

Review of NHBC Undertakings: Comments on Competition & Markets Authority's ("CMA") Provisional Decision dated 29 June 2017

Introduction

[REDACTED] ("[REDACTED]") welcomes the CMA's provisional decision. Set out below are some comments on the evidence referred to in the provisional decision, together with some suggestions as to which elements of NHBC's organisation, procedures and/or rules might need to be modified in order to achieve the CMA's stated objectives.

Overview of NHBC and structural warranties

The CMA identifies a number of features relating to the NHBC which appear, on their face, to be inconsistent with NHBC's role as a provider of structural warranties. The first of these is the fact that, since 1985, NHBC has been a major private sector supplier of 'Approved Inspectors', who can monitor compliance with building regulations alongside those working for local authorities.

There have been a number of Press Articles over the last 12 months highlighting major quality issues with some new build homes. [REDACTED] assumes these homes are covered by NHBC's structural warranty since the builders concerned have been the major national house-builders. The most recent Press Article appeared in The Sunday Times dated 9 July 2017, link:

<https://www.thetimes.co.uk/edition/news/builders-gag-buyers-over-shoddy-work-ph07gw6pv>

and refers to issues relating to homes built by Bellway, Taylor Wimpey and Barratt.

It cannot be in the best interests of the purchaser of a new home to have the home inspected and declared fit for occupation by an inspector who works for the provider of the structural warranty, unless that inspector is merely carrying out a secondary inspection with the primary inspection (declaring the property fit for occupation and constructed in accordance with building regulations) having been carried out by a suitably qualified, competent, independent third party. NHBC should be ensuring that its registered builders are adhering to the relevant quality standards mandated by NHBC as part of its membership requirements, and where those standards are not being adhered to, NHBC should be taking steps to ensure adherence to the standards with sanctions

being applied to registered builders where appropriate (including termination of their membership of NHBC in cases of flagrant and/or persistent failures to adhere to NHBC's standards). It is not clear to what extent NHBC does take steps to ensure its quality standards are adhered to by all of its registered builders. [✂]

Having appropriate standards that are both policed and enforced should be a key priority for all stakeholders in the building industry. It is only by doing so the house building sector is likely to avoid scenarios such as those which occurred recently with [✂]. More generally, if standards are enforced, satisfaction levels on the part of purchasers of new build homes should genuinely increase. Appropriate standards should also minimise the risk of major catastrophes being caused by the use of inappropriate building materials, [✂].

The second feature of NHBC which merits some review is the make-up of its Board and its Council. Members of both these bodies should be sufficiently independent and not have either apparent or actual conflicts of interest. Neither the NHBC Board nor the NHBC Council should have members who also have a current role at a mortgage lender or a house builder. Such members run the obvious risk of promoting matters which are in the best interest of the lender/house builder as opposed to matters which are in the best interest of NHBC/the house building industry as a whole and purchasers of new build houses. [✂].

The third feature is the so-called return of surpluses to NHBC's registered builders via the NHBC premium refund scheme. This is something [✂] comments on in detail below. [✂].

Geographic coverage as a potential barrier to entry and expansion

The CMA refers to the need to have sufficient inspector capacity to conduct site inspections in all appropriate locations to meet large builders' requirements (see paragraph 4.20 of the CMA's provisional decision). This would seem to suggest that UK-wide builders are only interested in dealing with one structural warranty provider. If this is genuinely the case, the CMA needs to better understand the reasons for such a stance and what can practically be done to persuade such builders to purchase structural warranties from a variety of suitable providers. [✂] The CMA states it is aware of one other warranty provider that has equivalent coverage to NHBC. Are the large builders purchasing structural warranties from that warranty provider? [✂].

The lack of UK-wide coverage should not be a barrier to entry and expansion for structural warranty providers who compete with NHBC. There is no immediately obvious reason why this should be the case. Consequently, the CMA needs to understand why it is being presented as such a barrier by the large builders. Without this understanding, the CMA runs the real risk of implementing new Undertakings and conducting a further review of the NHBC Undertakings several years down the line only to find that things have not really

changed to any material degree – which is what the CMA has found in conducting this review.

Market share of NHBC

The DCLG data referred to in paragraph 4.29 of the CMA's provisional decision shows NHBC's average market share was 84.8% during the last 10 years. In 2015/16, NHBC's market share recovered to its pre-recession level of 91%. This demonstrates that any new entry by competing structural warranty providers has had a very limited if not negligible impact – NHBC's market share in 1990 was estimated by the MMC to be 90%.

[redacted] takes issue with the approach to calculating NHBC's market share described in paragraphs 4.31 – 4.33 of the CMA's provisional decision. This approach looks at the value of warranties sold, rather than the volume of warranties sold. If different warranty providers charge different prices, this will affect the accuracy of the market share figures unless valid steps are taken by the CMA to correct for this discrepancy. Similarly, there needs to be a consistent methodology used by all the warranty providers to calculate the value of warranties sold. Finally, the CMA has itself identified a number of issues with the data on the value of warranties sold, which are described in notes 2 – 4 to Table 2 in the provisional decision.

There are clearly factors still at play which are working to maintain NHBC's dominant position, a position which it has held now for over 25 years. What these factors are and how they can be addressed is the remit of this review.

If the CMA has had insufficient engagement from relevant stakeholders in this review process, it should consider using whatever means it has at its disposal to elicit the information it is still missing.

The CMA claims, in paragraph 4.33 of its provisional decision, that the data does not show growth of market share across a range of other warranty providers who compete with NHBC. If that is the case, and bearing in mind the market share of NHBC calculated using the DCLG data, it is difficult to accept the CMA's conclusion that "NHBC now faces more competition than at the time of the MMC report". There may be more providers of structural warranty products in the UK in 2016/2017 as compared with the position in 1990, but NHBC's market share has not reduced – in fact, based on the DCLG data for 2015/16, NHBC's market share appears to have increased slightly from the position in 1990.

[redacted] submits, [redacted]. [redacted] does not believe NHBC faces any greater competition for the custom of its larger registered builders than it did back in 1990. [redacted]

House builders' ability to dual source or switch warranty provider

The CMA notes, according to government statistics, the market has become increasingly weighted towards large builders. In paragraph 4.41 of its provisional decision, the CMA states that of the five large house builders who provided data to the CMA, only three are dual sourcing and even then "to a very limited extent".

This raises a number of questions. First, why did the CMA only manage to obtain data from five of the UK's large house builders? Second, who are the three house builders that dual source purchasing structural warranty products from? Third, when the CMA states the three large house builders are dual sourcing "to a very limited extent", what are the respective numbers of policies/percentages of policies sourced from NHBC and the other supplier, when did the dual sourcing start, what prompted the dual sourcing to start, and has the dual sourcing occurred in several years or only during a single calendar year (and if a single year, which year)?

Paragraph 4.43 of the CMA's provisional decision lists a number of factors which allegedly influence builders' decisions as to how and from whom they source their structural warranties. Some of these are uncorroborated, such as the NHBC premium rating scheme. Others, such as the size of NHBC's annual registration fee, are irrelevant to NHBC's core customer base of large/larger builders. On price it is interesting to note that at least two large builders refer to the fact that other providers of structural warranties are cheaper than NHBC – one such builder saying it could make "significant savings" from sourcing warranties from a provider other than NHBC. However, it is not clear whether these same large builders actually purchase warranties from other providers? If they do not, or they only purchase small quantities of structural warranties from other providers, this begs the question why is that the case?

Paragraph 4.50 of the CMA's provisional decision makes clear the lack of desire, on the part of large builders, to switch away from NHBC. Whilst wholesale switching away from NHBC is not to be expected at this stage of the evolution of the structural warranty market, which only experienced a wave of new entrants since 2009, one would have expected a greater degree of dual-sourcing if the UK market for structural warranties was working effectively. The fact that most new entrants came into the market after 2010, more than 15 years after NHBC entered into the current undertakings, is itself indicative of this market not functioning well. Also, the fact that the new entry appears to have been based [✂]

Premium refunds

Of all of the factors listed in paragraph 4.43 of the CMA's provisional decision, the one that, from a purely commercial perspective, is likely to have the greatest influence on a large builder's purchasing decision is NHBC's premium refund scheme. NHBC has, itself, confirmed to the CMA that "it is not common for large builders to leave its register" (paragraph 4.59 of CMA's provisional decision).

There are a number of "loyalty inducing" elements to NHBC's premium refund scheme. The first of these is the fact that any builder who would otherwise be eligible for a premium refund will no longer be eligible for any further premium refunds if it leaves NHBC. Bearing in mind the size of these premium refunds (see paragraph 4.65 of CMA's provisional decision), it is most unlikely that a builder would recover these sums through lower premium prices offered by a competing structural warranty provider.

The second "loyalty inducing" element are the eligibility criteria referred to in paragraph 4.62 of the CMA's provisional decision. NHBC looks at a period of 20 years and sets both a financial threshold and a volume threshold that will be difficult for smaller builders to achieve. NHBC also suggests (see paragraph 4.63 of CMA's provisional decision) that a builder needs a cumulative premium contribution well in excess of £100,000 in order to qualify for sizeable premium refunds.

The premium refund scheme appears to operate in much the same way as a rebate scheme, with the greater the volume of business placed with NHBC the greater the potential premium refund. Under UK and EU Competition Law, dominant companies are only permitted to offer discounts or rebates where those discounts or rebates pass-on costs savings which the dominant company makes (see *Coca Cola* case at an EU level). Is this the case with the NHBC premium refund scheme?

The third "loyalty inducing" element is the amount of refund paid to builders by NHBC. The CMA has found that in some cases, the premium refund exceeds the premiums paid by a builder in a particular year. More typically, the premium refund is around half of the amount of fees (by which we assume the CMA means premiums) a builder pays each year to NHBC (see paragraph 4.65 of CMA's provisional decision). A competing structural warranty provider will not be in any position to match this level of refund through the mechanism of lower premium costs.

Once a builder starts to receive substantial premium refunds from NHBC, it will very quickly become reliant on those payments to boost its net profitability. In addition, a builder in receipt of substantial premium refunds is unlikely to want to switch business away from NHBC to any material degree, as a reduction in the level of structural warranty business placed with NHBC will subsequently lead to a reduction in the level of any premium refund paid (always assuming the scheme continues in its current form).

The CMA has established that the NHBC premium refund scheme only benefits around 20 builders. If these are the 20 largest house builders in the UK, who together account for over 58% of the new build houses in the UK, this is a very substantial part of the market that is de facto foreclosed to competitors of NHBC due to the "loyalty inducing" nature of the NHBC premium refund scheme.

NHBC claims that the aim of the premium refund scheme "is to raise the standard of construction, by rewarding builders who have a good claims history

on closed policies" (paragraph 4.61 of CMA' provisional decision). However, this is already done by NHBC through the operation of its premium rating system, which rewards those builders with the highest premium ratings with lower policy premiums in each relevant year. [REDACTED].

The premium refund scheme has, to-date, only made payments to around 20 builders. According to NHBC's 2015/16 Annual Report, it had 10,953 registered builders. The 20 builders who received premium refunds together account for 0.18% of the total number of builders registered with NHBC. Whilst these 20 builders may together account for over 58% of the new build houses in the UK, this still leaves a large part of the market and of the NHBC membership that is not being incentivised "to raise the standard of construction", because they have no prospect of satisfying the criteria applied by NHBC for premium refunds.

Paragraph 4.67 of the CMA's provisional decision refers to so-called one-off payments by NHBC to builders which are not treated as premium refunds. If it has not already done so, the CMA should establish the frequency with which such payments have been made by NHBC since 2009, and the actual reasons for those payments. [REDACTED]. If these payments are de facto "loyalty inducing", the CMA needs to be aware of this when considering which elements of NHBC's rules, practices and procedures and/or NHBC's behaviour have the object of discouraging NHBC registered builders from dual sourcing from, or switching to, other providers of structural warranties.

Whilst [REDACTED] notes the CMA's comment that "the link between the upfront choice of warranty provider and a possible future premium refund is indirect and uncertain", it believes the NHBC premium refund scheme plays a major role in disincentivising switching and/or dual sourcing to a material degree. [REDACTED] view appears to be supported by many other structural warranty providers – see paragraph 4.58 of the CMA's provisional decision. Once a relevant builder becomes entitled to a premium refund and starts receiving them, the builder will wish to continue to receive such payments since many if not most of these payments have been and are likely to continue to be substantial. There is no suggestion the NHBC proposes to change any element of its premium refund scheme.

The proposed revised NHBC Undertakings

[REDACTED] welcomes and supports the varied Undertakings proposed by the CMA in its provisional decision. The key to making any varied Undertakings more effective, as the CMA is undoubtedly aware, is identifying the problem areas that need to be addressed by the Undertakings and ensuring the varied Undertakings effectively and proportionately address those problem areas.

Whilst the CMA has indicated it would be highly desirable for there to be increased transparency in relation to the operation of NHBC's premium refund scheme, in [REDACTED] view [REDACTED].

[REDACTED] acknowledges that wholesale switching away from NHBC by the larger builders is unlikely and is unrealistic to expect. However, [REDACTED] does not see any valid reasons why, in a properly functioning market, larger builders would not increasingly dual-source or multi-source their structural warranty requirement, perhaps sourcing from one provider for one development site and from a different provider for another development site. This is not currently happening, to the best of [REDACTED] knowledge.

[REDACTED]. This will require some form of effective monitoring by the CMA. In this context, [REDACTED] does have concerns about the CMA's proposal that NHBC no longer be required to submit rule changes to the CMA for prior approval. It must surely be considerably easier for the CMA to object to new rules and/or procedures before they are introduced, than to have to try and correct changes that have already been made and which the CMA objects to. [REDACTED] invites the CMA to consider how many times, since the current Undertakings were entered into, did NHBC submit rule changes for prior approval. If, as [REDACTED] suspects, this was not very often, then maintaining such an obligation on NHBC in any varied Undertakings should not impose an overly onerous burden on the CMA.

14th July 2017