse") level of builder insolvencies can occur. An example of such turmoil is the Global Financial Crisis (GFC). Because the GFC had only a mild impact on Australia, the level of builder insolvencies only increased modestly at the onset of the GFC, in contrast to what was seen in other parts of the world and, for example, in the Great Depression.

The liability estimates used in this capital management plan include an allowance for “adverse” requests of twice the level of “working” requests. While “adverse” conditions can occur at any time, the expectation is that these will not be spread evenly. Rather, they will be concentrated in periods of a few years, with longer intervals, possibly several decades long, in between. Because accounting and regulatory principles do not recognise a liability for events beyond the expiry of existing certificates, unless an “adverse” event actually occurs, that part of the contribution flows into surplus over the life of the certificate and must be accumulated as capital against the day that one does occur.

Capital target

In accordance with the Actuary’s advice, APRA requirements and NTA guidance, the Trustees have, on 8 February 2013, adopted a minimum capital amount (as required by regulation 79(2)(a)) in the form of a solvency margin (net tangible assets), estimated in accordance with APRA standard GPS 340, of \$2 million and an additional capital amount (as required by regulation 79(2)(b)) of \$3 million. These, together, give a total capital target of \$5 million, which the Actuary advises should be increased broadly in line with inflation. The Fund has already achieved the minimum capital position as at 30 June 2023.

The distinction between GPS 340 solvency and the accounting treatment is an important one. The accounting treatment of contributions is retrospective. It releases contributions paid into request liabilities, expenses and profit progressively over the period of coverage, in proportion to the expected cost of coverage. Thus, nothing is released into profit at inception. The GPS treatment of contribution liabilities, in contrast, is prospective. The liability is the expected present value of requests and associated expenses, plus a risk margin. If the contribution exceeds the initial liability, there is an immediate release of that excess into surplus. In the case of the contributions for the Fund, there is a substantial capital contribution, over and above what is needed for the risk margin, and this is released into surplus when a certificate is issued.

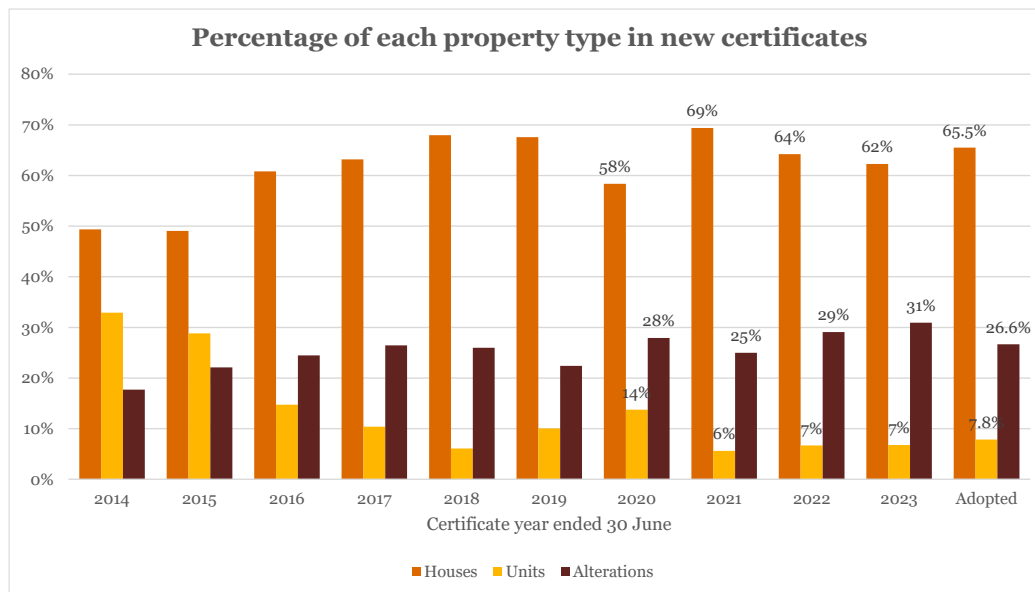
Review of Projection Assumptions

The projection is highly dependent on its key assumptions. To ensure the key assumptions remain relevant, we have conducted a review and altered some of them for the projections in this appendix.

The projection shown considers an expected certificate volume of 550 p.a. going forward, i.e. the scenario defined in Section 7.5. Assumptions relating to the type of properties for new certificates are largely unchanged. The proportion of houses has increased marginally from 65.4% to 65.5%, the proportion of additions and extensions has increased from 26% to 27% and the proportion of units has decreased from 9% to 8%. These revisions reflect the emerging experience where there has been an increase in the mix of houses and a reduction in the mix of units certified. Therefore, a 5-year average has been taken since building activity in NT has been particularly subdued since 2018, barring the 2020/21 financial year.

The following chart shows the split of property types for MBFF by policy year. It shows that, early in the Fund’s life, units formed a significantly greater portion of new certificates than additions and extensions, though additions and extensions have now become more common than units. These assumptions affect the projected value of certificates since the projection model assumes a separate average value for each property type.

Mix of certificates volume by property type over time

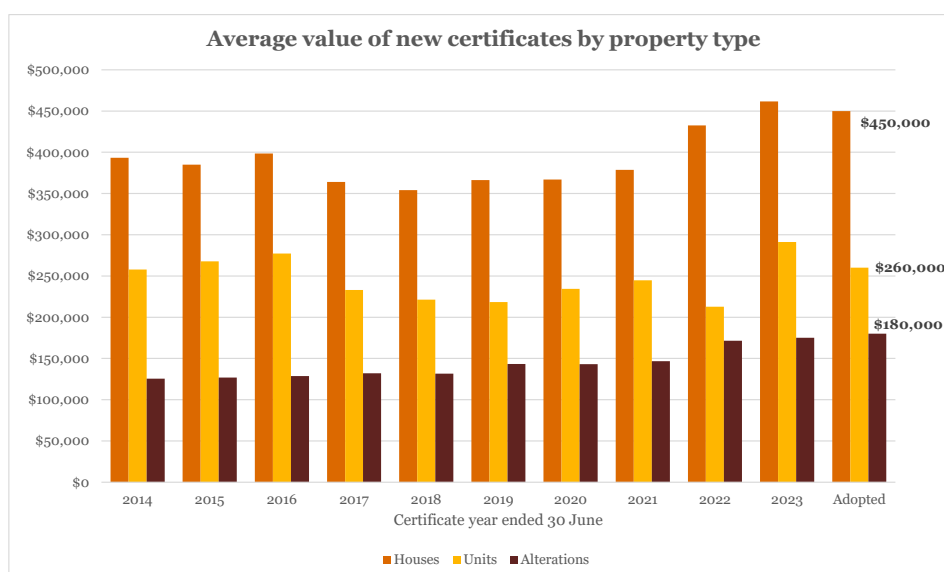


The average value for all property types has roughly increased by 6% to the following assumptions:

- House: \$450k
- Unit: \$260k
- Additions and extensions: \$180k

These adopted values reflect the average values for each property type over the last two underwriting years. The following chart shows average value by property type and policy year for MBFF. Average value over the last two years has increased compared to the previous reviews for all property types, averaging \$449K, \$257K, and \$176K for houses, units and additions and extensions, respectively.

Average contract value by property type



Note that property types were based on a text analysis of the descriptions provided by MBFF in the file “Historical Fidelity Certificate 2013 to 2023.xlsx”. A small number of certificate records had ambiguous or incomplete descriptions. This is likely

to have minimal impact on the results and conclusions above since the descriptions have only been used to derive percentages and averages for each property type (as opposed to totals, which would be heavily influenced by categorisations).

The direct expenses assumed have increased from \$150k to \$225k p.a. compared to the Capital Management Plan as at 30 June 2022 for the first projected financial year to reflect the higher expenses observed in the current year.

The management fees assumed have been updated to be the greater of 30% of all contributions paid to the fund or \$801,866 (which is the management fee charged in 2022/23), inflated by the assumed inflation rate of 3.50% per annum.

Besides the above, no other projection assumptions have been changed since the previous report. The Actuary has adjusted the calculations in that report to incorporate the results of the Fund's operation, up to the valuation date, including the results of this valuation.

Projection Results

The projection results are shown below. The Actuary emphasises that these are projections, not forecasts or estimates. The probability that these will closely resemble what actually emerges is likely to be small.

In the projection, direct expenses are about \$0.225 million, increasing at the assumed inflation rate of 3.50% per annum, and a management fee of the greater of 30% of contributions and \$801,866 (in 2022/23 dollars) inflated by the assumed inflation rate of 3.50%. Contributions are projected under the scenario of 550 certificates and increase at the assumed inflation rate of 3.50% per annum.

The projections assume that the Fund is subject to Company Tax of 27% of accounting profit.

The accounting projections assume that the current insurance accounting regime (AASB 1023) remains unchanged. A new international insurance accounting standard is likely to emerge during the term of the projections and may have some impact.

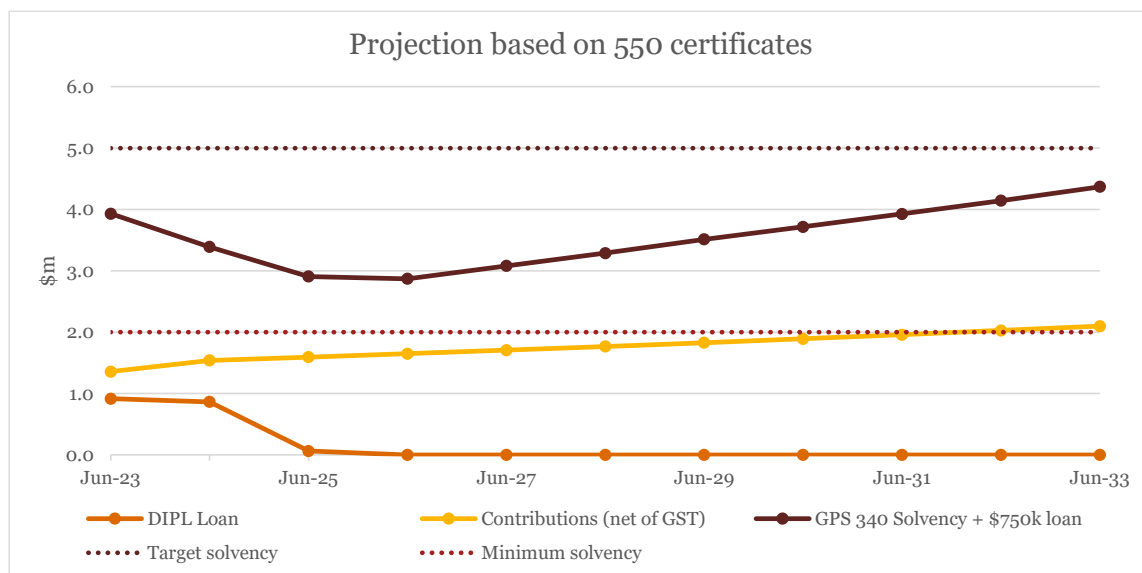
Expected Outcome – 550 certificates p.a.

This projection assumes "working" claims, plus half of the yearly allowance for adverse claims, at the rates assumed in the Actuary's valuation calculations. The figures overleaf and the chart below uses the expected outcome presented of 550 certificates for all future periods up until the end of fiscal year 2033. As discussed in Section 7.4, this has reduced by 50 certificates compared to the last review due to lower long-term average volumes.

The current cash position is about \$4.9 million. Given the DIPL loan is expected to be repaid fully over the next three years, the actual cash position at the end of 2032/33 is expected to increase to \$7.3 million. The cash position is projected to grow faster than under the expected outcome projection of the last review due to increased investment rates reflected by the uplift in the Australian yield curve. Under this scenario, there would be no cash call against the NTA guarantee over the next year.

The projection assumes that the loan will be repaid in equal annual instalments of \$51,645 to cover the interest and administration fee accrued up until 30 June 2020, as well as additional repayments to account for the interest and administration fee accrued later. The final repayment relating to the accrued interest and administration fee is assumed to occur on 31 January 2026, whereas the outstanding principal of \$750,000 is expected to be paid on 30 June 2025. These assumptions are based on the revised deed containing new repayment terms for the DIPL loan. As such, it is assumed that the loan will be repaid in full by 31 January 2026.

On the GPS 340 solvency basis, the current solvency margin is about \$3.2 million excluding the DIPL loan. There are reductions in the short-term until 30 June 2025, after which the principal on the DIPL loan is repaid. This is followed by an increase in the solvency position over the next 8 years of 54% due to contributions and investment income outweighing request costs and expenses, with the projected solvency position returning to \$4.4 million at the end of fiscal year 2033 (which does not include the DIPL loan as it was repaid in 30 June 2025).



Multi-Year Projection	30/06/2023	30/06/2024	30/06/2025	30/06/2026	30/06/2027	30/06/2028	30/06/2029	30/06/2030	30/06/2031	30/06/2032	30/06/2033
Contributions (net of GST)	1,356,227	1,539,398	1,593,277	1,649,041	1,706,758	1,766,494	1,828,321	1,892,313	1,958,544	2,027,093	2,098,041
DIPL Loan Balance	-916,858	-865,213	-63,568	0	0	0	0	0	0	0	0
GPS 340 Solvency	3,180,605	2,637,896	2,844,317	2,870,210	3,081,059	3,288,295	3,512,352	3,716,754	3,925,375	4,142,132	4,369,682

**Note that this GPS 340 Solvency does not include the \$750k DIPL loan, therefore is lower than the solvency margin graphed above*