



Department of
Building and Housing
Te Tari Kaupapa Whare

Guidelines on 'Adequate Means' for Private Building Consent Authorities

April 2008



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This document has been prepared by the Department of Building and Housing (the Department) as guidance information in accordance with section 175 of the Building Act.

The recommendations and suggestions in this guide are not mandatory and are not intended to be prescriptive. Quality documentation can be provided in a number of ways. This guide is intended to provide guidance only.

This document is not a substitute for professional advice. While the Department has taken care in preparing the document, it should not be relied upon as establishing compliance with the Building Code in all cases that may arise. This document is not a Compliance Document in terms of the Act and may be updated from time to time. The latest version is available from the Department's website at www.dbh.govt.nz

Summary

Private organisations seeking registration under the Building Act 2004 (the Act) as building consent authorities must satisfy the Department of Building and Housing (the Department) that they have 'adequate means' to cover any civil liabilities that may arise in the performance of the organisation's functions as a building consent authority. This might be achieved, for example, through insurance, a bond or a guarantor.

The Department would assess whether the organisation's arrangements for meeting civil liabilities are adequate in the event of a claim for damages. This would include arrangements for any claims that may arise within 10 years after an organisation ceases to provide building consent authority services.

Following public consultation in 2007, the Department has recommended to Ministers that regulations be made under the Act prescribing minimum terms and conditions, and acceptable conditions and exclusions for building consent authority civil liability insurance. Subject to usual government approval and drafting processes, we expect that regulations will be made and come into force during 2008.

These guidelines, while developed in anticipation of the proposed regulations, should in no way be interpreted as pre-empting the outcomes of government policy or regulation development processes. Rather the Department wishes to provide general information in a timely manner to assist potential applicants. In particular, so they can consider whether they might, in future, seek accreditation and registration as a building consent authority; and what information might be necessary for the Department's assessment of adequate means.

Introduction

The Government is implementing a series of reforms to improve consumer protection and increase public confidence in the building control sector. The accreditation and registration of building consent authorities to ensure further professionalism, competencies and upgrading of quality assurance measures in the building consenting and inspection processes are key aspects of the improvement process.

Collectively these initiatives help to ensure:

- improvements in the competencies and performance of all who participate in the building sector, including designers, constructors and regulators
- better-quality buildings and outcomes for all consumers.

These guidelines provide information to assist private organisations¹ who may, in future, consider applying to be registered as a building consent authority under the Act. In particular, the guidelines explain requirements relating to the assessment the Department would undertake of an organisation's means of covering civil liabilities.

¹ A private organisation includes an organisation that is not a territorial or regional authority and that is empowered under the Building Act 2004 to undertake the functions of a building consent authority (eg, issuing building consents, undertaking building inspections and issuing related certificates and approvals).

What is required?

Section 192(1)(c) of the Act requires the Department to be satisfied, before registering a private organisation as a building consent authority, that the organisation has adequate means to cover any civil liabilities that may arise in the performance of building consent authority functions.

In determining whether an organisation has adequate means, the Department may have regard to whether the organisation:

- holds an insurance policy that meets the minimum terms and conditions prescribed by regulations made under section 402 of the Act
- holds an insurance policy under a scheme of insurance approved by regulations made under section 402 of the Act²
- has put in place any arrangements that provide for effective consumer protection (for example, by giving a bond or having a guarantor).

The Department has proposed that minimum terms and conditions for private building consent authority civil liability insurance be prescribed in regulations as follows.

- Cover for claims arising in the year the annual premium applies
- Forward cover for at least 10 years for claims arising out of building control work undertaken during the year the annual premium applies. This cover must apply even if the private building consent authority ceases operating during that 10-year period³
- Retrospective forward cover, where applicable, for claims made in future years arising out of building control work undertaken in years prior to commencement of the policy. This cover is only required where building control functions performed in the last 10 years are not already covered by some other form of adequate means
- Continuous cover that may not be cancelled by the insurer without at least 60 working days' prior notice⁴
- Insurer's liability for the costs and expenses of defending or settling any claim incurred, with the consent of the insurer
- A self-insured deductible or excess under the policy that is no more than \$20,000 for each and every claim
- A sum insured, not less than the sums specified in Table 1 below, that is the maximum amount of liability of the building consent authority for which the building consent authority is indemnified by the policy (ie, for claims made in relation to building control functions carried out in each year the annual premiums apply)

² No such regulations have been made as the initiation of such a scheme is the prerogative of private enterprise – for example, prospective private building consent authorities and/or insurers.

³ If cover was for less than 10 years (the period allowed by the Act for claims to be made), consumers of private building consent authority services would have substantially less protection than the consumers of territorial or regional authority building consent authority services.

⁴ Notice is required to enable the Department to consult with the private building consent authority and for the authority to otherwise demonstrate that it has adequate means. Failure by the authority to demonstrate adequate means within that time would be a failure to meet the standards and criteria for registration.

Table 1

Total value of building projects the building control functions relate to	Sum insured for any one claim	Sum insured in the aggregate for all claims
Less than \$5,000,000	\$1,000,000	\$2,000,000
\$5,000,000 or more	\$1,000,000 plus \$150,000 for every \$1,000,000 or part thereof over \$5,000,000 of building project value	Twice the relevant sum insured for any one claim ⁵

The Department has proposed that insurance policies may include standard insurance conditions and exclusions necessary to:

- enable the insurer to effectively meet their obligations under the policy
- protect the insurer from specific or unusual events unrelated to building control functions
- protect the insurer from dishonest or malicious clients
- enable insurers to limit their liability in respect of financial penalties that might be imposed on their clients (eg, by a court).

Examples of matters covered by such standard conditions and exclusions include:

- admitting liability, settling claims or incurring costs and expenses without the written consent of the insurer
- giving reasonable cooperation to the insurer and prompt notice of any claim made and of material changes in the risk
- the provision of information
- setting and reviewing premiums
- claims arising from allegations of defamation, ionising radiation, acts of war or similar events
- claims caused or contributed to by dishonest, fraudulent, criminal or malicious acts or omissions
- limiting liabilities to pay fines, punitive or exemplary damages.

Civil liability insurance policies with conditions or exclusions that, in the Department’s view, substantially reduce the value of cover may be regarded by the Department as contributing to adequate means but, on their own, may not be accepted as constituting adequate means for the purpose of the Act. Examples of such exclusions would include exclusions relating to weathertightness or toxic mould claims.

⁵ That is, twice the sum insured derived from the formula in the adjacent column of the table.

How would the Department assess adequate means?

The Department's assessment of whether a private building consent authority has adequate means would be based on an assessment methodology as outlined below.

The Department would assess all of the following components.

- The applicant's risk management arrangements, in particular:
 - exposure to risk
 - operational risk management procedures
 - total risk (including transferred risk and retained risk)
 - funded liabilities
 - unfunded liabilities
- The likely retained liability
- The capital available to support the likely liability
- Whether adequate means is assured for the full responsibility period

The Department would, as appropriate, seek and consider advice from specialist advisors engaged by the Department from the fields of insurance, law, finance/accounting and risk management. If the applicant does not have similar specialist 'in-house' expertise, the Department would recommend that applicants consider engaging specialist advisors to prepare supporting information. Such information should demonstrate how they have addressed the above components in their application.

Appendix A contains a risk management framework that illustrates how an organisation seeking registration as a building consent authority would be expected to plan, implement and monitor its risk management strategy.

What evidence would be needed to support an application?

In completing an application, robust documentary evidence would be needed to show how the applicant has addressed the components used to assess adequate means. An example of robust evidence of available capital would be audited financial accounts and business plans showing how capital is to be used or managed for the foreseeable future.

Exposure to risk

To assess the exposure, among other things, it would be necessary to consider:

- statistics on the number and value of all buildings (if any) for which consents and certificates have been issued in the last 10 years
- the projected statistics for the next year from the applicant's business plans
- any historical claims and outcomes and/or current litigation.

Exposure may also depend on the location and type of buildings to be consented/certified and the scope of accreditation and consequent consenting and certification activities.

The likely liability would generally run off over the 10-year period. It is important, therefore, to keep records of each year's consents and certificates separately to enable an estimate of the likely liability. Initially there would be no history to consider, so projections would need to be clear (as would the assumptions that underpin them).⁶

Operational risk management procedures

Operational risk management procedures would generally concentrate on reducing the likelihood of any errors or negligence occurring, and hence reducing the likely frequency of claims. The assessment of operational risk management would primarily be addressed during the accreditation process rather than the adequate means assessment.

For the assessment of adequate means the Department would, however, take account of operational risk management procedures that reduce liability by reducing the maximum amount and/or the average claim amount – for example:

- any liability cap (limitation on the maximum liability) that is legally and effectively able to be included in contracts
- any client acceptance procedures or criteria that the building consent authority has in place, as these can potentially reduce risk of liability claims.

⁶ Depending on when litigation begins and how long it takes to be resolved, liability could extend beyond the 10-year limitation in the Building Act 2004.

Risk

To help the Department understand and consider all the risks, it would be useful to construct a table of all the likely liabilities you may face in carrying out consenting and certification activities and the likely maximum amount and duration of each liability.

Other factors that need to be taken into account are the extent of:

- joint and several liability that is in place, as this increases your risk if a jointly liable party is not in a position to pay their contribution to the loss. You would need to show evidence of their ability to cover their share, or how you would cover it in the event of default
- uninsured liability in any event for which a claim is made (assuming your insurance is on a claims-made basis) in the period that falls outside the policy definitions or is subject to an exclusion, or any amount over the maximum insured, plus the excess.

Transferred risk

There are a number of ways that risk can be transferred to other parties. Examples of these and the evidence that would be required by the Department are:

Contract or other arrangements to transfer risk

Full details would be required of all contracts or arrangements that are in place to transfer risk, including:

- contract parties
- scope of contract
- period of contract
- amount of contract.

An example of a transferred risk would be a contract with a builder in which the builder guarantees to rectify any building defects. This may be backed up by building warranty insurance to cover any remaining risks, including the bankruptcy risk of the builder.

Professional indemnity insurance

The assessment of insurance cover would consider the current insurance contract and the applicant's likely ability to continue to obtain this cover for the full 10-year run-off period.

The assessment of insurance cover would consider all relevant information including:

- the capital available to support the likely liability
- whether adequate means is assured for the full responsibility period
- the rating of the insurance company providing the cover
- the definition of liability (generally a professional negligence definition)
- any other civil liabilities covered
- the term and nature of the insurance
- the maximum amount covered and the reinstatement of cover provisions
- policy conditions
- exclusions
- amount of excess
- premiums.

The assessment would take into account the significance of insurance to your risk management strategy and your ability to purchase ongoing insurance based on your previous claims experience and any emerging liability claims.

Other risk transfer

You would need to provide full details of any other risk-sharing arrangement with a third party.

This would include evidence of:

- the terms, duration and scope of the arrangement
- the intended action at the end of the term
- any additional arrangements in place to back the risk-sharing arrangement.

Organisations would need to consider any circumstances where the risk-sharing arrangement may break down, whether this causes the liability to fall on the organisation and how this would be managed. Examples of potential circumstances would be if the other party to the risk-sharing were to go out of business, or if the term of the arrangement is less than the full responsibility period.

Retained risk

You may find it useful to develop a table, such as the one below, to clearly document all likely risks. This would make it easier for the Department to identify and understand the full risk picture.

Table 2 shows an example of one risk divided into total risk, transferred risk and the net retained risk.

Funded liabilities

It is not necessarily a requirement that you fund your retained liabilities. However, if some of the liabilities are to be funded, it demonstrates a serious commitment to the risk management strategy, and is likely to make the assessment of adequate means somewhat easier.

When assessing the funding arrangements you have in place, the Department would need to consider:

- the risk being funded
- the type of arrangement for funding
- whether there are any charges, covenants or restrictions over the assets backing the funded liability
- any arrangements to separate the fund from day-to-day business activities
- the extent and pace of funding – for example, whether it is fully funded or includes any additional margins
- monitoring procedures in place
- data and assumptions underlying the funding calculations
- collateral data such as industry experience or insurance premiums
- the nature of the assets or other instruments backing the fund.

Table 2

Risk	Component	Secondary risks	Maximum	Duration
Negligence	Total		Building value	10 years
	Insured		500,000	1 year
	Net retained		50,000 plus (claim – 500,000)	
		Non-renewal of insurance	Building value	9 years

Unfunded liabilities

There are two parts to this final stage.

1. Assessing the remaining assets, capital and access to additional capital
2. Assessing the remaining unfunded liabilities

You would need to provide detailed financial information, along with details of all financial assets and instruments. If you are proposing to raise additional capital, or invoke a guarantee or another arrangement to cover unfunded liabilities as they arise, the details of these arrangements must be provided to the Department.

You would need to provide evidence that the extra capital would be available, particularly if you intend to access the capital in times of adverse financial results.

The next stage is assessing the remaining unfunded liabilities. You would need to provide detailed information on the extent and nature of the remaining unfunded liabilities. The Department may combine the unfunded and the funded liabilities and consider all the retained liability together.

Sustainability

The assessment would need to carefully consider the sustainability of any arrangements. The 10-year responsibility demands this. The main problems in the past with private building certifiers resulted from lack of sustainability of arrangements. Principally, there were the difficulties in renewing professional indemnity insurance without substantial exclusions and the loss of all insurance on ceasing business.

The assessment would consider, for example, the effect on the run-off liability of insurance being cancelled.

Applicants would need to provide evidence of:

- mechanisms in place to continue to provide for likely liabilities on ceasing business or winding up the company
- provision for controls that may be needed around the paying of dividends or return of capital that resulted in the adequate means capital position being breached.

Appendix A: Risk management framework⁸

A key factor in assessing the likely liability is the risk management practices of the building consent authority. In order to assess the total risk management package it is useful to consider a generic risk management methodology.

The risk management framework set out on the following pages is not intended to be comprehensive, or for all parts to be achievable. The framework is included as a guide so that the various possible mechanisms that might be used can be categorised and their effectiveness evaluated.

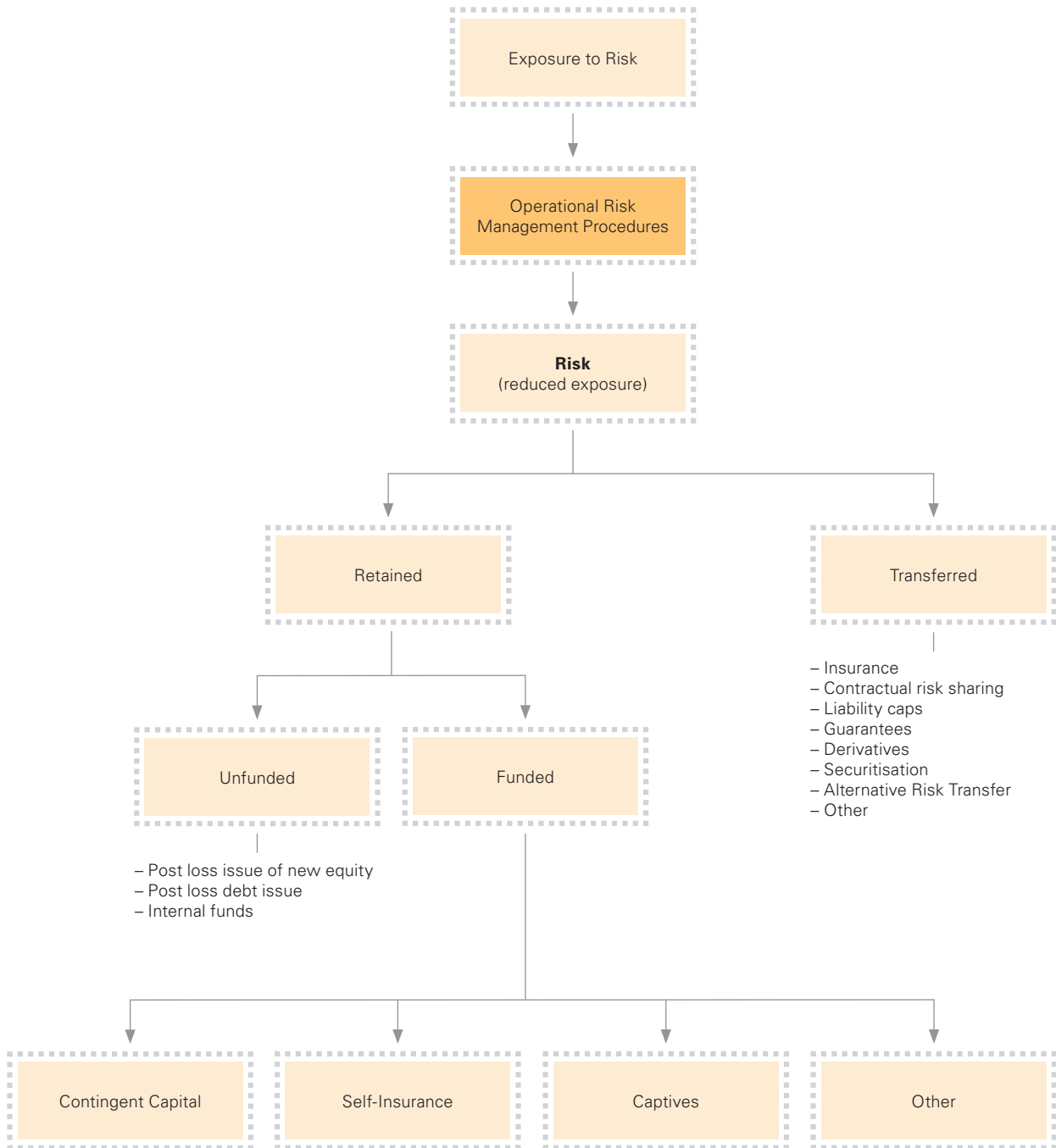
The onus is on applicants to undertake this work and present the documentation to the Department for assessment. It is likely that applicants would require legal and other professional advice to do this.

This work has to be based on realistic assumptions and to a standard that enables the Department to assess the likely liability with confidence. The required adequate means may, otherwise, have to default to the full value of all buildings consented or certified.

The diagram opposite sets out the framework. Comments follow on the specific application of the framework to a building consent authority.

⁸ The content of this Appendix has been extracted from advice provided to the Department of Building and Housing by PricewaterhouseCoopers in August 2005.

Risk management framework



Exposure to risk

The first consideration is the potential exposure to risk. This would depend on the number and value of building consents or code compliance certificates that have been issued. The risk extends for the period of 10 years from the time of certification. All buildings certified in the last 10 years as well as the planned activity over the next period (eg, year) need to be considered.

In addition to the specific civil liabilities resulting from performing the duties of a building consent authority, any other significant risks should be considered. These other risks should be considered to the extent that they would reduce the means available to cover the specific liabilities being considered by the Department.

Operational risk management procedures

The next step is to consider the operational risk management procedures. This information should largely be available from the accreditation process, and is likely to cover skills, experience, qualifications, procedures, scope of accreditation and any other relevant items.

Risk

A building consent authority is liable, for 10 years from the date the certificate is issued, for any civil liability claim for an act or omission by the building consent authority. The value of the risk under consideration is the value of future liability claims awarded against the building consent authority.

The most likely scenarios include:

- a certificate being issued for a building that does not comply with the Building Code
- failure in some aspect of the building
- subsequent inspection revealing non-compliance with the Building Code
- negligence in the process of inspecting the building and issuing the code compliance certificate.

There may be other likely scenarios where the building consent authority incurs a liability. All likely scenarios or risks should be considered, but it should not be necessary to consider every conceivable risk.

Joint and several liability adds an extra risk if any of the contributing parties have contributed to the liability, but are unable to pay their contribution.

Transferred risk

Risk can be transferred to a third party through a variety of mechanisms, including insurance.

While ultimately the risk to be considered under the Act is the public liability claim, any risk transfer that is based on the event that gives rise to the liability claim should be considered. As mentioned earlier in these guidelines, an example of this would be a contract with a builder guaranteeing that the builder rectifies any building defects. The contract may be backed up by building warranty insurance to cover any remaining risks, including the bankruptcy risk of the builder.

It would be expected that the building consent authority would also have professional indemnity insurance covering civil liabilities resulting from negligence.

Retained risk

The retained risks are defined as all risks that have not been transferred. Consideration should be given to all the details of risk transfer contracts and policies including:

- the definition of risks transferred
- the duration for which the risk has been transferred
- exclusions
- excesses or deductibles and maximums.

The retained risk should consider the full term of the liability and include allowance for:

- non-renewal of risk-sharing contracts that do not cover the full term of the liability (eg, annual contracts)
- default risk of counter-parties.

The retained risk is the basis for determining the likely liabilities for which adequate means must be shown. There are a variety of financial assets and instruments that can be used to provide the adequate means. However, all methods would involve capital or access to additional capital in some form.

Funded liabilities

The liability for the retained risk can either be funded or unfunded. The decision on whether to fund the liability would depend on the nature of the liability. In general small, frequent liabilities would tend to be funded, whereas larger, less frequent and more uncertain liabilities may not be funded. An insurance company is required to fund all of its liabilities. The insurance accounting standards would provide guidance on how much additional margin is required in addition to the best estimate.

A key distinction for funded risk is that the arrangements are put in place before the event or loss happens. In order to fund a liability, the expected value of the liability needs to be estimated in some way. This would necessitate the implementation of processes and methodology to estimate and then monitor the value of the expected liability.

There are a number of possible methods for funding the liability, some of which are discussed below.

Self-insurance

An internal insurance fund is established on insurance principles to cover the expected retained losses. The self-insurance fund might be pooled with other, similar companies.

Captives

Self-insurance may also be undertaken through a captive, which is a subsidiary company set up and managed as an insurance company. The cash-flows to the subsidiary would be initial capital, premiums and claims. If a captive is used, the assessment should be on a 'look through' basis, considering the capital of the captive as well. If the captive does not have sufficient capital, additional capital would be required elsewhere.

Contingent capital

This may take several forms, but one example would be an arrangement with a third party to provide debt capital on pre-defined terms, if a pre-defined event were to happen. The provider of the capital is likely to require a fee up front that would reflect the likelihood of the loan being taken up and the subsequent risk of default. The loan might, for example, be triggered if liability claims reached a certain threshold. Another example could be a letter of credit from a bank.

The difference from insurance is that the building consent authority would still have to repay the capital. The third party's risk is the risk of the building consent authority being unable to pay the loan rather than the original liability risk.

Unfunded liabilities

An unfunded risk is where no prior arrangement has been made for funding that risk. It is what remains after allowing for transferred risk and funded retained risk.

The default position, if no other procedures have been put in place, is for all the risk to be unfunded. A building consent authority may not be able to, or may choose not to, fund any of the liabilities. If this is the case, the remaining unfunded liabilities would be difficult to evaluate.

The unfunded liability would include the additional margins not already funded or transferred that are needed to provide the required level of sufficiency.

The unfunded liability has to be met from the remaining reserves and capital of the company, or from additional capital.

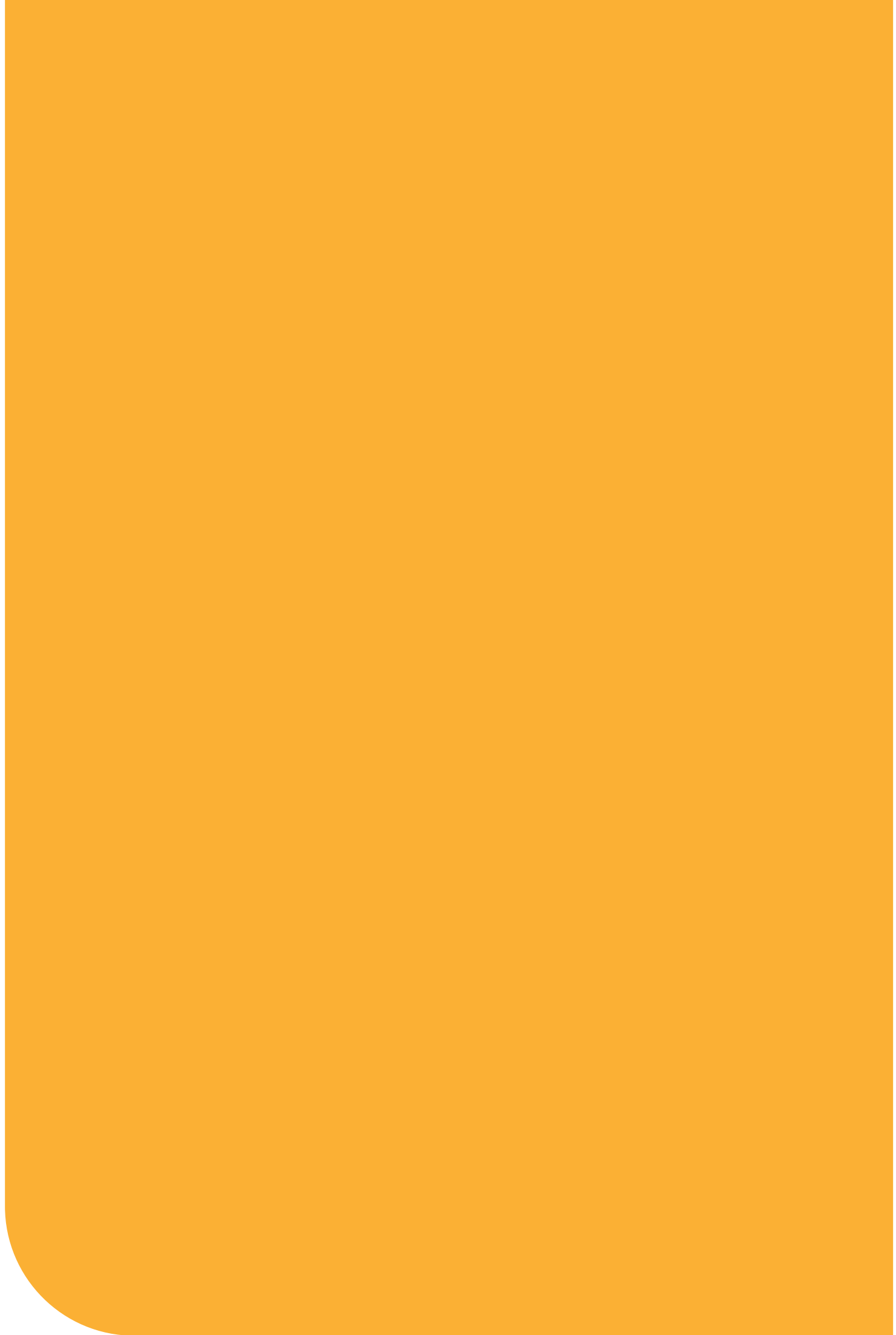
The capital reserves of the company would be evaluated from the net assets adjusted for any additional liabilities, or funded amounts already considered.

The additional capital could include borrowing capital from the bank, or a capital injection. This additional capital should only be counted towards the adequate means if there is some guarantee in place that it would be available. If there is a guarantee of availability, the amount and terms on which the capital is provided should be considered.

Sustainability

All the components discussed above have to be sustainable for the full 10-year responsibility period of the liability. If any of the components are not sustainable the risk would default down into the unfunded liability. The sustainability of this would depend on the continuing existence of the building consent authority for 10 years after it ceases operating as a building consent authority.

The risk management plan should address the arrangements for ensuring this capital continues to be available.



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