# REQUEST FOR REVIEW AND RELEASE OF NHBC STRUCTURAL WARRANTY SERVICES UNDERTAKINGS DUE TO CHANGE OF CIRCUMSTANCES

## Executive Summary

- The Monopolies and Mergers Commission (**MMC**) issued a Report in 1990 (**the MMC Report**), finding that:

    1. The National House Building Council (**NHBC**) supplied over 90% of new home warranty services[1] in the UK and had only one competitor;

    2. Rule 12 of the NHBC Rules of membership (**the NHBC Rules**) restricted competition by preventing dual sourcing and the sampling of alternative schemes; and

    3. Rules 38 and 41 of the NHBC Rules restricted competition by discouraging NHBC's members to cancel their membership in order to switch to a competing scheme due to the risk of losing cover on unsold schemes.[2]

- The MMC issued Recommendations to amend the NHBC Rules, and NHBC gave the new home warranty services Undertakings (**the Undertakings**) committing not to make any further amendments or additions to the NHBC Rules without applying for consent from the relevant competition body.

- NHBC requests the Competition and Market Authority (**CMA**) to undertake a formal review and release of the Undertakings.

- There has been a material change of circumstances since the Undertakings were issued in 1990, and the market is sufficiently different that the Undertakings are no longer relevant for the current market. The material changes of circumstances are detailed as follows:

<u>Concern</u>: NHBC's position in the market:

- Emergence of new competitors;
- Flexible mortgage lender requirements which no longer favour NHBC; and
- Reduction in market share.

[1] The MMC Report referred to structural warranty services. NHBC uses the term new home warranty and for consistency we will refer to this throughout the submission.

[2] The references to Rule 12, 38 or 41 in this submission will be to the version of the Rules of membership in effect at the time of the MMC Report.

Concern: restriction on dual sourcing:

- NHBC is no longer the benchmark; and
- House builders have the ability and incentive to dual source.

Concern: NHBC Rules 38, 41 and the omission in the NHBC Rules relating to the preservation of premium ratings and the cancellation of NHBC membership:

- Builders are now able to switch, dual or multi source; and
- Unsold houses can now be protected.

- NHBC is in the process of carrying out an internal review of the NHBC Rules to ensure they are fit for purpose, and the Undertakings restrict NHBC's ability to do so.

## Index

## PART 1: BACKGROUND TO NHBC AND THE NEW HOME WARRANTY MARKET

### Part 1.1 - Setting up and origins of NHBC

1. The history of new home warranty services in the UK is essentially the history of NHBC.[3] The boom in house building in the 1930s led to concerns over the quality of new houses. As a result, the National House Builders Registration Council (**NHBRC**) was created in 1936 to tackle the sub-standard house building practices seen in the inter-war years. NHBRC was set up as a not-for-profit organisation, and this status has remained until today (see below, paragraphs 9 to 11).

2. During the 1940s, NHBRC became the leading independent standards setting body within the industry, approved by the Ministry of Health. NHBC established an approved house builder register (currently known as the **NHBRC Register**), the first specification of standard construction for new homes which included an inspection and certification regime. The Government consulted NHBRC when drafting legislation therefore NHBRC had a quasi-regulatory role at the time. Registration with NHBRC also included a two-year warranty for the buyers of certified houses.

3. In 1955, NHBRC became independent and self-supporting using the income generated from house builder registrations. In 1967, NHBRC created a new executive committee, including representatives of all the bodies recognised by the Government as being the official voice of their particular interest in the house building market. Financial control passed away from the house builders through their own initiative. The scheme was strengthened in the 1960s, with the support of the lending institutions and house builders, as the Government threatened the imposition of statutory controls if the industry did not conform. NHBRC continued to enjoy the support of Ministers over the following years.[4]

4. In 1973, NHBRC changed its name to NHBC. From then, NHBC was in control of its governance and became independent of the Government and house builders. NHBC was approved as an insurance company by the Department of Trade in 1978. In 1985, NHBC became the first private approved inspector offering a building control service.

[3] For more information on the historical background, see the MMC '*New home warranty services in relation to new homes: A report on the existence or possible existence of a monopoly situation in relation to the supply within the United Kingdom of new home warranty services in relation to new homes*' (14 December 1990) (**the MMC Report**), para. 2.16 to 2.49.
[4] The MMC Report, para. 6.2.

5. NHBC continued to drive the industry agenda forward through the funding of research and its work with the Government.[5] In 2010, NHBC was a founder member of The Consumer Code for Home Builders, which gives added protection and rights to the buyers of newly built homes. However, NHBC no longer exerts a quasi-regulatory role for the house building industry, in a large part due to regulatory requirements (see paragraph 71 below) and it is no longer the only new home warranty provider to set standards.

6. A detailed timeline of the history of NHBC is in Annex I.

**Part 1.2 - Role in the new home warranty market**

7. NHBC currently provides warranty and insurance for over 1.6 million homes. NHBC's warranty scheme, Buildmark, covers homes before they are built, providing protection from the exchange of contracts until the end of the tenth year following legal completion.

8. NHBC publishes and revises its standards (**the NHBC Standards**) annually. The NHBC Standards set the minimum standards to be achieved by house builders, together with supporting guidance and performance standards. They cover the design, material specification and standards of site work for each part of the build process. The NHBC Standards and regular development of their content are an integral part of NHBC's purpose to improve the construction quality of new homes. To sell a home with a Buildmark warranty, NHBC's registered builders must ensure that every home is designed and built in accordance with the applicable NHBC requirements.[6] Compliance is assessed during site-based inspections by NHBC's Building Inspectors. House builders also have the responsibility to self-monitor under Rule 10 of the current NHBC Rules. The aim is to keep potential problems for the homebuyer to a minimum.

**Part 1.3 - Non-profit distributing status**

9. NHBC's role is to work with the house building industry to raise the standards of new homes and to provide protection for homebuyers. NHBC is an independent, non-profit distributing company limited by guarantee - neither part of the Government, nor a charity. This non-profit distributing status is the direct result of NHBC's history as a quasi-regulatory body for the house building industry. NHBC was founded to increase standards in the construction industry, which then led to the supply of new home warranties. NHBC's aim and ethos is not to distribute a profit to shareholders.

[5] See for example the NHBC Foundation, described below at para. 19.
[6] Current version of NHBC Rules, Rule 10 (a)

10. NHBC was founded as a company limited by guarantee, which is a common vehicle for business activities that are not intended to generate a profit or where surpluses are not distributed. The guarantors of the company, by agreeing to be bound by the memorandum and articles of association, undertake to guarantee the debts of the company if it is wound up. Each guarantor's liability is limited to one pound. The NHBC constitution specifically provided that the guarantors are the members of the NHBC Council. It also specifically provides that they are not to be paid (or rewarded) except in defined circumstances.

11. Because of NHBC's non-profit distributing status, NHBC does not aim to make a profit for distribution to members. Income is applied:

    a. To meet operating costs and solvency requirements (see below, Part 1.4); and

    b. Any surplus is applied to help achieve NHBC's mission of raising the standards of construction in the house building industry by funding research projects (see below, Part 1.6) and providing a premium refund to house builders. The refund calculation is based on factors such as claims history, length of time on the NHBC Register and is structured to incentivise house builders to achieve high standards and low levels of claims.

**Part 1.4 - Requirement to maintain adequate capital resources (Solvency II)**

12. As an insurance company, NHBC is required at all times to maintain adequate capital resources. NHBC must submit to the Prudential Regulation Authority (**PRA**) its own assessment of its capital requirements based on the criteria set by the Solvency II Directive.[7] In addition, NHBC is required to submit annual returns, together with audited annual financial statements to the PRA. The PRA uses the annual return to monitor the solvency of NHBC to pay future claims. In 2015/2016, NHBC held a solvency ratio of 181%, in compliance with the Solvency II requirement (see Annex III). For the same year, NHBC held technical provisions of £959 million.[8] The non-profit distributing status of NHBC does not affect its regulation by the PRA.

[7] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (the **Solvency II Directive**), OJ L 335/1

[8] NHBC annual report 2015/2016, accessible at: http://www.nhbc.co.uk/AboutNHBC/AnnualReport20152016/

## Part 1.5 – Supporting in achieving high standards of construction

13. In addition to the new home warranty, since 1995 NHBC has developed a range of other services (**NHBC Services**) to support house builders and developers, in achieving high standards of construction. These services include:

***Health & Safety***

14. Health and safety services include guidance on the Construction (Design and Management) Regulations 2015, site waste management plans, health and safety audits, site inspections and training and an online management reporting system to view and share health and safety site performance data. In 2015/2016, NHBC undertook around 8,000 health and safety inspections.

***Land Quality Endorsement***

15. This involves assessing brownfield sites with complex contamination or geotechnical issues for suitability for residential development and thereafter supporting landowners in remediation schemes who intend to sell the land to house builders.

***Energy and sustainability***

16. NHBC provides sustainability and energy feasibility reports for planning, to help house builders meet the demanding targets within the Code for Sustainable Homes and other Building Research Establishment Environmental Assessment Method (**BREEAM**) Assessments. In 2015/2016, NHBC provided approximately 11,700 Energy Performance Certificates and Simplified Building Energy Performance Model ratings as well as 13,200 Standard Assessment Procedure ratings.

***Customer Satisfaction***

17. Since 2004, NHBC has conducted the National New Homes Survey for the benefit of the house building industry and to facilitate the Home Builders Federation's Star Rating Scheme. This involves of survey of new homebuyers which is carried out at eight weeks and nine months after legal completion. The homebuyer rates the house builder's performance.

***Training***

18. In addition to the above, NHBC Services provide a range of construction-related training specifically for house builders and industry professionals. These qualifications and e-learning programmes include NVQs and health and safety training. In 2015/2016, NHBC Services delivered almost 5,500 training days in health and safety management and technical training to the house building industry.

**Part 1.6 - the NHBC Foundation**

19. The NHBC Foundation was established in 2006. It provides high-quality research and practical guidance to support the house building industry and address some of the problems consumers experience with their new homes. To date, the NHBC Foundation has published over 70 reports on a wide variety of topics including the sustainability agenda, homeowner issues and risk management.

**Part 1.7 - NHBC Building Control Services (NHBC-BCS)**

20. NHBC-BCS was set up in 1985 to provide statutory building control services, as an 'approved inspector' under the Building Act 1984. The aim of this statutory scheme is to help house builders ensure that Government-set Building Regulations are met. NHBC-BCS supports NHBC's purpose of raising standards and protecting homeowners. It also supports the Government and the wider construction industry on regulation changes and other related matters. During 2015/2016, NHBC-BCS carried out building control on over 89,000 new homes across the private and affordable housing sectors.

**Part 1.8 - Pride in the Job and Health and Safety Awards**

21. NHBC recognises the highest achievers in the industry through high-profile competitions, namely Pride in the Job and Health and Safety Awards, both of which reward excellence in UK house building.

## PART 2: THE MMC REPORT

### Part 2.1 - Background to the MMC Report

22. In 1990, the MMC was asked to investigate the supply of new home warranty services in the UK. This reference followed complaints by Municipal Mutual Insurance Ltd (**MMI**) and by the Federation of Master Builders (**FMB**) to the Office of Fair Trading (**OFT**). The MMI complaint alleged that Rule 12 of the NHBC Rules, which required registered builders to submit all new homes they intended to build to the NHBC. MMI alleged this was anti-competitive and restrained its own entry to the market. The FMB also complained that Rule 12 resulted in house builders being 'expelled' from the NHBC Register if they chose to use MMI's services.

23. As a result, the MMC Report focused predominantly on concerns around Rule 12, and how it prevented dual sourcing. As will be set out in more detail in Part 3, the concerns initially raised by the MMC around dual sourcing have become historic, mainly due to the amendments required by the MMC to Rule 12. Those amendments have contributed to the increase in dual sourcing and therefore the change in circumstances in the market. The concerns raised in the MMC's Report are set out in more detail below.

### Part 2.2 - NHBC's position in the market

24. The MMC found that, until early 1989 when MMI launched its Foundation 15 product, NHBC was the only supplier of new home warranties on newly built homes (or new home warranties, as they are referred to throughout this document). In 1989, NHBC held over 90% of the market share, measured by the number of new homes notified for inspection with warranty schemes, and NHBC was likely to retain over 90% of the market in 1990.[9] The MMC concluded that NHBC was in a monopoly situation in the supply of new home warranty services in the UK.[10]

### Part 2.3 - The barriers to entry and expansion

25. The MMC stated that a potential new competitor in the market of new home warranties had to attract business away from the current schemes to gain significant market share. In practice that meant attracting business away from NHBC. The MMC identified the NHBC Rules as a major barrier to entry and growth in the new home warranty market. The two other barriers included mortgage lenders' requirements and economies of scale.

#### ***The NHBC Rules***

26. The MMC found that the NHBC Rules restricted the ability of a new competitor to attract house builders away from NHBC in three ways.

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[9] The MMC Report, para. 5.12.
[10] Ibid. para. 8.5.

a. Firstly, the house builders faced the cost of sampling, because Rule 12 required NHBC members to submit *all* their new homes to NHBC. Therefore, if they wanted to try an alternative scheme they had to leave NHBC or pay a fee for both schemes.[11]

b. Secondly, there were costs of switching for house builders because there was no Rule regarding the preservation of their position, should they choose to leave NHBC and re-join at a later date. In addition, if a house builder was to leave, they risked losing cover on any unsold homes registered within the NHBC scheme. This was a result of an omission in the NHBC Rules concerning the preservation of premium rating, and Rules 38 and 41.[12]

c. Finally, if a house builder wanted to place some, but not all of its homes under a new scheme, it had to pay twice for those new homes, due to the obligations under Rule 12.[13]

***Mortgage lenders' requirements***

27. The MMC found that most mortgage lenders only granted a mortgage in relation to homes covered by a new home warranty scheme. A new competitor therefore had to satisfy the mortgage lenders that its scheme was acceptable.[14] At the time of the MMC Report, NHBC was only provider of new home warranties that was acceptable for mortgage lenders.

***Economies of scale***

28. At the time of the MMC Report, the major cost for a new competitor was that of setting up a national network of inspectors and essential head office functions for setting standards and administering the scheme. Given the number of competitors, it was not possible to estimate accurately the scale necessary, but NHBC indicated that most of the scale economies were realised at 85,000 units covered by warranty each year. While MMI gave an estimation of 45,000 units and a minimum of 20,000 units. MMI added that a lower cost structure could be attained by using a network of agents, instead of an in-house inspectorate.[15]

29. The MMC noted that, in theory, entry to the new home warranty market could occur on a smaller or regional scale. However, it would be more difficult for the scheme to attract national house builders, and the scheme would still need to gain the acceptance of mortgage lenders. It would also be possible for a large house builder to set up its own warranty service, provided that it gained approval of the mortgage lenders. Finally, the MMC pointed out that

[11] The MMC Report, para. 5.44.
[12] Ibid. para. 5.45 and 5.46.
[13] Ibid. para. 5.47.
[14] Ibid. para. 5.48.
[15] Ibid. para. 5.49 and 4.50.

a warranty scheme would need to provide its own insurance and may find it difficult to obtain reinsurance.[16]

**Part 2.4 - The conclusion of the MMC report**

30. The MMC concluded that Rule 12 on the one hand, and a combination of Rule 38, 41, and the omission relating to the protection of premium ratings on the other hand, operated against the public interest. However, the MMC found that, in providing a vertically integrated scheme, NHBC had not taken any steps for the purpose of exploiting or maintaining the monopoly situation. Nor were NHBC's actions attributable to the existence of the monopoly situation or expected to operate against the public interest. On the contrary, the MMC recognised the efficiency of vertical integration in the market.[17]

31. On 14 December 1990, the MMC Report was issued, concluding the following:

- NHBC supplied over 90% of new home warranty services in the UK and had only one competitor;
- Rule 12 of the NHBC Rules restricted competition by preventing dual sourcing and the sampling of alternative schemes; and
- Rules 38 and 41 of the NHBC Rules restricted competition by discouraging NHBC's registered house builders to cancel their membership in order to switch to a competing scheme.

**Part 2.5 - The Undertakings**

32. Following the MMC Report, NHBC gave the following undertakings to the Secretary of State under section 88 of the Fair Trading Act 1973:

- The NHBC shall not make any amendment or addition to the Rules of Membership to which this paragraph applies unless the Director General of Fair Trading has previously given his consent thereto in writing.

- The above paragraph applies to any amendment or addition to the Rules of Membership that has or may have the result that the NHBC ceases to comply with or complies to a lesser extent with, the MMC recommendations.

33. Currently, more than 25 years after the publication of the MMC Report, the material circumstances in the market for new home warranties have changed significantly. NHBC is therefore requesting a full review and release of the Undertakings.

[16] Ibid. para. 5.51.
[17] The MMC Report, para. 8.29.

## PART 3: RELEVANT CHANGES IN CIRCUMSTANCES

34. The CMA considers variation and termination of undertakings, when there has been a change of circumstances. The change of circumstances must be such that the undertaking is no longer appropriate to deal with the competition problem originally identified.[18] The following sections below will detail:

    a. The three specific areas of concern identified by the MMC:

        i. NHBC's position in the market;

        ii. Restrictions on dual sourcing; and

        iii. Rules 38, 41 and an omission in the NHBC Rules relating to the preservation of premium ratings and cancellation of NHBC membership.

    b. The relevant change of circumstances since publication of the MMC Report which render the Undertakings as being obsolete.

**Part 3.1 - NHBC's position in the market**

35. The concerns identified in the MMC Report in relation to **NHBC's position in the market**, break down into:

    a. Lack of competitors;

    b. Mortgage lenders' requirements favouring NHBC; and

    c. High market share of NHBC.

36. Since 1990, the relevant changes of circumstances in relation to NHBC's position in the market are:

    a. Emergence of new competitors;

    b. More flexible mortgage lenders' requirements no longer favour NHBC; and

    c. Reduction in market share.

37. Each of these changes in circumstances is explained below.

[18] CMA, 'Remedies: Guidance on the CMA's approach to the variation and termination of merger, monopoly and market undertakings and orders' (2015) CMA 11, para 2.4 and 2.5.

### *Emergence of new competitors*

38. At the time of the MMC Report, there were only two other companies providing new home warranty services: MMI and the Housing Association Property Mutual Ltd (**HAPM**). HAPM's approach was considered to be fundamentally different from NHBC and MMI, and for this reason, the MMC did not consider HAPM to be a relevant competitor to NHBC. However, both MMI and HAPM had evolved through local authorities and housing associations, respectively, coming together to create bodies that could provide products relevant for their interests. As such, neither were commercial organisations with a profit incentive, or a wider interest in serving the market as a whole (at least at the outset). In addition, both companies entered the market at a time when the construction of new homes was in a downturn, which further limited their success in attracting builders away from NHBC.[19]

39. Insurers also indicated to the MMC that they were reluctant to enter the new home warranty market, because it was commercially unattractive. They explained that it involved long-term, uncertain loss projection and substantial premium reservation.[20]

40. The MMC found that the mere threat of competition had a significant effect on NHBC, in that NHBC was more receptive to proposals for change.[21] NHBC had improved its Buildmark scheme in order to make it more "user friendly" and NHBC also had improved its conciliation procedures.[22]

41. At the time of the MMC Report, NHBC's main competitor was MMI, a large insurance company established by a group of local authorities in 1903. MMI provided insurance mostly for public sector bodies, including motor, general liability, pecuniary loss and accident insurance. It entered the new home warranty market in 1989. In 1993, MMI had gained a 10% market share.[23] MMI suffered substantial losses which caused its net assets to fall below the minimum regulatory solvency requirement and they ceased to write new policies in 1992.

42. In 1993, Zurich bought MMI's assets relating to the writing of direct contracts of non-life insurance in the UK, including a book of new home warranty policies. Zurich then re-branded and launched its own range of new home warranties, known as Zurich Building Guarantees (**ZBG**), which lasted ten years. Zurich offered a range of warranty policies for the private and public sectors, commercial developments and self-build projects. The insurance cover offered was flexible, with optional additional clauses and twelve-year policies where social housing building contracts were under seal.

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[19] This point is raised by the House Builders Federation in the MMC Report, para 7.36.

[20] The MMC Report, para. 7.78. In addition, the MMC found that "it is not generally considered to be an attractive market for insurers even when an integrated warranty scheme is available providing both registration and inspection" para. 8.15.

[21] Ibid. para. 8.23.

[22] Ibid. para. 2.42 and 6.4.

[23] European Commission, Case No IV/M.286 – *Zurich/MMI*, 2 April 1993, para. 9.

43. Zurich was NHBC's main competitor at that time, and the entry of a large-scale player posed a significant threat to NHBC's market share. NHBC found that some of NHBC's registered house builders registered with both NHBC and Zurich. It also appeared that some Housing Associations imposed Zurich on the house builder because it was seen as a more flexible alternative. In September 2009, Zurich announced that it was exiting the market.

44. Since the MMC Report, there has been a significant increase in the number of new home warranty providers, all of which are private companies with profit incentives. By 2008, NHBC had five competitors - Building LifePlans, MDIS operating under the name of Premier Guarantee and Local Authority Building Control Warranty and Zurich[24] - and it now faces actual (and potential) competition from over ten companies.

45. NHBC's current main competitors operating in the market are:

   i. MD Insurance Services - Premier Guarantee and Local Authority Building Control (LABC) Warranty;

   ii. Building Life Plans;

   iii. Checkmate;

   iv. CRL; and

   v. Buildzone.

   More details on the competitors are set out in Annex II.

46. There is now strong competition in the new home warranty market. NHBC has to compete for business on a site-by-site basis. Feedback from NHBC's office and field-based staff allows NHBC to monitor competitor activity, although this is anecdotal research. For example, field staff may notice a site with a competitor's advertising material, or office based staff may notice that one phase of work on a site is registered with NHBC, but not the next. In October 2016, NHBC recorded [✂] lost units across [✂] sites to competitors.[25]

47. With the new build market supported by Government initiatives and stretching targets, it is likely that competition will continue to increase.[26] NHBC has been reacting to this increased level of competition by analysing the reasons behind losses and adapting the business model to be more suited to individual house builders' needs.

48. New competitors have been able to enter the market relatively easily, using the agency/broker model. NHBC, however, is an insurer and therefore subject to dual regulation by the FCA and PRA.

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[24] OFT 'Homebuilding market study – Annexe J – New home warranties' (2008) para. 2.15
[25] Internal NHBC statistics.
[26] See Annex IV on changes in the house building sector

49. The agent/broker, like those referred to in paragraph 45, obtains new home warranty insurance on a block basis from major insurers such as Allianz, AmTrust Ltd, AXA, Inter Hannover, Great Lakes Reinsurance (subsidiary of Munich Re) and Lloyd's of London. The agent/broker can then bundle new home warranties with other insurance products of interest to house builders. This may include developer insurance, public liability insurance, business interruption and other commercial insurance products, which are also available from these major insurers. However, such additional policies are not offered by NHBC as NHBC only focuses upon new build warranties for homes, flats and Housing Associations.

50. There is nothing to prevent existing insurers from selling new home warranty products directly to house builders. However, the market practice within the commercial insurance industry is for an agent/broker to procure insurance on behalf of its commercial customer. Therefore, the agent/broker model has proved to be the preferred route to market for new home warranties.

51. **In summary**, since the MMC report, many new competitors to NHBC have entered the new home warranty market. This addresses the concern that NHBC had a lack of competitors.

***More flexible mortgage lenders' requirements that no longer favour NHBC***

52. The MMC Report concluded that mortgage lenders' requirements were a barrier to entry.[27] Today, mortgage lenders require homes to be covered by either a warranty scheme, or a professional consultant's certificate (previously called architect or surveyor certificate). It is important to note that mortgage lenders do not express any preference for NHBC's Buildmark scheme. In fact, the Council of Mortgage Lenders (**CML**) states expressly on its website that it "does not approve or endorse warranties and schemes" and adds that "it is up to the individual lender to decide which schemes they are prepared to accept". The CML simply states considerations for lenders.[28] Therefore, lenders can choose from a variety of schemes, and there are no general acceptability criteria. In fact, most mortgage lenders accept a wide range of products offered by new home warranty providers.[29]

53. If a newly built home is not covered by a new home warranty, and inspections have not been conducted during the construction, it is possible to obtain a retrospective insurance policy known as a completed property warranty from NHBC's competitors. This policy is accepted by most mortgage lenders.

[27] The MMC Report, para 5.48.

[28] Council of Mortgage Lenders, 'New build and converted properties – requirements and considerations' accessible at https://www.cml.org.uk/consumers/buying-a-home/new-build-and-converted-properties-lending-requirements/

[29] The CML provides a list of lenders and the providers of new home warranty that they accept: https://www.cml.org.uk/lenders-handbook/englandandwales/question-list/1913/

54. **In summary**, since the MMC Report, mortgage lenders have become more flexible in their lending requirements. This addresses the concern that mortgage lenders' requirements were a barrier to entry.

***Reduction in market share***

55. Since the MMC Report, NHBC's market share has declined. NHBC is currently in the process of accumulating market share data which will be shared with the CMA as soon as it becomes available. NHBC considers that the decline in market share is due to a combination of competitor activity (see above on the emergence of new competitors) and builders' increased buying power, discussed below.

56. The house building industry is increasingly concentrated in a small number of house builders. In 2007, the top ten builders were responsible for 44 per cent of the total output, compared to 18 per cent in 1973.[30] One significant example of consolidation in the industry is the merger of Taylor Woodrow and George Wimpey in 2007, to create Taylor Wimpey, the UK's second largest private house builder. This consolidation is expected to continue further, and there may be as few as five main house builders in the new homes' market by 2020.[31]

57. The top five house builders are now major organisations, constructing over fifty thousand new homes per year. As such, using a slightly cheaper alternative to NHBC can represent large economies of scale for them; a saving of a relatively small amount per home could result in significant cost savings. The larger builders also have sophisticated procurement departments dedicated to negotiating the best prices they can obtain from their suppliers including new home warranty providers.

58. If just one or two of the top house builders were to significantly increase the use of a competitors' products, this would have an immediate impact on NHBC's revenues and market share. NHBC's market share is dependent on the business and buying power of a small number of house builders, and it could decrease rapidly if any of the larger house builders were to do this. There is a real and credible risk to NHBC of this happening as the majority of house builders dual source for new home warranty products.

59. **In summary**, since the MMC report, NHBC's market share has declined and house builders buying power has increased as they dual source. This addresses the concern that NHBC has a high market share.

[30] Office of Fair Trading "Homebuilding market study" (2008) OFT1020, para 3.30. In addition, in 2006 only 13 builders on the NHBC Register, out of a total of 5850, registered more than 2000 units, but it constituted 43% of the total output of new homes (para. 3.3 and 3.4).

[31] EY Report 'UK construction: consolidation ahead', available at http://www.ey.com/Publication/vwLUAssets/ey-uk-construction-consolidation-ahead/%24FILE/ey-uk-construction-consolidation-ahead.pdf

### Part 3.2 - Restriction on dual sourcing

60. The concerns identified in the MMC Report in relation to **restrictions on dual sourcing**, break down into:

    a. The lack of alternatives to NHBC; and

    b. The cost of sampling alternative schemes.

    Since 1990, the relevant changes of circumstances in relation to restrictions on dual sourcing are that:

    a. NHBC is no longer the benchmark; and

    b. Builders have the ability and incentive to dual source.

61. Each of these changes in circumstances is explained below.

***NHBC is no longer the benchmark in the new home warranty market***

62. The MMC Report found that Rule 12 of the NHBC Rules had the purpose and effect of requiring house builders to pre-notify all their planned new homes to NHBC (subject to two exceptions related to (i) architect or surveyor certificate and (ii) housing associations). This meant that all homes built by NHBC registered builders were subject to inspection and warranty by NHBC and to payment of NHBC's fees. Rule 12 therefore allowed NHBC to have overall control of a builders' output.

63. At the time, house builders who wanted to switch from NHBC had two options; (i) use another supplier while remaining on the NHBC Register which meant that the costs of new home warranties was doubled (although NHBC did not enforce this); or (ii) change supplier and leave the NHBC Register completely, meaning they could not use NHBC when they wished to.

64. The MMC considered that there was a significant risk to the second option, because house builders would have had to switch their entire output to a new, untested scheme. As a result, Rule 12 was found to constitute a barrier to entry in two ways: it created a cost of sampling alternative schemes, and it restricted the ability of house builders to use two or more

schemes.[32] The MMC found that the cost of sampling existed mainly because the competitors at the time were new and did not have established warranty schemes.[33] The value of a warranty scheme can only be assessed when claims are made, usually several years after the policy was incepted.

65. The MMC also found that the abolition of Rule 12 would not have implications for consumer protection because purchasers, their advisers and mortgage lenders would still demand warranties. The MMC also found it unlikely that dual sourcing would increase the risk of adverse selection (therefore leading to higher insurance prices) because the degree of inspection was very high in this sector, and concluded that the loss of significant economies of scale was unlikely.[34]

66. However, the MMC emphasised the importance that, in the interests of consumer protection, all homes that an NHBC member placed outside the NHBC scheme, should be covered by a scheme broadly comparable to Buildmark.[35] The MMC also acknowledged the need for NHBC to have reassurance that other warranty schemes were of a broadly comparable standard to its own, given the inevitable differences of detail between schemes.[36]

67. As a result, the MMC recommended that:

> *"Rule 12 should be amended so as to allow a builder to source from other bodies providing the reference services but only where the standards of those bodies are broadly comparable to those of NHBC's Buildmark scheme. […] We recommend therefore that Rule 12 should additionally permit two forms of exception, which would apply only to those new homes, which:*
>
> > *(a) have been accepted for cover by Foundation 15 or any other scheme of broadly comparable standard to NHBC's scheme; and*
> > *(b) comprise an entirely separate housing unit, for example a block of flats, a sheltered home development covered by a single management agreement or an individual home not sharing common parts with any other home. (This would prevent, for example, the placing of one flat in a block with one scheme and the rest with another.)".*[37]

68. Following the MMC's Recommendations, the NHBC Rules were amended, to allow house builders to use suppliers who offered new home warranty schemes of a broadly comparable standard to NHBC. To set the benchmark for these schemes (of a broadly comparable

[32] The MMC Report, para. 5.44 and 5.47.
[33] This is particularly apparent from the MMC Report para. 8.73 to 8.75.
[34] Ibid. para. 8.62 to 8.71.
[35] Ibid. para. 8.96.
[36] Ibid. para. 8.98.
[37] The MMC Report, para. 8.94.

standard), the NHBC Rules incorporated a definition of 'Other Home Warranty'; as a scheme comprising the following four characteristics:

a. **Register**: a register of builders and developers on which applicants may be entered provided they can show a good standard of building ability and sound business knowledge as applicable;

b. **Technical standards**: a set of published technical standards with which registered builders and developers must comply and which include reasonable standards of design, quality of materials, workmanship and durability;

c. **Inspection**: a system of inspecting new homes during construction so as to ensure that they are built in accordance with the published technical standards;

d. **Transferable warranties**: warranties which provided the owners of homes covered by the scheme with a right, for at least ten years from the date of completion of construction of the home, to have repairs carried out or to be indemnified against the cost of repairs, at least in respect of damage resulting from defects in the structure of such homes.

69. At the time of the MMC Report, it was appropriate for NHBC's Buildmark scheme to be considered as the benchmark. The 'Other Home Warranty' criteria meant NHBC set the minimum standards and NHBC became a quasi-regulator of new home warranty products.

70. However, since the time of the MMC Report, both the new home warranty market and the regulatory environment in which insurance products are sold have changed considerably and they will continue to change. The 'Other Home Warranty' criteria and quasi-regulator role for NHBC have become obsolete.

71. In practice, it has not been necessary to apply the 'Other Home Warranty' criteria strictly. New entrants to the new home warranty market have achieved minimum standards and comply with CML requirements without adhering to the criteria. NHBC no longer considers the criteria strictly applicable to its own business model, which demonstrates how the market has changed since the MMC report.

72. The relevant changes in the regulatory environment and new home warranty market are explained in paragraphs 73 to 86 below.

*Changes in the regulatory environment*

73. Following the introduction of the Financial Services and Markets Act 2000, the design of any new consumer insurance product is driven by FCA regulation. There have been a series of developments that strengthen the position of the consumer. For example:

a. **Principle 6 of the FCA's Principles for Business**, requires insurers to pay due regard to the interests of their customers and treat them fairly. New home warranty products, like all other consumer insurance products, must be designed to meet the needs of today's consumers (homeowners).

b. **The Insurance Mediation Directive** (2002/92/EC) (IMD) implemented the Insurance: Conduct of Business sourcebook (ICOBS). ICOBS specify how insurers (e.g. NHBC) and insurance intermediaries (e.g. NHBC's competitors) should interact with policyholders and potential policyholders in relation to insurance policies from the start of the sales process through to dealing with any claims, or complaints. Insurers carry out root cause analysis of complaints and the output of this is fed back into the product design process.

c. **Treating Customers Fairly** or 'TCF' is an FCA initiative which builds on Principle 6 of the FCA's Principles for Business. Firms have had to be able to demonstrate, to themselves and to the regulator, that they consistently treat their customers fairly and are delivering against the 'TCF outcomes' relevant to their business. The emphasis is on the actual outcomes for customers, not on the means by which the outcomes are achieved. To reinforce this, the FSA outlined 6 key consumer outcomes, which summarise what the TCF initiative was expected to achieve for consumers. These outcomes include 'Outcome 2', that *'Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly'* and 'Outcome 5', that *'Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect'*.

d. **The Directive on Insurance Distribution** ((EU) 2016/97) will be implemented in the UK from 23 February 2018. This is designed to further improve EU regulation in the insurance market by ensuring a level playing field among all participants involved in the sale of insurance products. It is also designed to strengthen policyholder protection. It will repeal and replace the Insurance Mediation Directive (2002/92/EC). In particular, Article 25 (*Product oversight and governance requirements*) will require insurance undertakings and intermediaries, to maintain, operate and review a process for the approval of each insurance product, or significant adaptations of an existing insurance product, before it is marketed or distributed to customers.

*Changes to the new home warranty market*

74. If the ‘Other Home Warranty’ criterion is applied strictly to NHBC and/or other new home warranty providers, it will increasingly inhibit innovation in the new home warranty market. For example:

   a. **The register criteria**. NHBC operates a register to pre-qualify builders, as meeting its minimum underwriting criteria. However, some new home warranty providers operate successfully without the expense of a registration scheme.

   b. **The technical standards criteria and the inspection criteria**. In England, government set Building Regulations prescribe minimum standards for construction and compliance is independently assessed by the Local Authority, or a private sector ‘Approved Inspector’. There are similar systems operating in Wales, Scotland and Northern Ireland. NHBC’s own standards supplement the minimum standards set by the Building Regulations and its on-site inspection provides valuable feedback on quality to NHBC and builders. However, some new home warranty providers operate successfully without the expense of developing and publishing their own technical standards and/or carrying out site-based inspections. Some new home warranty providers like BLP, do not carry out inspections, some providers carry out only one inspection and Checkmate’s inspections are based on photographs. Developments in technology and data analysis are likely to provide new home warranty providers with a greater range of choices as to how they assess build quality, and in future, this many not necessarily involve site-based inspections in all cases.

   c. **The transferable warranty criteria:** this reflects a simple owner-occupier model of home ownership. With the increasing prevalence of social housing schemes, shared ownership, private rental and mixed-use developments, new home warranty products will not necessarily fit this model.

75. For NHBC’s product range to continue to adhere to the ‘Other Home Warranty’ standard and for NHBC to continue to monitor the extent to which NHBC’s competitors adhere to the ‘Other Home Warranty’ is increasingly irrelevant. It is no longer necessary nor appropriate that NHBC, through Rule 12, operates as a quasi-regulator of new home warranties because this role has been superseded by FCA regulation. The definition of ‘Other Home Warranty’ does not necessarily reflect the needs of today’s or tomorrow’s home buyers.

76. Subject to the CMA’s approval, NHBC will be amending (the old) Rule 12. It is no longer appropriate for the Buildmark scheme, as it was at the time of the MMC Report, to be the benchmark that all new home warranty providers have to meet.

77. **In summary**, since the MMC report, NHBC no longer sets the benchmark, nor operates as a quasi-regulator. The 'Other home warranty' criteria in Rule 12 do not reflect the needs of today's or tomorrow's home buyers and insurance product design is now driven by FCA regulation. This addresses the concern in relation to dual sourcing; that there is a lack of alternatives to NHBC and NHBC has a high market share.

***House builders have the ability and incentive to dual source***

78. In the 1990s competition in the new home warranty market was beginning to emerge. However, the MMC considered that builders did not have sufficient knowledge about alternative schemes to leave NHBC or switch to another provider. The amendments to Rule 12 of the NHBC Rules have enabled builders to save costs by dual sourcing and sampling other providers. In addition, the transparency and availability of information to builders is significantly greater now than in 1990.

79. NHBC acknowledges that its registered builders leave NHBC and/or dual source from a competitor's schemes for two main reasons:

   a. When they are not satisfied with the quality of services provided by NHBC; and/or

   b. When they find less expensive products elsewhere.

80. There are now several competitors in new home warranty market, as explained in paragraphs 38 to 51 and in Annex II.[38] Competition occurs in relation to the new home warranty premium, which the house builder pays. House builders have choice in the level of premium they pay, which reflects the extent of the insurance coverage they are seeking. For example, a new house builder entering the sector with no track record, or a house builder with a high claims' record may well choose competitors' product to avoid paying a high premium. As part of its pricing of insurance risk, NHBC may require a house builder to provide a security bond.[39] Some of NHBC's competitors advertise that they do not require security.

81. The housing market has changed considerably since the 1990s, which was the catalyst for NHBC and its competitors to develop new products. As a result, some of NHBC's competitors have established themselves in niche parts of the new home warranty market. Diversification has resulted in products aimed at, for example, social housing, mixed-use developments, conversions and self-build.

82. NHBC mainly focuses upon the standard ten-year Buildmark policy for newly built homes and flats and Buildmark Choice for Housing Associations. NHBC no longer offers a self-build warranty and any new business enquiries are referred to a competitor, Self-Build Zone who

[38] See also OFT 'Homebuilding market study - Annex J – New Home Warranties' (2008) para. 1.3.
[39] Ibid. para. 4.38 and 4.39.

specialises in this market sector. In addition, NHBC has reduced its market share in the conversion warranty sector. Combined, the self-build and conversions sector, are a reasonable proportion of the new home warranty market. NHBC's competitors have the majority market share in offering these products.

83. There is a considerable incentive for house builders to dual source in order to obtain a more suitable product from another provider, if they consider that their business needs are better met by a competiting product. The act of dual or multi sourcing may exert a competitive constraint on providers. It could reduce barriers to searching for suitable products and switching.[40] In the new home warranty market, many of the products have already been tested by house builders, and consequently house builders do not need to 'explore' their competitive quality and/or cost. In addition, because house builders have already tried other products, it is likely they will be less reluctant to switch to new entrants offering an alternative product.

84. It is now standard practice for the majority of house builders to dual source new home warranties from a range of providers. For example, [✂], one of NHBC's top three customers, dual-sources approximately 50% of its new home warranty requirements from NHBC's competitors. This is evidenced in the data provided in Annex V, which sets out the NHBC registrations by year for [✂] since 1995. The total number of NHBC registrations for [✂] has fluctuated between 16,227 at the highest point (1999) to 5,939 at the lowest point at the peak of the property crash (2008). Over the period from 1995, this has meant a win/loss movement from +37% at the highest point (2007) to -62% at the lowest point (2008).

85. In addition to [✂], NHBC's other house builder customers in the top ten[41] (BDW Trading Ltd, Taylor Wimpey UK Ltd, Bellway Homes Ltd and Bovis Homes Ltd) will also actively dual source in a similar way to [✂]. Dual or multi sourcing is now considered standard practice in the house-building industry.

86. This clearly demonstrates the strength of a house builder's buying power. If NHBC attempted to adopt a new Rule restricting dual sourcing, house builders could switch their entire business to a competitor, because the maturity of the new home warranty market now allows them to do so without having to sample alternative schemes beforehand.

87. **In summary**, since the MMC report, house builders have the opportunity and incentive to dual source. This addresses the concern in relation to dual sourcing, concerning the cost of sampling alternative schemes.

**Part 3.3 – Rules 38, 41 and an omission in the NHBC Rules related to the preservation of premium ratings**

[40] CMA 'Retail Banking Market Investigation – Final Report' (2016) para. 6.27 to 6.35.

[41] List of top 5 customers based on 2016 registrations.

88. The concerns identified in the MMC Report in relation to **Rules 38, 41 and an omission in the NHBC Rules related to the preservation of premium ratings** were that:

a. House builders were dissuaded from switching because of the lack of a rule on the preservation of premium ratings; and

b. Unsold homes could be left without new home warranty cover if the house builder cancelled its membership.

Since 1990, the relevant changes of circumstances in relation to Rules 38, 41 and an omission in the NHBC Rules related to the preservation of premium ratings are:

c. house builders are now able to switch, or dual-source; and

d. unsold homes can now be protected.

89. Each of these changes in circumstances is explained below.

***House builders dual-source rather than to switching to a competitor***

90. In the 1990s, NHBC's Rule 38 stated that if a house builder were to cancel its membership with NHBC, the house builder would only receive Buildmark for homes for which contracts had been exchanged, but they would not be covered for homes that were in the process of construction prior to the exchange of contract. The MMC reported that house builders would not be able to obtain coverage from any other scheme because they would not have had the opportunity to carry out inspections. The MMC concluded this deterred house builders from switching, as they would be left with a number of unsold homes without structural warranties.

91. Rule 38 was to enable NHBC to deregister house builders for reasons such as health and safety, or insolvency concerns. Once the house builder ceased to be registered with NHBC, they no longer had the authority to bind NHBC for other homes that had not been sold. [42] At the time, and given NHBC's position in the market, it was not contemplated that house builders would opt to deregister. However, the MMC concluded that in the event a house builder wanted to deregister and move to a competitor, this would be the relevant Rule they would rely on. It therefore acted as a disincentive (albeit theoretical at the time) to house builders switching to other new home warranty providers.

92. Under Rule 41, a house builder cancelling its membership had an option to pay a lump sum to NHBC in exchange for NHBC assuming the obligations of the house builder for the remainder of two-year liability period under NHBC's Buildmark product. Although this was

[42] The MMC Report, para 6.14.

optional, the NHBC Rules did not make this sufficiently clear. House builders regarded Rule 41 as a fee or financial penalty for leaving NHBC.[43]

93. The MMC also found that there was no rule to protect the premium rating of a house builder who decided to cancel its membership but wanted to re-join again later. Again this was because the NHBC Rules at the time did not foresee this situation occurring. As a result, NHBC did not have a clear policy on the emphasis it should attach to a house builder's claims record with another scheme, if it chose to return to NHBC.[44] The MMC considered this was a further disincentive for house builders to move to a competitor.

94. The MMC concluded that Rules 38, 41 and NHBC's omission to protect premium ratings constituted a barrier to entry. Although the MMC clarified that they did not constitute steps taken by NHBC for the purpose of exploiting or maintaining a monopoly situation, in combination they imposed a disincentive to switch and were therefore anti-competitive.[45]

95. The MMC recommended the following:

> *"(a) NHBC should introduce a new rule confirming the right of a builder to cancel his registration with effect for all homes not yet notified to it. Any homes already notified to NHBC under the rules prior to notice of cancellation of a builder's registration being received by NHBC would remain covered by Buildmark, so that normal documentation would continue to be issued for them to their purchasers, and in respect of which the builder would retain all his liabilities under the scheme.*
>
> *(b) An additional new rule should be introduced under which a member cancelling registration with NHBC would be allowed to re-join it at a later date without prejudice to his previous length of membership with NHBC.*
>
> *(c) Rule 41 should be clarified to make clear that it is for the builder withdrawing from membership to decide whether to exercise his option to pay the lump sum to NHBC (as notified to him by NHBC) to cover his existing liabilities or to choose to retain his liabilities for the remainder of the initial two-year period for each new home"*.[46]

96. In addition, at the time of the MMC Report, the MMC considered there to be a potential gap in the cover of homes either i) under construction; or ii) completed but not sold, if a house builder opted to leave NHBC's Register.

97. Since the MMC Report, and as described above, house builders now have the option of dual sourcing from NHBC competitors and many house builders do so. This has meant that rather than leaving the NHBC Register, house builders that dual-source can stay on the NHBC Register and maintain a claims' record to achieve the highest available A1* premium rating.

[43] The MMC Report, para 6.13.
[44] The MMC Report para 6.14.
[45] The MMC Report, para 5.45 and 5.46.
[46] The MMC Report, para 8.100

98. NHBC introduced rules to protect the premium rating of a house builder who decided to cancel its membership but wanted to re-join again later.

99. Rule 41 is very rarely invoked. NHBC considers that it no longer compatible with FCA regulation, because the effect is to remove unilaterally, rights that the homeowner has under their Buildmark policy. Subject to the CMA's approval, NHBC will be amending Rule 41 entirely from the NHBC Rules.

100. The 'gap' no longer exists.

   a. Developments in FCA regulation, described at paragraph 73 have driven improvements in NHBC's administration procedures. A homebuyer can accept an offer of Buildmark cover when they exchange contracts to purchase a home. If the house builder then leaves the NHBC Register, the Buildmark cover remains in place.

   b. A retrospective warranty product (a completed housing warranty) has become available from other new home warranty providers. Should a house builder leave the NHBC Register with homes under construction or completed and where there has been no exchange of contracts/acceptance of Buildmark cover by homebuyers (i.e. there is no Buildmark cover in place), they would have access to this retrospective cover. In any event, NHBC would not remove a house builder from its register except where a serious breach of the NHBC Rules had occurred and not been remedied within a reasonable time, following notification of the breach. In these circumstances, house builders have the right to appeal against a decision to remove them from the NHBC Register. Therefore, in practice, it will rarely be the case that a house builder has to obtain this cover, but it is available.

101. **In summary**, since the MMC Report, developments in the new home warranty market mean that house builders have the opportunity and incentive dual source or switch. This, together with changes to the NHBC Rules, addresses the concern in relation to house builders being dissuaded from switching. In addition, changes in the new home warranty market mean that unsold homes will not be left without new home warranty cover. This addresses the concern regarding unsold homes.

## PART 4: CONCLUSION

102. It is over 25 years since the publication of the MMC Report, and the material circumstances in the market for new home warranties have changed significantly since 1990. NHBC's position in the market has evolved considerably, and NHBC faces actual and potential competition from a significant number of alternative providers. This increase in competition, combined with the countervailing buyer power of house builders, has already eroded NHBC's market share. It also poses a credible threat to further reduce NHBC's position in the market.

103. The concerns identified by the MMC regarding Rule 12, and the restrictions on dual sourcing, are now historic and outdated. NHBC no longer represents the benchmark, and is not in a position to prevent house builders from dual sourcing from competitors. House builders now actively dual or multi source new home warranty products.

104. Financial regulations designed to protect consumers have also superseded NHBC's historic quasi-regulatory role.

105. The concerns identified by the MMC regarding restraints on switching are no longer relevant. House builders adopt a dual or multi sourcing model, meaning they do not need to leave the NHBC Register in order to use competitors' products. When house builders do leave NHBC's Register, unsold homes are protected due to the improved administration of NHBC's products driven by increased FCA regulation, or through the availability of retrospective new home warranty products.

106. Given the significant changes in the new home warranty market, and the increase in competitors providing new products suited to the evolving market, the NHBC Rules are in need of updating to ensure they are fit for purpose. However, substantially amending Rule 12 would render the Undertakings devoid of their meaning, and this would raise a difficulty in proving compliance.

107. NHBC is therefore requesting a full review and release of the Undertakings on the basis that they are outdated, and no longer fit for purpose in the current market. NHBC is strongly of the view that this is the most efficient way to proceed. Given the significant changes in the market since the adoption of the Undertakings, the changes to the NHBC Rules that NHBC is contemplating, and the CMA's current work stream focused on reviewing historic monopoly remedies, NHBC believes a full review of the Undertakings, with a view to their termination and release is the most advantageous and cost-effective solution for all relevant parties.

**13 January 2017**