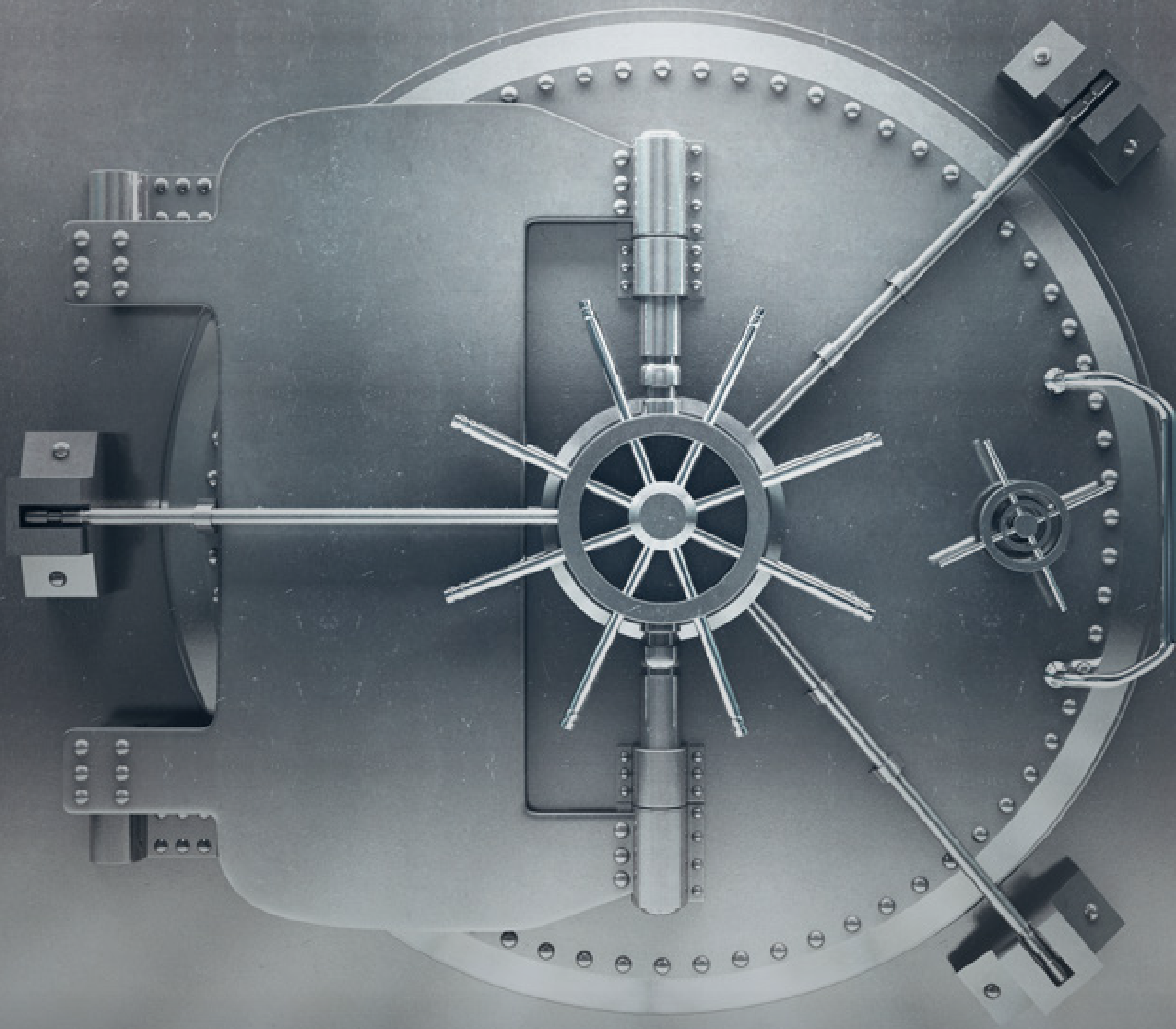
TRUST DEFICIT

Why project bank accounts are a hammer in search of a nail



AUSTRALIAN CONSTRUCTORS ASSOCIATION

About the Australian Constructors Association

The Australian Constructors Association is the only representative body for contractors delivering vertical and horizontal construction projects, as well as undertaking infrastructure asset management. Our members construct and service the majority of major infrastructure projects built in Australia every year. Our goal is to create a more sustainable construction industry.

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Key points

- Project Bank Accounts (PBAs) aim to protect subcontractors from not being paid on time or in full by head contractors. They require that any payment made under a contract be held ‘in trust’ by the principal contractor and used only for the purposes of that contract.
- These schemes are applied only to the construction industry. This selectivity rests on the assumption that construction is a ‘special case’ that requires additional supply chain protections over-and-above the normal rules of commerce.
- This assumption does not stand up to scrutiny. Construction is in-principle no different to any other industry. All businesses rely on inputs from other businesses to deliver their end product. The difference is one of degree not kind.
- The only valid reason to impose additional regulation on construction payments would be if an industry’s payment performance is systematically worse than others.
- There is no evidence that this is the case. Indeed, the payment performance of construction firms is similar to those of firms in other industries. The rate of late payments in the construction industry is *below* the average of other industries.
- Construction is therefore neither a ‘special case’ in-principle, nor a ‘problem case’ in-practice. This fundamentally undermines the legitimacy of PBA schemes that impose significant restrictions on what is already one of the most heavily regulated industries in the economy.
- Putting aside these wobbly foundations, PBAs are ineffective at impacting the sorts of practices and behaviours they target.
- An extensive legal framework is available to deal with unfair payment practices. PBAs add no additional protection while adding a significant regulatory and cost burden on commerce. They are a textbook example of regulatory over-reach.
- Should the government remain committed to implementing additional protections for subcontractor payments, a range of options are available that are likely to be more effective while having less impact on legitimate trade.

Introduction

The *Australian Government Guide to Policy Impact Analysis* notes that all regulation should seek to minimise its impact on trade to the greatest extent possible. While there is a legitimate role for government in correcting market failures, the restrictions imposed by regulation must be outweighed by the risks it seeks to mitigate.

The purpose of this paper is to assess the merits of Project Bank Accounts (PBAs). It considers three key questions:

1. Market impact – what effect do PBAs have on legitimate trade?
2. The extent of the problem being addressed – is underpayment real or perceived?
3. The efficacy of the regulation – are PBAs an effective means of addressing underpayment?

What are Project Bank Accounts?

A Project Bank Account (PBA) scheme is a special case of the common statutory trust scheme. These schemes are widely used across the legal, accounting, stockbroking and real estate sectors.

Statutory trusts are utilised where monies belonging to one party need to be temporarily held by another party under strict conditions. The most common example is a property transaction, whereby a real estate agent or solicitor holds a buyer's deposit 'in trust' until the transaction is finalised, at which time the funds are released to the vendor.

The essential feature of statutory trusts is that the funds legally belong to other people. At no point does the trustee (e.g. the real estate agent or solicitor) 'own' the money. As such, there are very strict rules around how trustees can handle and use trust funds.

PBA schemes apply this model to construction projects. The basic scenario is where a developer contracts a builder to deliver a project, who then subcontracts other entities to perform a portion of the works. As the project proceeds, the builder makes payment claims to the developer and the subcontractors make payment claims to the builder.

A PBA requires the builder to hold the developer's payments in trust and distribute the funds according to strict rules set out in legislation. Neither the builder nor the developer can treat the monies in a trust as its own property. In general, a PBA prohibits the use of contract payments for any purposes not related to that specific building contract. The builder effectively becomes a trustee of project payments, performing the same function as a solicitor in a property transaction.

Impacts of PBAs on legitimate trade

PBAs distort normal market mechanisms in several important ways. The first distortion arises from the mistaken assumption that construction contracts are directly analogous to other transactions where trusts are used, such as property sales. It is often assumed that monies paid by a client to a builder represent two distinct components: payment to the builder for 'project management' services and payment for goods and services supplied by subcontractors.

This misrepresents most construction contracts. Clients generally let a project to a builder who takes full responsibility for delivering the entire project and assumes all the attendant risks. The builder will then make decisions about the portion of the works it will self-perform and those it will subcontract to another business.

This is the standard template for any business transaction - every firm exercises 'make-or-buy' decisions. While it is true that builders tend to 'buy' more than most industries, this is a difference in degree not kind. All businesses have some measure of dependence on the supply chain. And it is worth noting that construction's supply chain dependence is not the highest - manufacturing relies upon its supply chain for 72% of its output compared to construction's 70%.[1]

The key point is that building is no different to any other commercial transaction. The builder alone is responsible to the client for the delivery of the contract and bears full accountability for the outcome. In return for this responsibility, the builder receives an agreed revenue flow. This is standard commerce and bears no resemblance to 'trust fund' scenarios, such as property transactions. Trust arrangements are ill-suited to standard commercial models for building projects.

PBAs further distort the market by preventing builders from using revenues generated from one activity to fund another. This standard practice, known as 'cross subsidisation,' is relied upon by business of all industries to smooth cashflows, manage risk, and make investments. Indeed, growth and innovation would be severely curtailed if all businesses were forced to match revenues to expenditures in the manner required by PBAs.

In effect, PBAs compulsorily acquire a builder's legal property (project revenues) and reduce that property to the status of trust money.[2] PBAs also remove a builder's discretion to employ a range of legitimate commercial strategies that are widely practiced across industries to ensure financial stability and promote growth. PBAs therefore represent a significant regulatory intervention that is inconsistent with fundamental legislative principles.

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It is also important to consider the significant administrative overhead associated with PBAs. Builders must expend considerable cost and effort to modify systems and processes to comply with PBA legislation. PBAs not only create an additional burden for builders, but also imply the creation of a new congeries of PBA specialists dedicated to auditing and reporting on the accounts. This additional overhead will disproportionately impact smaller builders and create a further drag on industry productivity. Ultimately, the cost of PBAs will be passed back to the end user.

While builders clearly must pay their suppliers according to the terms of their contracts, a substantial body of commercial law is in place to enforce that obligation. PBAs represent an additional layer of regulation over-and-above these standard protections. Such intervention is not inherently inappropriate — additional regulation can be justified where there is demonstrable market failure. However, a core tenet of good policy is that the negative impacts of any regulation must be outweighed by the harm it seeks to minimise.[3]

That PBA schemes have significant impacts on the construction market is not seriously in question. Proponents of these schemes say these impacts are justified because the normal laws of commerce are disproportionately failing the industry. The need to protect subcontractor payments is assumed to outweigh any restrictions imposed by PBAs on legitimate trade.

The key question for policy makers is whether these distortions and regulations are a reasonable and proportionate response to the perceived problem.

Extent of poor payment practices in construction

That construction firms systematically fail to pay subcontractors on time has become an uncritically accepted assumption. The influential Murray Review exemplifies this view in its comment that the construction industry "is notorious for its payment issues along the whole supply chain."[4]

Yet untested notoriety is a poor foundation for good policy. To date, no rigorous and objective evidence has been presented to substantiate the view that payment performance is systematically worse in construction than other industries.

The lack of evidence underpinning PBA policy and legislation could be excused by the historically weak availability of rigorous data. At the time of the Murray Review, for example, no high-quality payment performance data was publicly available. Since then, however, a range of relevant data has become available.

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In January 2020, the Australian Government introduced a Payment Times Reporting Scheme requiring businesses with an annual turnover of more than $100 million to publicly report on their payment terms and times for their small business suppliers. The Scheme is administered by a dedicated Payment Times Reporting Regulator with legislative powers to enforce reporting.

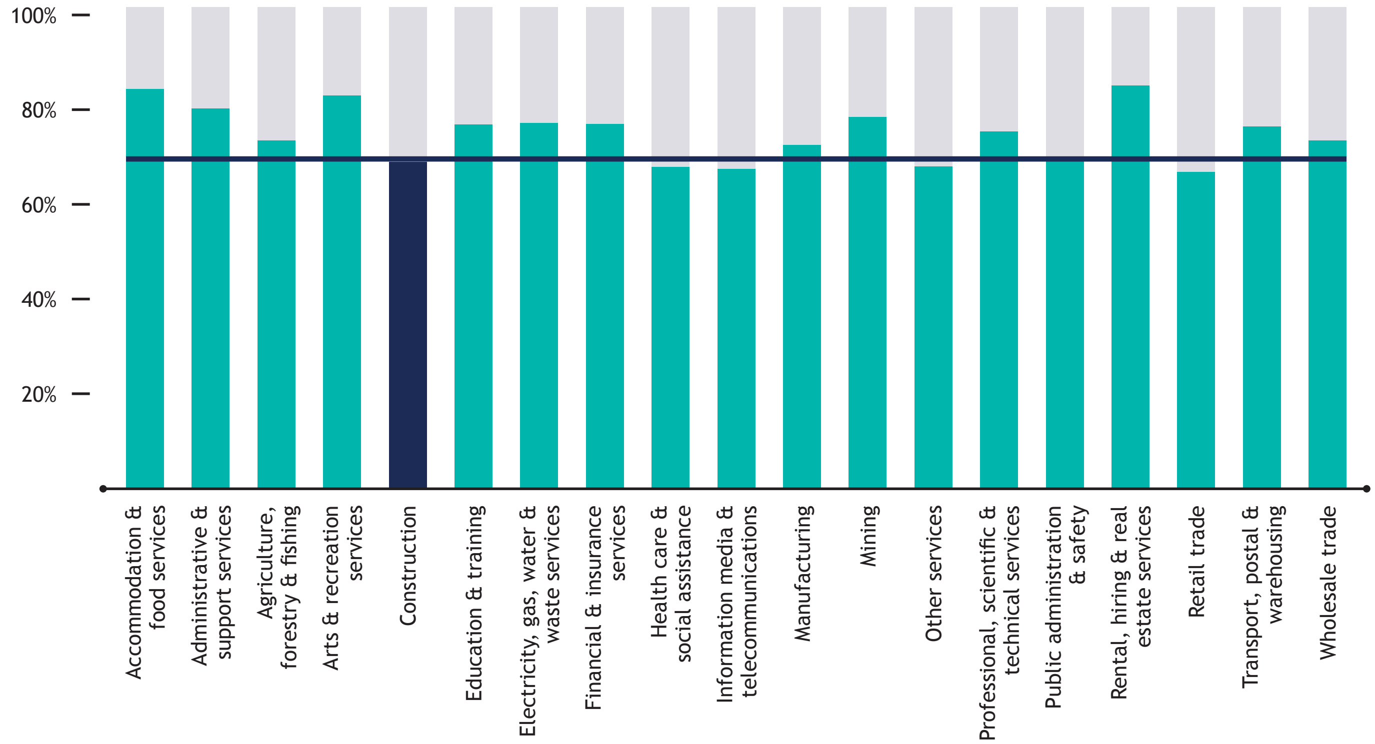
Data from the Register suggests payment performance among construction firms is not dissimilar to many other industries (**Figure 1**).

The Payment Times Reporting Register is not the only source of relevant data that has emerged in recent years. The widely used accounting platform, *Xero*, now publishes a Small Business Index based on the millions of transactions facilitated through its platform. These statistics also suggest construction payment performance is on par with other industries (**Figure 2**).

It is therefore clear that construction is neither a 'special case' in-principle, nor a 'problem case' in-practice when it comes to payment performance. Construction firms are fundamentally no different to any other industry and are subject to the same rules of commerce. Furthermore, there is no evidence that construction firms are more likely than other industries to break those rules.

Figure 1: On-time payment performance

Average percentage of invoices paid within entity's standard payment terms, 2022

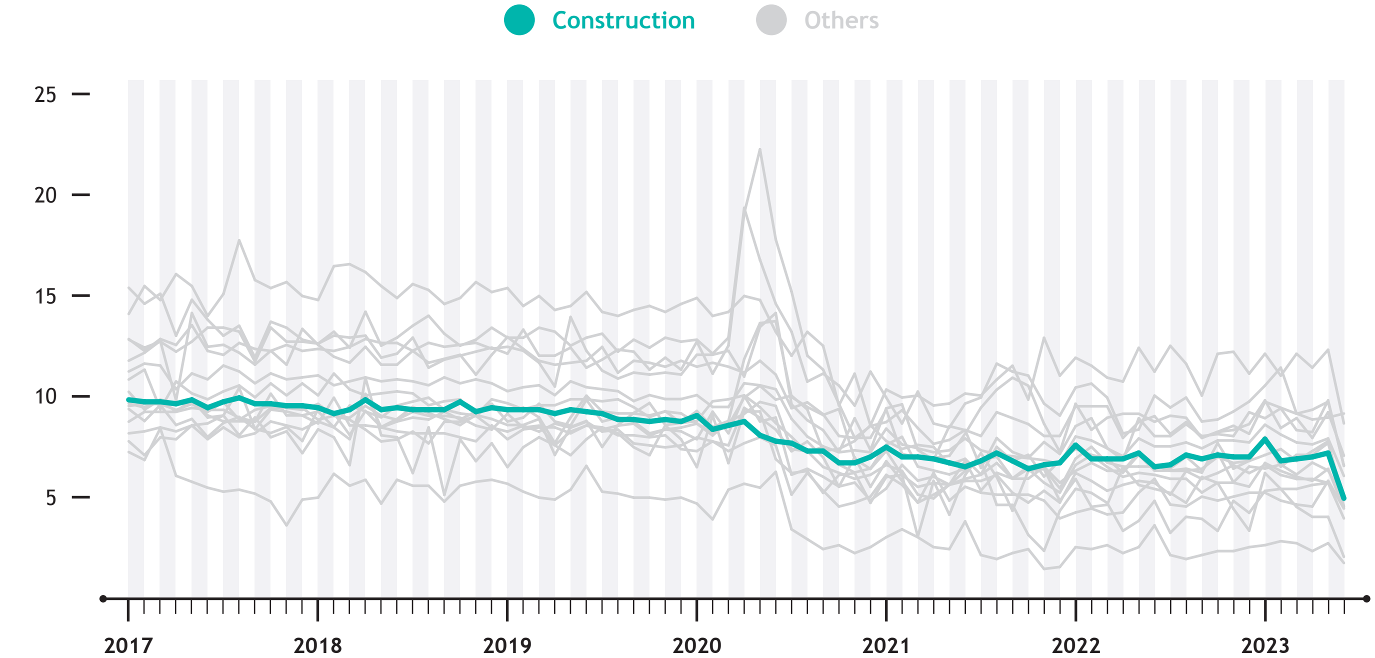


Notes: On-time payment performance is calculated for each payment report as a ratio of the estimated median payment time to the entity's standard payment terms. Includes reports from PTRS reporting cycles 3 and 4 (CY2022). Consistent with PTRS assumptions, analysis excludes nil responses, superseded reports, and reports that do not include payments to small business suppliers.

Source: ACA analysis of Payment Times Reporting Register

Figure 2: Late payment by industry

Average days late, seasonally adjusted



Source: Xero Small Business Index - Australia

Protecting supply chains from insolvency events

The disproportionately high rate of insolvencies in the construction industry is often offered as a justification for PBAs. The rationale is that when a construction firm fails, subcontractors are often left out of pocket.

It is an unfortunate reality of any insolvency event that debtors often do not receive all monies they are owed. It is for this reason that there exists an extensive legal framework providing for orderly and effective insolvency procedures. As noted above, PBAs rest on an assumption that the construction industry represents a 'special case' for which normal regulatory frameworks are failing. This is another assumption that has until now remain largely untested.

It is true that construction companies are over-represented in the insolvency statistics. While only 17% of all businesses are construction firms, those companies account for 29% of all insolvencies. Construction firms face an insolvency risk more than twice that of other industries.[5]

While concerning, it is important to keep these numbers in proper perspective when contemplating additional regulation. While construction is a poor performer, it is not the worst in the economy. The rate of insolvency was higher, sometimes much higher, in several other industries over the course 2022-23 (**Figure 3**).

It is also important to note that PBAs regulate only one corner of the construction industry—principal building contractors. In 2022-23, a total of 710 building firms entered administration. By comparison, almost twice as many insolvencies (1409) were recorded among 'construction services' firms, colloquially known as subcontractors. The failure of a subcontractor represents as much of a financial cost to builders as does its opposite, yet there is little-to-no policy focus on risks that cascade up the supply chain.

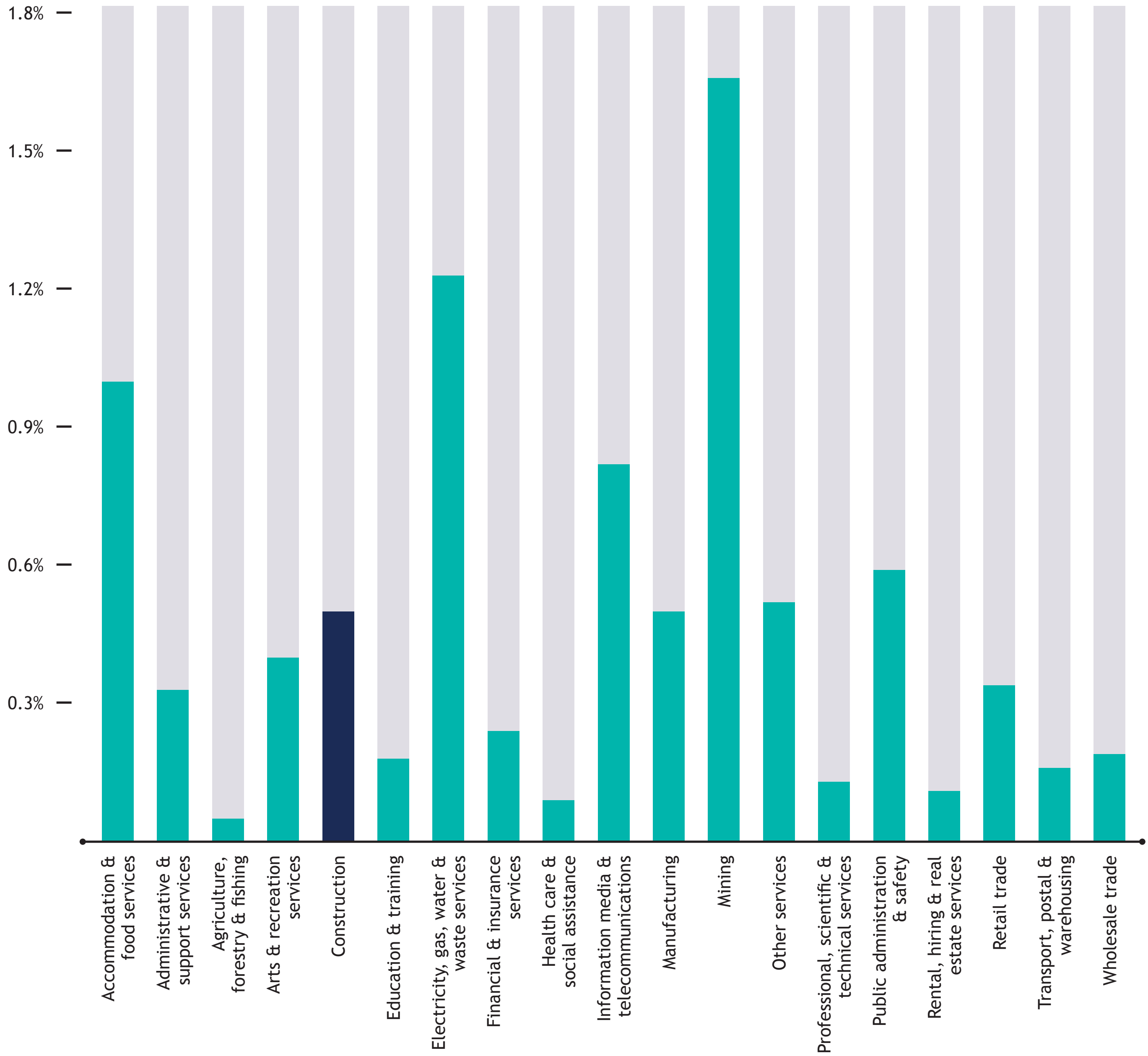
> While all industries suffer from underpayments and insolvencies, PBAs single out one industry for special treatment. That position cannot be justified by the evidence.

It is also worth noting that PBA schemes rarely extend to the ultimate source of project payments — clients. The payment chain on any construction project begins with the client and, in many cases, the client's financier. PBAs do nothing to protect builders or subcontractors from non-payment by a distressed developer or uncooperative banker.

All of this is not to argue that other industries should be roped into PBA-like schemes. It is merely to observe that all corners of all industries suffer from underpayments and insolvencies to varying degrees. The key policy question is whether one industry's performance is so materially worse than others that it justifies an additional layer of regulation over-and-above existing commercial protections. From this perspective, the data presented here casts serious doubts over the justification for PBAs.

Figure 3: Insolvency rates

Ratio of insolvencies to businesses operating in 2022–23



Notes: Insolvency risk calculated as the ratio of insolvencies during FY2022-23 to businesses operating at the beginning of FY2022-23.

Source: ASIC, ABS, ACA

The ineffectiveness of PBAs

This paper has so far emphasised the lack of a sound evidence-based policy rationale for PBA schemes. Yet even if we accept the premise that building subcontractors require greater payment protection, the effectiveness of PBAs in achieving this outcome is highly doubtful.

The failure of PBAs to achieve their stated objectives is evidenced by the first test case of the Queensland Government's PBA scheme, introduced in 2017. The large national builder, PBS Building Group, entered administration in March 2023 owing $169 million across 500 creditors. The company's PBAs reportedly held less than 10% of the funds owed to subcontractors.[6]

That PBAs have not worked as intended is unsurprising to those familiar with the operations of the construction market. PBAs fail to address the root causes of payment failure in connection with payment-related disputes between a client and builder, and client insolvencies.

PBAs only address the proximate source of subcontractor payments (builders) while ignoring the ultimate source (clients). By design, PBAs cannot expedite or resolve any payment delays or failures arising from the insolvency of a client, or a dispute between client and builder. Overall, PBAs offer subcontractors little protection from builder-client disputes or client insolvency.

Furthermore, PBAs perversely increase the risk that builder-client disputes will cascade through the supply chain. This is because PBAs remove the discretion of builders to use funds from one project to offset cashflow constraints on others. As noted above, cross-subsidisation is routinely employed across all industries to smooth cashflows. By prohibiting this practice, PBAs greatly limit the ability of builders to minimise the impact of client-side payment delays on subcontractors, while increasing the risk of insolvency.

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A further root cause of payment failures and insolvency that PBAs do not address is the liquidity challenges arising from unfair contract terms and inappropriate risk allocation.

Better paths to securing industry liquidity

Any analysis of construction payment security must begin with an understanding of the mechanisms underlying the industry's chronic illiquidity. ACA's recent report, *All risk, no reward: fixing the building industry's profitless boom*, provides further detail on the underlying causes and what can be done to meaningfully improve the sustainability of the construction industry.

Put simply, the weak financial position of the construction industry is the direct result of a market that values the lowest bid price above all other factors. The construction market applies a simplistic commercial model to a complex product that is laden with uncertainty and risk. This model of total risk transfer drives a corrosive set of commercial practices that lead to a downward spiral into razor-thin margins and high rates of insolvency—a race to the bottom.

To the extent that policy makers are motivated to address the liquidity challenges facing the industry, they should focus on reforming commercial models. Rather than imposing punitive and ineffective PBA schemes, governments should commit to relational and collaborative approaches to contracting that appropriately share risk. This will not only improve liquidity throughout the supply chain but will also drive productivity in one of the economy's most important but lagging industries.

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PBA schemes should also not be considered in isolation. As noted earlier, PBAs reduce the discretion of builders to deploy revenues and limits their commercial options. Yet at the same time, builders are asked to continue to accept a full burden of commercial risk. It is unreasonable to expect a business to adopt an uncapped downside risk profile while capping the upside. If the policy intent is to restrict the degrees of commercial freedom available to builders, the policy response should include arrangements that fairly reflect the new balance of risk and reward.

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An example of such an arrangement is the 'Managing Contractor' model.[7] Under this model, the builder performs a purely management and advisory service for the client, organising subcontractors to undertake all design and construction functions. While the builder does pay the subcontractors, it merely passes these costs directly through to the client. In return, the builder receives a management fee. As a Managing Contractor, the builder can genuinely be said to hold subcontractor payments 'in trust' and a PBA arrangement would be quite compatible.

Larger construction projects are also increasingly delivered under 'open book' frameworks—so-called 'Alliance' models—where the flow of monies is carefully controlled and transactions transparent. In such cases, PBA legislation would add unnecessary complexity and administration for no additional benefit.

The role of developers in the building supply chain is another policy space worth exploring. In Queensland, for example, a recent review recommended the establishment of an accreditation scheme to ensure developers meet minimum standards and strengthens safeguards around unfair contracting.[8] Such measures have the potential to address the more fundamental causes of the industry's illiquidity, particularly unfair contracting terms and inappropriate risk allocation.

It is also worth noting that a range of existing Security of Payment (SoP) mechanisms are available in various jurisdictions to provide an additional measure of protection to subcontractors. For example, the SoP regimes in NSW and Queensland provide for maximum payment timeframes in contracts between clients and builders, and builders and subcontractors. Most SoP regimes also provide an adjudication process that ensures disputed payment claims are quickly and efficiently determined so that prompt payment can be made. This can include the ability for a claimant to require the counterparty to retain sufficient money to cover the claim.

Despite their widespread use, SoP legislation remains inconsistent nationally. This creates confusion and administrative duplication which undermines the effectiveness of the arrangements. Streamlining SoP legislation nationally would be a more effective and feasible policy direction than implementing burdensome and heavy-handed PBA schemes.

Conclusion

PBA schemes are a non-market intervention that impose significant restrictions on legitimate trade. Any policy intervention of this scale demands a compelling case that the firms targeted present a level of risk that is not adequately mitigated by existing legislative frameworks. Policy makers must clearly demonstrate a public policy problem necessitating intervention.

Despite myriad legislation, Parliamentary reviews and independent inquiries, the case for PBAs is yet to be convincingly made. By contrast, the data presented in this paper suggests that PBAs constitute a significant regulatory over-reach. Payment performance in the construction industry is no worse than many others, despite it suffering from a relatively high risk of insolvency. Indeed, several other sectors have higher rates of insolvency yet escape the sort of scrutiny applied to construction.

The proposition that construction demands direct government intervention in the form of regulation simply does not stand up to scrutiny.

Endnotes

1 ACA analysis of ABS, *Australian National Accounts: Input-Output Tables* (cat no. 5209.0.55.001)

2 This point was acknowledged in the Explanatory Note to the Building Industry Fairness (Security of Payment) Bill 2017 (*Qld*).

3 Australian Government, *Australian Government Guide to Policy Impact Analysis*, March 2023

4 Australian Government Attorney-General's Department, *Review of Security of Payment Laws*, May 2018

5 ACA analysis of ASIC insolvency statistics, 12 months to August 2023, Series 1. Insolvency risk calculated as the ratio of insolvencies during FY2022-23 to businesses operating at the beginning of FY2022-23.

6 The Courier Mail, *Liquidators find PBS QLD owes subbies $4m, but trust accounts hold less than $400k*, 20 July 2030

7 The Managing Contractor model is increasingly favoured in public procurement. For example, the Department of Defence uses the model extensively in the delivery of its Estate Program.

8 Developer Review Panel, *Setting the tone: the role of developers in Queensland's building and construction industry*, April 2023

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