

# Guarantees and Insurance Products: *market and policy analysis*

Prepared for

---

Ministry of Business, Innovation and Employment

#### Authorship

Tim Denne, Alexia Beer

#### Suggested citation:

Denne T and Beer A (2018) *Guarantees and Insurance Products: market and policy analysis*. Report to Ministry of Business, Innovation and Employment. Covec Ltd. Auckland.

#### Acknowledgements

We are very grateful to Matt Earley of Hampton Jones, for assisting with this study, including through helpful discussions and reviews of draft reports.

© Covec Ltd, 2018. All rights reserved.

#### Disclaimer

Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, Covec Ltd accepts no liability for any actions taken on the basis of its contents.

# Contents

---

Executive Summary	i
1 Introduction	1
1.1 Background	1
1.2 Allocating Liability	2
1.3 Requirements of this Study	7
2 Current Market	8
2.1 Demand for GIPs	8
2.2 GIPS in New Zealand	9
2.3 Scheme Characteristics	10
2.4 Potential for Expansion	18
2.5 International GIPs	19
3 The Problem and the Role of GIPs	23
3.1 Overview	23
3.2 Potential costs	23
3.3 Efficiency of Insurance Markets	24
3.4 Consumer Trust	25
3.5 Current Decision Making	25
3.6 Market Failure Analysis	26
3.7 Conclusions	27
4 Policy Options and Analysis	29
4.1 Characteristics of Ideal GIPs	29
4.2 Analytical Approach	37
4.3 Policy Analysis Criteria	40
4.4 Option 1: Do Nothing	41
4.5 Option 2: Promotion of GIPs (that meet desirable criteria)	41
4.6 Option 3: Compulsory GIPs	43
4.7 Option 4: The Government as GIP provider	48
4.8 Summary	49
5 Conclusions	52
5.1 Overall Costs and Benefits of Options	52
5.2 Compulsory or Not?	52

5.3	Next Steps	53
	References	54
	Glossary	56
	Annex A Building Activity in New Zealand	57
	Annex B Consumer Protection under Law	60
	Annex C Insurance Industry Regulation	63
	Annex D International GIPs	65

# Executive Summary

---

## Background

Guarantees and insurance products (GIPs) provide consumers with protection against non-completion of building work and post-completion defects. They ensure that builders complete the work or correct the defects, or they provide a pay-out that funds these corrections. This report examines the New Zealand market for GIPs relating to residential building in New Zealand, including supply and demand, potential market failures and the rationale and scope for policy intervention to increase their supply or effectiveness.

## GIPs in New Zealand

There are several GIPs currently available in New Zealand. These are broadly classified into:

- **Member schemes** available to organisation members:
  - Halo Residential Guarantee provided for work done by members of the New Zealand Certified Builders Association (NZCBA);
  - Master Build Guarantee for work done by a member of the Registered Master Builders Association (RMBA);
- **Independent schemes** available to any builders meeting certain quality criteria:
  - Stamford Building Warranty Insurance, available from any builder which is approved by Stamford;
  - BuiltIn insurance 10-year building warranty, which was formerly underwritten by CBL Insurance. They are now re-sellers of Stamford Insurance, with slightly different terms and prices;
- **Building company schemes** provided by large building companies and which come automatically with houses they build. These include those provided by:
  - Signature Homes;
  - Golden Homes; and
  - Classic Builders.

In Table ES1 we provide an estimate of the number of GIPs currently supplied per year. It suggests that approximately 53% of new properties are built with one, as are approximately 23% of renovations.

Table ES1 Estimated numbers of GIPs supplied per year

	New properties	Renovations	Total
Master Build	10,000	2,000	12,000
Halo/CBNZ	3,000	3,000	6,000
Independent schemes	2,000	1,500	3,500
Building company schemes	1,500		1,500
Total	16,500	6,500	23,000
% of total residential consents	53%	23%	39%

Three of the schemes are backed by insurance – the Halo scheme and the independent schemes. RMBA has stated its intention to move towards insurance-backing later in 2018. Classic Builders Ltd is also considering moving to an insurance-backed scheme currently.

In general, a guarantee provides assurance that something will be fixed if it goes wrong, whereas insurance provides an offer of compensation for loss. Because of the financial requirements, insurance companies are regulated (under the Insurance (Prudential Supervision) Act) and independently audited to ensure that they have sufficient capital to cover possible liabilities. Thus, in general insurance companies have deeper pockets.

The NZ insurance-based products have many characteristics of guarantees. Generally, they will seek to ensure the builder fixes the problem first before stepping in with compensation. Pure compensation might be required when building firms collapse and another builder is required. Insurance-based schemes provide greater protection when a builder refuses to remedy faults, and they provide greater protection if there is a widespread systematic problem which might overwhelm a building firm.

A number of schemes exist in other countries. Mostly these are compulsory and insurance-backed.

## The Problem

The current problems that enhanced GIPs might address include the following:

- The information constraints on homeowners and others which limit the extent to which decision makers take account of risks in choosing builders, building designs, materials and other factors affecting the risk of unexpected costs;
- The potential for those most responsible for faults being able to avoid liability such that it falls on others. This is both
  - **Inequitable** – it unfairly penalises those not responsible for the problems; and
  - **Inefficient** – it does not provide incentives for risk-limiting behaviour;
- The limited choice in building markets and the absence of competitive pressure to push out poor performers, which may mean decision makers do not have access to several suppliers of low-risk products (including builds and materials); and
- The transaction costs of pursuing those who cause problems.

GIPs are identified as having the potential to reduce some or all of these problems, provided that they have the following characteristics:

- **Wide availability** either by being compulsory and/or widely recognised by consumers;

- **Incentivise building quality improvement** through differential pricing to reflect risk and/or having entry standards which limit high risk factors (bad builders and bad designs);
- **Do not reduce competition** eg by market entry barriers that result in market consolidation. This might happen if, to limit risks, only large companies with extensive track records can obtain cover; and
- **Certainty of redress** – they enable simple and easy redress without the need for high transaction-cost pursuit of those responsible for faults.

## High Quality GIPs

If policy is introduced to encourage GIPs, it is useful to understand the attributes of high quality GIPs. The key attributes are summarised in Table ES2

Table ES2 Desirable attributes defining high quality GIPs market

Objective	Component	Desirable attribute
Limiting homeowner liability	Comprehensiveness cover	GIPs cover: <ul style="list-style-type: none"> <li>• loss of deposit, completion-failure and post-completion defects</li> <li>• all causes, whether the responsibility of the builder or others</li> </ul>
	High level of financial backing	Insurance-backing with significant available reserves
	Certainty of any remedy	First-resort insurance
Incentivising building quality improvement	Restricted entry	Builders meeting criteria relating to qualifications, experience, project and business management
	Differential pricing	GIPs priced to reflect builder- and project-specific risk
Efficient pricing	Competitive market for GIPs	Builder quality information (including defect history) widely available
Wide availability	Increased supply and demand	Available with all building work (above size threshold) GIPs available as retail products Known about and valued by consumers
Low transaction costs	Automaticity of redress	First-resort insurance

Ideally, GIPs would:

- Be of high quality. They would
  - Limit homeowner liability by being comprehensive in their cover, backed by scheme providers with significant financial resources and provide certainty of redress;
  - Incentivise building quality improvement by restricting builder entry to schemes and/or through differential risk-based pricing, which would also provide consumer benefits;
- Be widely used by being:

- widely available and purchased, for all building jobs, including as retail products; and
- widely recognised for their value; and
- Work simply and effectively, including through having low transaction costs so redress is automatic.

## Policy Options and Analysis

Four policy options are considered:

1. Do Nothing – leave the development of GIPs to the market
2. Information provision only
3. Compulsory GIPs, including (a) with no opt-out, and (b) with an opt-out.
4. Government GIPs provision in case of under supply

Table ES3 sets out the criteria that are used in summarising the analysis of the individual policy options. They address both equity and efficiency concerns.

Table ES3 Policy Analysis Criteria

Criterion	Explanation
Reduced homeowner liability	This is addressing the primary equity objective
Increased total use of GIPs	Assuming current market failures limit use of GIPs, increased use is regarded as a benefit
GIPs targeted at risk-averse	Targeting at risk-averse people limits the costs falling on the risk-neutral
Increased quality of GIPs	Higher quality GIPs are those which provide better liability protection (as discussed in Section 4.1)
Incentives for improved builder/building quality	Building quality problems are the underlying reason why GIPs are required. GIPs policy should improve quality or not make it worse
Reduced BCA risk-aversion	BCA risk-aversion increases costs. GIPs which reduce liabilities for homeowners should not do so at the expense of BCAs
Costs to Government	GIPs policy should not involve significant regulatory costs which are not justified by significant benefits

Table ES4 summarises the analysis above. Options 1 to 3 increase in their expected costs and effectiveness. Option 4 does not function on its own, but alongside Options 3(a) or 3(b).

- Option 1 (*Do Nothing*) would see small incremental developments in the GIPs market over time but these are not expected to fundamentally change the underlying problems. This might be an appropriate option if the Government is considering other policies which would be expected to reduce the level of underlying homeowner (and BCA) risk.
- Option 2 (*Promoting Good GIPs*) would have uncertain effects because of uncertainty over the effectiveness of any campaigns. It would be expected to have small impacts both on the supply side (improving GIP quality) and demand (encouraging purchase). If successful, GIP purchase would be focussed



on risk-averse homeowners.

Ideally, information campaigns would be accompanied by risk communication also, but there are constraints on the extent to which risk information is available, eg relating to builder or build-type risk.

- Option 3(a) (*Compulsory GIPs with no opt-out*) would be a significant intervention in the market. The costs and benefits depend on the extent to which the policy is making risk-neutral homeowners purchase GIPs they do not want (even with full information) or forcing risk-averse homeowners to purchase GIPs they did not realise were available or needed.
- Option 3(b) (*Compulsory GIPs with opt-out*) would be likely to improve the allocation of GIPs to the risk-averse, so long as people understand risk and are not influenced by builders against purchasing.
- Option 4 (*Government as GIP provider*) could operate alongside a compulsory GIPs policy (Option 3) to ensure there is supply. It enables the Government to directly influence GIP design and, by doing so, to provide incentives for build quality. The costs increase for the Government to match the improved benefits, but some (or all) can be recovered via product premiums.

Table ES4 Analysis of Options against Criteria

Criterion	Option 1	Option 2	Option 3(a)	Option 3(b)	Option 4
Increased total use of GIPs	Very small impact	Small positive impact	Significant impact – 100% coverage above threshold	Significantly greater coverage expected	Would ensure 100% coverage
GIPs targeted at risk-averse	No	Small positive impact	Yes, to the extent that the threshold functions to isolate risk-averse	Yes, although this may be better or worse than in 3(a)	As for 3(a) and (b)
Increased quality of GIPs	Very small impact	Positive impact	Compulsory GIPs would also set quality criteria		As for 3
Incentives for improved builder/building quality	No appreciable impact	Small positive impact	Quality criteria for GIPs would isolate higher quality builders		Yes if it involves quality criteria and/or differential pricing
Reduced BCA risk-aversion	None expected	None expected	Potential for insurance companies to pursue BCAs still exists (unless this option is removed by regulation)		As for 3
Costs to Government	None	Costs of promotion	Costs of regulation		Costs of regulation & of establishing and operating insurance

## Conclusions

The analysis of policy options for GIPs does not allow a simple assessment of net benefits. GIPs primarily function to change who pays for building problems which arise. The social costs of building problems are the costs of fixing them; GIPs shift these costs from the homeowner to the insurance company, builder or membership organisation, and ultimately via premiums, to all people who contract for building work. This has equity benefits and has wellbeing net benefits to the extent that risk-averse people purchase GIPs that they would not otherwise, and that this benefit exceeds the sum of GIP premiums paid by the risk-neutral.

Additional social benefits are obtained when GIPs policy results in improved build quality and if it enables BCAs to be less risk-averse, eg if regulation of compulsory GIPs requires that insurance companies relieve them of liability.

The analysis of the potential costs of building problems which GIPs address was estimated to be approximately \$85 million per annum. With GIPs covering a little over 50% of the market, this would suggest an annual expected cost of approximately \$40 million. Compulsory GIPs would shift this some of this cost (that from projects exceeding a threshold) from a small number of homeowners and spread it across the market as a whole.

## Compulsory or Not?

It is notable that many other countries have adopted compulsory GIPs. If New Zealand was to do the same there are local examples that are currently as good as, if not better than many of the international schemes. In particular we believe the NZ schemes are preferable to those on offer in Australia.

Whether compulsory GIPs is a good policy depends on whether a significant proportion of people are expected to be risk-averse with respect to building problems. It is more likely that the risk-averse will be covered by the policy if the threshold for compulsory GIPs is relatively high.

Currently there is only one player in New Zealand who could step in to provide GIPs to the market as a whole: Stamford Insurance. The others are either limited by membership or by company. This provision would need to be overseen by the Government to ensure against the exercise of market power, unless as suggested above, additional players could be encouraged to enter the market. A further option is the Government's direct involvement in the market as a GIP provider. This is worth serious consideration, especially if further discussions with the industry suggest full coverage is unlikely or if extension to cover the whole market would be unlikely to be done efficiently (through differential risk-based pricing).

## Next Steps

The analysis in this project does not lead to a clear case for or against compulsory GIPs or for the involvement of the Government. However, we believe it is worth assessing further, particularly in consultation with the industry. Issues to explore further include:

- Desirable qualities of GIPs. We have provided some suggestions in this report, but it would be useful to obtain additional comment and feedback before promoting any Government expectations of high quality GIPs. This would include issues relating to differential pricing, including the data needs.
- The expectations for full coverage of the market under compulsory GIPs. We have received some assurances of market willingness to cover all builders (meeting some quality criteria), but additional assurance (or a Government GIP option as a back-up) would be needed before any decision to make GIPs compulsory.
- The appropriate level for a threshold for compulsory GIPs. This would need to consider levels below which damage costs would be reasonably tolerable and the current distribution of build costs.

# 1 Introduction

---

## 1.1 Background

Guarantees and insurance products (GIPs) provide consumers with protection against non-completion of building work and post-completion defects. They ensure that builders complete the work or correct the defects, or they provide a pay-out that funds these corrections. This report examines the market for GIPs relating to residential building in New Zealand, including supply and demand, potential market failures and the rationale and scope for policy intervention to increase their supply or effectiveness.

The current context for the study is that problems associated with residential building work, from a number of different sources across the whole supply chain, have led to greater liabilities falling on local councils as building consent authorities (BCAs) and/or on homeowners than either is responsible for.

In the brief for this work, MBIE suggests that problems with the current allocation of risk and responsibility between builders, councils, property developers and owners, include:

- parties facing a risk that is out of proportion to their involvement and/or control in the building process;
- some parties not being aware of the risks they face, or having limited options to manage them; and
- the efficiency and effectiveness of existing dispute resolution options being unclear.

In the remainder of this section we outline some of the background discussions which have led to the identified need for this research. We then:

- describe the current market in New Zealand, including the protection under law and the availability of GIPs. The use of GIPs in other countries is also explored (Section 2 and Annex D);
- analyse the current problem in New Zealand, including from a market failure perspective (Section 3);
- identify and assess policy options which might be used to address the identified problems (Section 4); and
- make recommendations (Section 5).

## 1.2 Allocating Liability

### 1.2.1 Multiple parties and joint and several liability

Problems that occur during or subsequent to a build may be a result of failures by any one or more of many people involved in the whole process. This includes problems resulting from poor design, faulty materials, poor construction, poor installation or inadequate completion. BCAs have a quality control role via consenting and inspection services; failures of that process can result in problems caused by others not being identified. Homeowners have an incentive to choose good quality builders and designers, but often do so with limited information.

If parties responsible for defects and other problems are held accountable, there is an incentive to ensure they do not occur. This is efficient<sup>1</sup> – a builder or other party will have the right incentives to weigh up the risks associated with different build options against their relative costs. Enforcing liability is also equitable or fair; those responsible for problems bear the costs.

Currently “accountability in New Zealand is underpinned by the “joint and several” liability rule, which is used to determine the liability of multiple parties in tort (negligence) law and how costs are allocated among them. Tort law is primarily concerned with ensuring an injured party is fully compensated (“made whole”) for damage or loss caused by negligent parties.”<sup>2</sup> The “joint and several” liability rule holds all who caused the loss 100% responsible for compensating the plaintiff. A claimant can bring a claim against one wrongdoer to recover all their loss. A defendant can then seek a contribution from other wrongdoers.

However, under joint and several liability, when some parties cannot pay, liability is left with those who can afford to rather than the responsible party(ies), and there is some evidence to suggest:<sup>3</sup>

- BCAs, architects and engineers are carrying the burden of other parties not being present;
- those commonly not paying their share are developers, main building contractors and sub-contractors; and
- the parties commonly not paying their share are often uninsured, are at risk of insolvency or bankruptcy when claims arise or have structured their business in such a way as to appear to avoid liability.

In its review of the costs of the leaky building crisis, PwC suggested the responsibility for weathertightness issues was very different from the expected final allocation of costs (Table 1).

---

<sup>1</sup> By efficiency we mean that all resources used in the economy are allocated in the optimal way. In this context, it means builders make the right choices with respect to building risks as they face the consequences of not doing so.

<sup>2</sup> Minister for Building and Construction (2011b)

<sup>3</sup> Minister for Building and Construction (2011b)

Table 1 Mismatch of estimated responsibility and eventual cost distribution

Party	Estimated Responsibility	Expected cost distribution
Owners	-	69%
Builders	60%	4%
Designers/architects	10-20%	-
Building consent authorities	20-30%	25%
Government	-	2%

Source: PwC (2009)

Owners were estimated to carry the largest share, as:

- i) they carry their own transaction costs;
- ii) failures occurring after the 10-year liability limit in the Building Act 2004 are the owner's responsibility;
- iii) many failures will have gone unrecognised and will, therefore, remain the owner's responsibility; and
- iv) some owners are responsible for the building work (they are the developer) or failed to mitigate damage when recognised (contributory negligence).

The Auckland Mayoral Housing Task Force notes that Auckland Council and its predecessors *"have spent over \$605 million on weather tightness liability claims, with the potential for additional claims. Councils facing these potential claims are understandably reluctant to approve new materials and building techniques without significant testing and assurance ... Transferring liability away from councils could enable more innovation, reduce costs for both councils and builders, and improve the certainty of consenting processes."*<sup>4</sup> As an alternative to address liability issues, the Task Force suggests warranty and insurance schemes, backed by appropriate quality assurance by builders and insurers.

The Productivity Commission, in its report on housing affordability, noted comments they had received that BCAs may require more information, take more time in their deliberations and increase the number of inspections, all of which increase costs.<sup>5</sup> They cited reports suggesting the number of inspections per house appear to have risen, and builders face costs including greater reporting requirements and higher risk margins to allow for building consent time delays, leading to construction costs increasing by approximately 10%.

### 1.2.2 Building Company Closure

It has been suggested that builders frequently liquidate their companies to avoid liabilities. However, there are questions both over whether this is successful in avoiding liabilities or if it is frequent.

Commercial and Construction lawyer Geoff Hardy argues that: *"Since the early 1990s our Courts have consistently ruled that the people who run companies can be equally as liable as the companies themselves, for wrongful acts and omissions committed in the course of the company's business activities. A limited liability company does protect shareholders from having to*

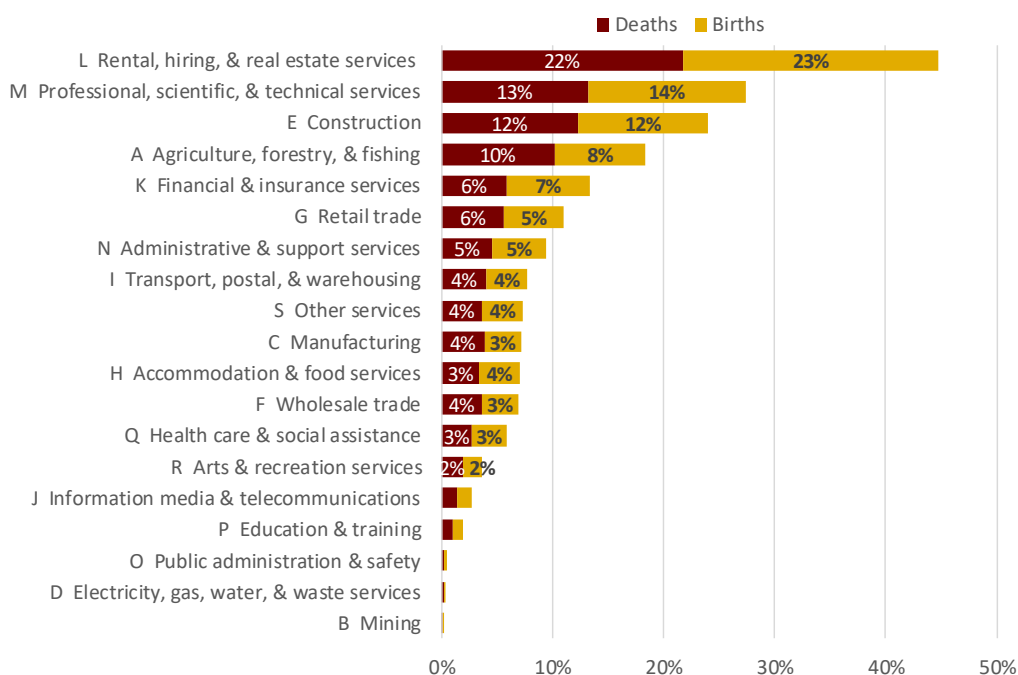
<sup>4</sup> Office of the Mayor of Auckland (2017)

<sup>5</sup> NZ Productivity Commission (2012)

contribute more money if the company can no longer pay its debts, but it does not protect the directors and senior managers from liability if the company does something wrong and they were responsible.”<sup>6</sup> He suggests that directors of large building companies have been more successful in avoiding liabilities than directors of small companies, because they have worked remotely from the building work. Despite this, liquidation can still be an effective ploy by increasing the difficulties and costs of pursuing a company.

The extent to which building companies churn, ie close and open again, is illustrated by business demography statistics. Figure 1 shows the percentage of companies in individual sectors which close (deaths) or open (births) each year. Construction companies have the third largest rate of churn amongst 19 individual sectors, with 12% of companies closing each year and the same percentage being new companies in any year also. Churn is not the same as liquidation to avoid liability, but there are no statistics that would allow us to identify such closures.

Figure 1 Business deaths and births (2006-2015) - % of companies by sector



Source: Statistics NZ Business Demography Statistics

### 1.2.3 Proportionate Liability

Proportionate liability was an alternative approach examined during the Building Act review (2009-11). Under proportionate liability, negligent parties who are found liable for a loss are only required to contribute a set amount, determined by court, based on the extent to which each negligent party was responsible for the loss and damage. If there are multiple parties, no single party can ever be 100% responsible for the loss, so the consumer must sue each responsible party if they want full compensation and, if any of those parties cannot pay, the consumer bears the cost. The “uncollected share” is not reallocated to other negligent parties, as it is under the joint and several rule.

<sup>6</sup> Hardy (2016)

Proportionate liability might reduce the problem from the perspective of the BCA, but it might require even greater recourse to the courts, with the homeowner left potentially with the residual amount plus costs.

In its 2014 report on multiple liability,<sup>7</sup> the Law Commission suggested liability considerations need to consider both equity and efficiency issues. Proportional liability may address equity concerns, but it is not efficient in the presence of limited liability companies, where residual liability passes to households. The same consideration of equity and efficiency issues needs to be extended to GIPs.

#### 1.2.4 The role of GIPs

The role of GIPs is discussed in this report in this multiple liability context. GIPs provide protection to homeowners in the form of:

- A guarantee that, should a problem arise, the responsible party will correct the problem; or
- An insurance policy that will provide a pay-out to compensate for the loss and/or to provide revenue to correct it.

Several GIPs are currently available in New Zealand and we describe them in more detail in Section 2.2. However, it is uncertain if they are adequately understood or known about by homeowners/clients, if they are available to all clients, or if they provide adequate cover. We address these questions in this report.

The potential for a more comprehensive and effective guarantee scheme was discussed by the Minister during the 2009-11 Building Act review.<sup>8</sup> He concluded, at that time, that private insurers are generally reluctant to or disinterested in providing comprehensive home warranty insurance. They feel the New Zealand market is too small and they are nervous about providing home warranty insurance, particularly because of factors making it difficult to price risk, including the lack of data (claims history) and the long tail, ie purchasing one-off insurance now to cover the next ten years of potential problems.

The Minister considered the main option available for providing comprehensive mandatory home warranty insurance was for the Government to establish its own scheme, either to replace or compete with existing schemes on the market.

This report will revisit some of these issues, and particularly whether recent developments in GIPs (both in New Zealand and other countries) have managed to address some of the underlying problems.

---

<sup>7</sup> Law Commission (2014)

<sup>8</sup> Minister for Building and Construction (2011a)



### 1.2.5 Building Act Review Outcomes

Following the 2009-11 Building Act review, rather than change the liability regime or introduce GIPs, the Government identified the need for several changes to the building regulatory system for:<sup>9</sup>

- clearer accountabilities for owners, designers, builders and building consent authorities;
- consumer protection and remedy changes, including mandatory contracts and disclosure requirements on builders;
- work to develop risk-based consenting, to ensure that the amount of checking and inspection required is aligned to the complexity of the work, and the skills and capabilities of the people doing the work.

This was addressed through a number of changes to the Building Act 2004, introduced via amendments, as summarised in Table 2.

Table 2 Reforms to the Building Act 2004 (and Construction Contracts Act 2002) following the Review

Reform	Details
Amendments to the Building Act to clarify responsibilities (Building Amendment Act 2012)	New provisions clearly stating the responsibilities of the parties involved in building work (new sections 14A - 14F which set out responsibilities of owner, owner-builder, designer, builder, building consent authority and product manufacturer or supplier) with corresponding changes to the purposes and principles of the Act in sections 3 and 4.
A move to risk-based consenting (Building Amendment Act 2012)	New section 401A of the Act set out the basis for different consenting requirements, eg the number and nature of inspections, depending on the risk, as defined under Order in Council.
Mandatory written contracts and disclosure (Building Amendment Act 2013)	New Part 4A of the Building Act requires a written contract for building work above a minimum price (as set in regulation – currently \$30,000 excluding GST). Part 4A also sets out the requirements for information disclosure and a checklist to be supplied to clients.
Clearer implied warranties and direct remedies (Building Amendment Act 2013)	Certain implied warranties (s.362I) apply whether there is a formal written contract or not.
Improved dispute resolution, under Construction Contracts Act 2002	Reduces reliance on tort law (and hence the joint and several rule) to resolve disputes: instead, consumers rely on contractual rights and obligations

Despite these changes, the current regime with joint and several liability, alongside market participants with different abilities to pay and different abilities to avoid payment, can result in a final misallocation of risk. Because BCAs can bear the greatest risk, they have responded through measures that reflect their risk aversion: more cautious consenting, with higher costs and longer time periods involved. The current system also leaves homeowners with significant costs (or other challenges) in obtaining redress. These issues are of concern at a time when there is a desire to improve the

<sup>9</sup> <http://www.mbie.govt.nz/info-services/building-construction/safety-quality/accountability-and-liability-within-the-sector>

efficiency of the building market, because of the implications for housing costs and affordability.

### 1.3 Requirements of this Study

GIPs are being examined in the context of problems which have persisted beyond changes to the Building Act. The objectives of this research thus include the following:

- Understand what proportion of new home builds in New Zealand are covered by a GIP;
- Obtain analysis of the quality and robustness of the existing GIP products in New Zealand, particularly in light of the recent failure of CBL Insurance, which was behind the BuiltIn Homefirst Guarantee;
- Understand the conditions necessary for a robust and competitive insurance market;
- Examine the conditions under which another provider (domestic or international) might be incentivised to enter the New Zealand GIP market, and whether any providers are currently contemplating entering the market.

The research needs to support MBIE in providing advice to Ministers on the nature and magnitude of the issues associated with risk and responsibility, and to conduct a cost-benefit analysis of a range of policy options.

## 2 Current Market

In this section we set out the current context for GIPs, including levels of building activity, consumer protection measures under the law and the current GIPs market. We also describe GIPs available in a number of other countries.

### 2.1 Demand for GIPs

The levels of current and future building activity determine the potential market for GIPs. We analyse consenting data in Annex A and provide a summary in Table 3. The cost of consents is estimated using building consent values reported by StatsNZ. These are modified to produce gross fixed capital formation numbers, as used by MBIE in its national construction projections.<sup>10</sup> This estimates the cost of the construction to the final user, including:

- costs prior to the application for consent, such as any feasibility studies and professional fees; and
- outlying costs, including subdivision works, costs of financing, legal / real estate fees, and any developer profit.

Pacifecon and BRANZ estimate these costs from consent values using a multiplier of 1.74, based on historic ratios of fixed capital formation: consent values.

Table 3 Residential building consent activity (calendar years)

	2017			Average (2008-17)		
	Number	Cost (\$m)	\$/consent	Number	Cost (\$m)	\$/consent
Residential New	31,087	\$19,967	\$642,296	21,337	\$11,700	\$548,353
Houses	21,022	\$15,006	\$713,835	16,011	\$9,647	\$602,495
Apartments	3,239	\$1,998	\$616,872	1,571	\$737	\$469,222
Retirement units	1,951	\$938	\$480,962	1,392	\$493	\$353,831
Townhouses, flats, units, and other	4,875	\$2,024	\$415,265	2,362	\$823	\$348,617
Renovations	28,339	\$3,443	\$121,480	26,217	\$2,563	\$97,754
Houses	21,854	\$2,562	\$117,220	20,180	\$2,047	\$101,413
Other	6,485	\$881	\$135,837	6,037	\$516	\$85,519

Note: Values are contributions to fixed capital formation (see text for explanation)

Source: Statistics NZ Infoshare

There were 31,087 residential new build consents in 2017, with a cost of close to \$20 billion. Close to 68% of the number and 75% of the cost is associated with houses. The numbers of consents have risen steadily from 2008 (and the Global Financial Crisis) and are now similar to pre-GFC numbers. Cost per consent has risen steadily over time.

<sup>10</sup> Pacifecon and BRANZ (2017) National Construction Pipeline Report 2017. A Forecast of Building and Construction Activity. Appendix C. MBIE.

Renovation numbers are similar to those for new builds, with a total of 28,339 in 2017, 77% of which are for houses. The value per consent is understandably lower than for new builds.

GIPs do not usually apply to large apartment buildings and some of the large retirement home providers cover their own risks as large developers also. Given this, the demand for GIPs, based on 2017 consents data, is likely to be closer to 25,000 for new builds and a similar number for renovations, ie a total of 50,000 covering a value of close to \$20 billion.<sup>11</sup> These numbers are expected to rise with the Government's stated objective to increase building rates, particularly associated with the Kiwibuild project.

## 2.2 GIPS in New Zealand

### 2.2.1 Current Schemes

In addition to the protection provided under the law (see Annex B for details), there are a number of GIPs that are currently available in New Zealand. These are broadly classified into:

- **Member schemes** available to organisation members:
  - Halo Residential Guarantee provided for work done by members of the New Zealand Certified Builders Association (NZCB);
  - Master Build Guarantee for work done by a member of the Registered Master Builders Association (RMBA);
- **Independent schemes** available to any builders meeting certain quality criteria:
  - Stamford Building Warranty Insurance, available from any builder which is approved by Stamford;
  - BuiltIn insurance 10-year building warranty, which was formerly underwritten by CBL Insurance. BuiltIn now re-sells Stamford Insurance, with slightly different terms and prices;
- **Building company schemes** provided by large building companies and which come automatically with houses they build. Schemes identified are those provided by:
  - Signature Homes;
  - Golden Homes; and
  - Classic Builders.

We provide more detail on these schemes in Section 2.3.

---

<sup>11</sup> \$17 billion for new builds and \$3 billion for renovations

### 2.2.2 Levels of Supply

In Table 4 we provide an estimate of the number of GIPs currently supplied per year. We explain our calculations below. It suggests that approximately 53% of new properties are built with one, as are approximately 23% of renovations.

Table 4 Estimated numbers of GIPs supplied per year

	New properties	Renovations	Total
Master Build	10,000	2,000	12,000
Halo/CBNZ	3,000	3,000	6,000
Independent schemes	2,000	1,500	3,500
Building company schemes	1,500		1,500
Total	16,500	6,500	23,000
Potential (see Section 2.1)	25,000	25,000	50,000
% of potential	66%	26%	46%
% of total residential consents	53%	23%	39%

Source: Covec estimates

The basis for the calculations is as follows:

- RMBA states that it provides Guarantees for approximately 50% of stand-alone new house builds, and less than 10% of renovations.<sup>12</sup>
- Numbers of Halo guarantees offered are uncertain, but several market commentators spoken to estimate their numbers at approximately 3,000; GJ Gardner now operates with the Halo scheme for most of its builds, and it built 1,462 houses in the year to July 2017. Conservatively, we assume the GJ Gardner demand represents 50% of the new house guarantees and that, numbers covering renovations are close to those for new builds.<sup>13</sup>

Independent scheme numbers were provided by Stamford Insurance,<sup>14</sup> and the building company scheme numbers are based on estimates of their builds per year.<sup>15</sup>

These are very approximate numbers. Scheme owners are reluctant to provide actuals.

### 2.3 Scheme Characteristics

In this section we discuss a number of scheme characteristics. They differ in a number of fundamental ways as summarised in Table 5 and outlined below.

<sup>12</sup> David Kelly, personal communication

<sup>13</sup> Grant Florence, personal communication, for this last point.

<sup>14</sup> Duncan Colebrook (personal communication)

<sup>15</sup> BCI New Zealand data: houses build August 2016 to July 2017 = Classic Builders (613), Golden Homes (513) and Signature Homes (347), as reported at:

[https://www.nzherald.co.nz/business/news/article.cfm?c\\_id=3&objectid=11913169](https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11913169)

Table 5 Scheme characteristics

Scheme	Insurance-backed	Compulsory	Availability
Master Build Guarantee	Planned <sup>a</sup>	Planned <sup>a</sup>	RMBA members
NZCB Halo Guarantee	✓	✓	Certified Builders
Stamford Building Warranty Insurance	✓		Approved builders
BuiltIn 10-year Warranty	✓		Approved builders
Signature Homes Guarantee		✓	Own houses only
Golden Homes Goldseal Warranty		✓	Own houses only
Classic Builders Warranty		✓	Own houses only

<sup>a</sup> RMBA intends to obtain insurance backing and make schemes compulsory from late 2018

Source: Covec

### 2.3.1 Insurance-backing

#### *Differences between Insurance and Guarantees*

There are a number of differences between a guarantee and an insurance product. But in general, a guarantee provides assurance that something will be fixed if it goes wrong, whereas insurance provides compensation for loss.

Because of the financial requirements, insurance companies are regulated (under the Insurance (Prudential Supervision) Act 2010) and independently audited to ensure they have sufficient capital to cover possible liabilities (see Annex C). Thus, in general insurance companies have greater access to funds than guarantee providers – they have deeper pockets.

Guarantees can have some of the same benefits as an insurance product, and in some cases greater benefits. This is partly why the New Zealand insurance-based schemes have many characteristics of a guarantee also. If a problem occurs with a building, normally the homeowner will want the problem to be fixed. Compensation payment via a pure insurance scheme pay-out may be provided quickly, but the homeowner might then need to identify and hire a builder to undertake the work. Where there are costs associated with search and contracting, this might be less desirable than a guarantee. Given this, the insurance-based products have many characteristics of guarantees also. Generally, they will seek to ensure the builder fixes the problem first before stepping in with compensation. Pure compensation might be required when building firms collapse and another builder is required, although the member schemes seek to address this by finding (and paying for) another member to fix the problem.

Insurance-based schemes provide greater protection when a builder refuses to remedy faults, and they provide greater protection if there is a widespread systematic problem which might overwhelm a building firm (or even a membership organisation).

#### *Insurance-backed schemes in New Zealand*

Three of the NZ schemes are backed by insurance. This means that a separate insurance company underwrites the protection provided, so that it does not depend on the financial reserves of the builder or member organisation. The current New Zealand schemes, all of which are backed by Lloyd's of London, are:

- the Halo scheme operated by NZCB which is administered by BrokerWeb Risk Services Limited (BWRS);
- the Stamford Insurance scheme; and
- the BuiltIn 10-year warranty, previously underwritten by CBL Insurance (see Box 1), and now a Stamford Insurance product, underwritten by Lloyd's.

RMBA has stated its intention to move towards insurance-backing later in 2018, potentially including it moving towards meeting the regulatory standards required of an insurer.<sup>16</sup> Classic Builders Ltd is also currently considering moving to an insurance-backed scheme, such as Stamford Insurance.

#### Box 1 CBL Insurance

CBL Insurance Ltd was the insurance underwriter for the BuiltIn Homefirst Warranty.

In February 2018 the Reserve Bank of New Zealand (RBNZ) successfully applied to have CBL put into interim liquidation because of concerns about their solvency ratio and a lack of compliance with directives from the regulator.

CBL is still trading in interim liquidation and all policies held with them are valid. However, they are advising policy holders to fix problems that arise themselves, and that they will then refund them if they can after their status is clarified in November 2018.

Stamford Insurance has offered to sell its building warranty to all homeowners whose building was completed within the last 12 months.

Source: <https://builtininsurance.co.nz> and Ben Rickard, personal communication

For the Halo scheme, the policy document explains (to a builder) how it works as follows:

*If the homeowner makes a claim during the build period or the first year of the Defects Insurance Period, the Lloyd's underwriter will pay the claim and recover the claim pay-out from you (the builder). This is normal under all residential guarantee insurance policies. However, after the first year of the Defects Insurance Period, the Lloyd's underwriter will pay the claim and waive the right to recover the claim pay-out from you (the head contractor/builder).*<sup>17</sup>

From the homeowner's perspective the scheme operates slightly differently. For example, GJ Gardner now very largely provides the Halo Guarantee to its customers.<sup>18</sup> However, if problems arise (which to date have been largely minor) they will fix this themselves; the Guarantee provides customer assurance that there is protection, were a franchisee to fall-over, but normally it will not be called on.<sup>19</sup>

The Stamford schemes operates in a similar way. It is paid out if a developer fails to fix the defect. In the first two years, the policy holder must first contact the develop; the insurance company is liable if the developer fails to respond within 15 days. After two years, the policy holder makes a claim directly to the insurer, who has the option of

<sup>16</sup> David Kelly, personal communication

<sup>17</sup> Halo Guarantee Handbook for Members of NZCB. Current as at November 2016.

<sup>18</sup> A small number of franchisees use the MB Guarantee.

<sup>19</sup> Dan Oliver, GJ Gardner, personal communication

either paying the cost of the repair, replacement or rectification works or arranging to have the repair, replacement or rectification works carried out.

Home warranty insurance schemes are often characterised as either first-resort or last-resort. In practice there is an intermediate cover also, as described in Table 6.

Table 6 Insurance cover typology

Type	Description
First-resort	Insurance company is the first point of call. They will compensate the homeowner or ensure a builder fixes the problem.
Semi first-resort	Insurance company is the point of call if a builder refuses to fix the problem or is unable to, eg because of company closure.
Last-resort	All other avenues of redress must be pursued first before insurance pay-outs are made, including establishing liability and suing builders.

It appears that the New Zealand insurance schemes operate as semi first-resort schemes in the first one (Halo) or two (Stamford) years after completion and are then first-resort schemes. In the initial period, the schemes seek to get the builder to fix problems first. Only if this does not happen (because of builder refusal or inability, eg because the company has folded) does the insurance cover kick in. This appears to be appropriate for the circumstances, and is likely to best meet the needs of the homeowner. The insurance-backed schemes also have introduced a separation between the insurance and the builder, in a way that does not exist for the guarantees. Because of the legal obligations on insurance companies in terms of how they must treat policy-holders, there is a greater certainty of redress.

### *Guarantees*

In contrast to the insurance-backed schemes, the others are backed by money put aside by the organisations running the schemes. The scheme owners seek to fix problems themselves, with the money set aside to be used under extreme circumstances only, such as when a RMBA member collapses (MB Guarantee) or a franchisee does for the Signature and Golden Homes schemes. The money is very seldom paid out as cash to a homeowner. Rather it is used to pay for another builder to fix the problem.

The concerns raised about these schemes have been that they might leave the homeowner with less control because their rights appear to be reduced. It may be some time before the builder (who might be busy with other work) fixes a problem, or before the fault can be demonstrated. In addition, concerns have been raised over the protection these schemes would provide if there were significant, industry- or company-wide problems which have very significant costs.

For RMBA, monies are held with a separate company and do not count towards the assets of the Association. The amounts are audited by independent actuaries to ensure that they are adequate to cover risks, as analysed from historical data.<sup>20</sup> According to RMBA, their reporting is sufficient to provide the Reserve Bank with assurance of their capital adequacy, ie they meet the solvency standard (see Annex C).

<sup>20</sup> Currently the independent actuaries are Melville Jessup Weaver (<https://mjw.co.nz/>)



As noted above, we understand RMBA is wanting to provide greater assurance of capital adequacy by complying with a wider set of standards that are applicable to insurance companies. This follows the positive market response to the rival Halo product.

Signature Homes and Golden Homes have also established separate companies to manage the funds deposited to back the guarantees. These are Residential Indemnity Ltd (RIL)<sup>21</sup> and Residential Warranty Ltd (RWL), respectively. These schemes have different levels of backing.

- Signature Homes reports that its guarantee is backed by a performance bond of \$1 million issued by ANZ Bank New Zealand, plus significant cash reserves. The performance bond and cash reserves are independently audited by Deloitte each year to ensure the bond and cash reserves are adequate to cover any potential claims.<sup>22</sup>
- The Golden Homes scheme is backed by \$0.5 million of capital that they have provided to set up RWL, plus a contribution of \$230 per house built.<sup>23</sup>

We understand Classic Builders currently has not established a separate entity and is intending to join an insurance-backed scheme.

The differences reflect the ownership structures of the companies. Both Signature Homes and Golden Homes have a franchisee model, in which the various regional entities building under the company banner are separate companies, not owned by Signature or Golden Homes. RIL and RWL enable defects to be corrected if a franchisee was to collapse. In contrast, Classic Homes has regional companies, partly or wholly owned by Classic Builders Group Ltd.

For all three building company schemes, it is not clear how the monies would be treated were the main company (the franchisors and Classic Homes) to collapse. The adequacy tests which they subject themselves to assess their ability to cope with “normal circumstances”, ie average rates of defects arising.

### 2.3.2 Coverage

The schemes appear to have different scope in the liabilities they cover. Specifically, the membership and building company schemes cover the liability of the builder, whereas the independent schemes cover a wider set of liabilities. For example, the Halo scheme includes the following words: *“In consideration of the premium being paid the Underwriters hereby agree that they will guarantee the Builder’s obligations to the Building Owner to the extent that they indemnify the Building Owner as set out in the terms and conditions contained*

---

<sup>21</sup> RIL is a company set up solely for the purposes of settling any possible claims under the key aspects of the guarantee programme offered by Signature Homes: Signature Homes. The Best Building Guarantees in New Zealand

<sup>22</sup> <https://www.signature.co.nz/blog/10-questions-about-guarantees>

<sup>23</sup> Len Helms, personal communication

*herein.*” And the Master Build Guarantee states that the Guarantee does not cover “matters or claims that are not the Registered Master Builder’s responsibility.”

The builder’s obligations are limited under Section 362S of the Building Act. Specifically, they are not liable for “a cause independent of human control”, acts by those other than building contractors, subcontractors and those for whom the builder is responsible for in law. They are also not liable when defects arise from failure to carry out maintenance or repairs.

In contrast, the obligations under the Stamford Insurance policy relate to the existence of a defect (in materials, design or workmanship), without specifying who caused it.

This appears to be a difference between the schemes. One set is covering the builders’ liabilities; the other is directly protecting the customer.

### 2.3.3 Whether Compulsory

Some of the schemes are compulsory for certain builders. The NZCB requires all Business Members of NZCB to take out the Halo 10 Year Residential Guarantee on all residential projects (both new and alterations) that are \$30,000 (incl GST) or over. This includes new builds, additions and alterations, labour only contracts and spec builds.

The Master Build Guarantee is available to all building work undertaken by members of the RMBA, but it is not compulsory to provide. Although encouraged by RMBA to provide it, some members have been reluctant because they perceive it is suggesting that their work or their company might be at risk. Given this, RMBA intends to make the Guarantee compulsory (above a threshold such as \$30,000), potentially from late 2018.

The guarantees provided by Golden Homes and Signature Homes are compulsory for their franchisees to provide. The Classic Builders warranty is provided for all houses they build.

The Stamford and BuiltIn schemes are not compulsory as they are independent products made available to any builder who meets eligibility criteria. The criteria include assessments of the:

- Company financials, including their solvency (checked annually at least);
- Bankruptcy history;
- Qualifications and experience;
- Project management, eg the number of supervisors; and
- Management systems, for pricing, accounting, monitoring etc.

For new companies, rather than historical finances, checks are made of their business forecasts.

### 2.3.4 Availability

The schemes differ in the extent to which they limit availability.

The Master Build Guarantee can be offered by Registered Master Builders only. They are members of the Registered Master Builders Association who are required to meet quality criteria. To become a member, applicants are assessed on:

- building experience;
- trade and professional qualifications;
- practical management experience;
- workmanship - previous clients have been contacted to ensure their work is of a high standard and has satisfied their expectations; and
- financial responsibility - written references have been provided from their bank, accountant and building material suppliers.

The Halo Guarantee must be provided by all Business Members of NZCB. Members are required to hold a recognised trade qualification equivalent to or better than National Trade Certificate in Carpentry Level 4. In addition, applicants are assessed in terms of their *“history of stability and success, continued solvency, absence of complaints by customers and suppliers, a good untarnished reputation and brand, and consistently high standards.”*<sup>24</sup>

The independent Stamford and BuiltIn schemes provide insurance-backed guarantees to any builder which meets the quality criteria set by the insurers. These include assessments of the builder’s finances, track record, qualifications and so on. The Stamford scheme is also made available as a retail product to homeowners, provided that the builder has been approved. Examples of retail purchasers of Stamford Insurance include body corporates that are undertaking significant renovations to multiple properties. The GIPs retail market does not appear to be widely developed or known about by homeowners.

The building company own schemes are provided by those companies only for their building work. They control factors which affect quality, including the quality of the builders, supply sources and designs. In some cases, these companies are building to a limited number of available house plans, which are designed to limit risks.

#### 2.3.5 Scheme Costs and Limits

The costs of the schemes and the limits that apply to cover are summarised in Table 7.

##### **Costs**

The prices of the schemes differ depending on the extent of the cover, the risks they are exposed to or their assessment of those risks. Prices charged for a \$350,000 build (including GST) are shown in Table 5. These are listed prices for individual houses; there are bulk discounts for large builders. The independent schemes are more expensive than the member schemes, possibly because of scale. The Stamford scheme has higher costs than BuiltIn because it offers greater levels of protection, eg up to 15% of contract price during build, rather than 10%.

The building company schemes are not priced separately because they are provided for all builds and are included in the contract price for the project. However, as discussed

---

<sup>24</sup> <https://www.nzcb.nz/about-nzcb/>

above, the Golden Homes scheme has an internal cost of \$230; this is the amount paid into RIL for every house built.

Table 7 Building Guarantee Schemes

Name	Price (inc GST) <sup>a</sup>	During build (whichever is less)	After build: defects <sup>b</sup> (whichever is less)
<b>Member Schemes</b>			
Master Build Guarantee	\$1,300 <sup>d</sup>	Loss of deposit: up to 10% of contract price or \$500,000 Non-completion: up to 20% of contract price or \$500,000	Up to contract price or \$1,000,000 for 10 years (structural) or 2 years (non-structural) <sup>e</sup>
Halo Residential Guarantee Insurance	\$1,202	Up to 20% of contract price or \$500,000	Cost to repair or replace (structural and non-structural) for 10 years
<b>Independent Schemes</b>			
Stamford 10-Year Building Warranty	\$2,013	Up to 15% of contract price or \$150,000	Up to Declared Project Value <sup>f</sup> for 10 years (structural) or 2 years (non-structural)
BuiltIn 10 Year Building Warranty	\$1,725	Up to 10% of contract price or \$100,000	Cost to repair or replace for 10 years (structural) and 2 years (non-structural)
<b>Building company schemes</b>			
Classic Builders Warranty	Included in build price	Cost to complete project (no upper limit)	Unlimited for 10 years (structural), 2 years (non-structural)
Golden Homes warranty	Included in build price	Loss of deposit: \$50,000. Cost to complete project or \$60,000.	Unlimited for 10 years (structural), 1 year (non-structural)
Signature Homes Building Guarantees	Included in build price	Cost to complete project (no upper limit)	Unlimited for 10 years (structural) and 2 years (non-structural)

<sup>a</sup> based on building contract of \$350,000 (incl GST); <sup>b</sup> including rot and fungal decay (if from a defect);

<sup>c</sup> non-structural includes defects in workmanship or in materials; <sup>d</sup> \$1,050 if opting out of Loss of Deposit and Non-completion covers; <sup>e</sup> To be covered for Rot and Fungal Decay, the design, materials and construction needs to achieve a score of 12 or less in the "Building envelope risk matrix" (MBIE Acceptable Solution E2/AS1)<sup>25</sup> at the time the building consent was issued; <sup>f</sup> Adjusted for inflation using Statistics NZ Residential Building Price Index

Source: Consumer NZ (2018); personal communications and company websites and brochures.

### Limits

If the building company collapses before work starts, the top four schemes will refund the deposit, provided it is no more than 10-20% of the total contract price. For the building company schemes the approach differs. Classic Builders and Signature Homes do not have limits, but guarantee to fix problems that arise. Golden Homes, which provides guarantees via RWL, has set limits which would apply to pay-outs if a franchisee could not fix the problem.

If the work is not completed, the member and independent schemes will cover the difference between the original contract price or quote and what another builder will charge to do the work. This is also limited to 10% or 20% of the contract price. The building company schemes are again simply guaranteeing that they will fix the

<sup>25</sup> <https://www.building.govt.nz/building-code-compliance/e-moisture/e2-external-moisture/>

problem. But this relies on their continued existence. Golden Homes has limited the pay-out.

### *Payment schedules*

In most cases, people are not covered for payments made to a builder in advance of work being done, and in some cases, doing so can mean no claims can be made at all. Paying builders to a schedule such that amounts paid are not in advance of costs provides considerable protection against company collapses, and to some extent defects which are identified early. It does not protect against the costs of finding a replacement builder, or for potential cost differences.

### *Defects*

Defects are defined as including:<sup>26</sup>

- non-compliance with the Building Code;
- non-agreed variations from consented drawings;
- failure to meet agreed contractual specifications;
- premature product failure; and
- failure to achieve acceptable industry levels of quality or performance on items not covered by the first four bullet points.

All schemes cover structural defects for 10 years and Halo covers non-structural defects for 10 years also. The others will only remedy non-structural defects in the first year or two.

### *Transfers*

All the guarantees can be transferred to a new owner if the property is sold, generally following payment of a fee, eg RMBA requires a fee of \$350 (including GST), whereas Stamford charges \$100. The Halo Guarantee is associated with the property, so transfers are automatic. There may be charges relating to mortgage documents.

### *Dispute Resolution*

RMBA have engaged FairWay Resolution Limited, an independent company providing specialist conflict management and dispute resolution services to manage disputes with a Registered Master Builder. Stamford Insurance (and BuiltIn) use Financial Service Complaints Ltd (FSCL). NZCB does not employ an independent dispute resolution service, but insurance claims are made to BWRS.

## 2.4 Potential for Expansion

The current set of GIPs does not cover all building work in New Zealand. However, market participants suggest this is limited more on the demand side than by supply. GIPs are provided with building work undertaken by master builders and certified builders. The independent providers make products available to other builders and projects. The providers suggest the size of the GIPs market is quite small compared to other insurance markets, eg for house insurance which covers the value of all buildings, such that there is unlikely to be a reinsurance limit. Stamford Insurance, backed by

---

<sup>26</sup> MBIE (2015)

Lloyds of London, suggested there would be unlikely to be a problem in extending insurance cover, backed by Lloyds, to a GIPs market for all New Zealand residential building.

Other potential reinsurers are likely to view the New Zealand market similarly. It is unlikely that there would be a supply constraint if GIPs were made compulsory.

## 2.5 International GIPs

GIPs are provided in many other countries. We summarise those from the UK, Australia, the US and Canada in Annex D. The schemes in other countries are summarised in Table 8 in comparison with the New Zealand schemes. There are several key findings from the international schemes as summarised below.

### *Compulsory Schemes*

Many of the schemes are compulsory, although not all under legislation. The UK schemes are de-facto compulsory as they are required by mortgage lenders.

### *Insurance backing*

The international schemes are all backed by insurance. They include an insurance element which generally starts after an initial period in which homeowners must seek redress directly from the builder.

New Zealand insurance-based schemes (Halo and Stamford/BuiltIn) are currently closest to genuinely first-resort schemes. Other countries include a greater requirement to seek builders to fix problems initially. The UK and US schemes effectively function as a last resort scheme in the first two years.

Queensland has a semi first-resort scheme also, which still requires a homeowner to first pursue a Queensland Building & Construction Commission (QBCC) Direction to Rectify.

### *Risk control mechanisms*

Schemes differ in the extent to which they provide risk control or feedback mechanisms.

- The UK scheme sets its own building standards and appoints inspectors to check building work against these standards.
- All schemes have entry requirements to weed out high risk builders.

### *Risk-based pricing*

- The UK and US schemes, and two state schemes in Australia (NSW and Victoria), have differential, risk-based pricing using historical data on builder performance and information on builder qualifications and experience, as do.
- The Queensland scheme has uniform pricing.

In the next section (Section 3) we examine the nature of the current problem in more detail before making conclusions about the characteristics of high quality and policy options which might be used to encourage them (Section 4).

Table 8 Comparison of international warranty schemes

Jurisdiction	NZ	UK	Australia	US	Canada
Type of scheme					
Insurance backing	Three schemes are backed by insurance. Another (RMBA) is intending to.	Guarantee initially. Insurance from year 3.	Most states offer (last resort) insurance; Qld provides Builder guarantee backed by insurance	Guarantee initially. Insurance from year 3.	Guarantee backed by insurance
Mandatory v voluntary	Voluntary. Mandatory for CBNZ members and shortly for RMBA members	<b>"De facto mandatory"</b> due to lending requirements	Mandatory in all states except Tasmania	Voluntary in most states (New Jersey has mandatory scheme)	Mandatory in 5 out of 10 Provinces
First v last resort	Insurance schemes are first resort	Years 0-2 = semi first resort Years 3-10 = first resort	Mostly last resort (QLD only first resort scheme)	Years 0-2 = semi first resort Years 3-10 = first resort	Semi first-resort
Nature of providers	Member organisations, independent insurance company, large builders	Mostly private insurers. Largest provider is NHBC, backed by Aviva Insurance	Mix of Govt providers and private providers with Govt backing	Mostly private insurers (State Warranty Plan operates in NJ)	Private insurers and <b>builders' associations</b>
Dispute Resolution service?	For large schemes	Yes	Yes	Yes	Yes
Features of warranty policies					
Scope of cover	Non-completion, post-completion defects	Non-completion of building defective design, workmanship or materials	Non-completion of building and defective design, workmanship or materials	Defective workmanship, systems and structural defects	Loss of deposit, defective workmanship, systems and structural defects
Period of cover	Generally 2 years for non-structural defects; 10 years for structural defects	2 years for non-structural defects; 10 years for structural defects	Range is 6 months – 6 years for non-structural defects; 5-6 years for structural defects	1 year for workmanship, 2 years for systems; 10 years for structural defects	Range is 1-3 years for non-structural and systems defects; 5-10 years for structural defects
Maximum claim value	Up to \$1 million	£1,000,000 (defects) £100,000 (loss of deposit)	Range is \$85,000 (ACT) to \$340,000 (NSW)	Fair market value of home at time of completion	Range is \$50,000 (maritime provinces) to \$300,000 (Ontario)
Warranty passes to new owner on sale of house?	Automatic (Halo); others, on payment of a fee.	Yes	Yes	Yes	Yes



Jurisdiction	NZ	UK	Australia	US	Canada
Risk control measures					
Eligibility criteria	Yes	Yes	Yes	Yes	Yes
Risk-based premiums?	No	Yes (based on claims history)	NSW and Vic only	Yes	Varies
Set building standards	No	Yes	No	No	No
Undertake inspections	No	Yes	No	No	No
Rules governing negligence liability in building defects cases					
Joint & several liability v proportionate liability	Joint & several liability	Joint & several liability	Proportionate liability	Varies by state. New Jersey applies proportionate liability for defendants less than 60% at fault; joint and several liability for defendants 60% or more at fault	Joint & several liability
Can homeowners or insurers sue local authority for negligent building inspection?	Yes	No	Yes	Varies by state. No in New Jersey.	Yes

## 3 The Problem and the Role of GIPs

---

### 3.1 Overview

In this section we elaborate further on the problems in the building market and some of the issues with GIPs. The problems that GIPs are addressing can be conceived of as follows.

Poor building work has occurred in New Zealand, and is a risk for the future, because of poor design, poor building materials and/or poor workmanship.

In an efficient market, these problems would be weeded out of the market through information about the problems being easily identified, widely known and by those responsible being held liable. However:

- People choosing builders or building designs, particularly for individual houses, do not have ready access to information on the sources of problems, or do not know how best to identify a good builder, or do not understand the price-risk trade-off; and
- The system of joint and several liability, combined with companies which may have closed, means the liability system does not always work to penalise poor performers.

When problems have arisen, the costs have tended to be borne either by BCAs or homeowners. As a result, a number of additional problems have arisen, including:<sup>27</sup>

- Undermining of trust, confidence and cooperation within the sector, driving up costs and reducing quality;
- Creation of overly risk-averse, defensive behaviours – especially in local government, as they are often the “deep pocket” or “last man standing”.

### 3.2 Potential costs

In assessing the potential benefits of GIPs, it is useful to understand the costs which might be avoided.

The leaky building crisis was the result of significant problems with the weathertightness of residential buildings constructed in the mid to late 1990s. The total costs were estimated in a 2009 PwC report to be approximately \$11.3 billion, across 42,000 houses or approximately \$269,000 per property on average.<sup>28</sup> This includes costs still to be realised in the market.

---

<sup>27</sup> Minister for Building and Construction (2011b)

<sup>28</sup> PwC (2009)

However, this is likely to be an overestimate of potential future costs resulting from current building work. The risks are uncertain, but one way to estimate this is based on the insurance industry's estimates of risk as evidenced by the premiums paid for GIPs. This assumes that insurers have full access to risk information so they are pricing at least as high as the risk they face. For example, if the maximum cost of fixing a defect for a \$200,000 building project is \$100,000 and the probability of such a defect is 1%, then the expected cost is \$1,000 ( $1\% \times \$100,000$ ). A premium would be at least that high, plus the administrative and other costs of running an insurance company. If the insurance industry was competitive, the premium should be no higher than these estimated costs. Thus, with information on the premiums and the value of building work, we might estimate the expected annual cost.

We assume the potential cost of a defect is equal to the \$350,000 (\$304,348 excluding GST) project value used in Table 7. The insurance-backed schemes vary in price for a \$304,348 build between approximately \$1,045 and \$1,750 per build, excluding GST, an average of approximately \$1,400. If we assume a small administration cost of \$100 per policy, the expected cost is then \$1,300 for a \$304,348 project or a defect probability of 0.43%. The value of residential new builds is approximately \$20 billion per annum. Assuming the same defect risk, this would suggest a 10-year risk of approximately \$85 million. If building activity is in a steady state, this is also the annual risk.<sup>29</sup>

These estimates only include the directly measurable financial costs. There are other costs associated with defects and failures, including time and money invested in court proceedings and the stress and health impacts on homeowners.

Guarantees have been used to deal with issues relating to company collapses. However, these can be substantially managed by clients only paying builders according to a schedule that matches the timing of costs. This does not deal with defects that occur later, or the costs of finding another builder. Independent holding of deposit monies might help in situations of builder collapse also.

### 3.3 Efficiency of Insurance Markets

Insurance companies are efficient if they price risk efficiently. That is, they offer premiums to people that are reflective of the risks faced. Efficient pricing of insurance requires good information on the causes of risks. This might be based on an identification of the factors likely to be associated with risk (eg lack of builder experience or qualifications) or based on empirical data that allow risky builders and/or risky projects to be identified.

Currently there is no comprehensive dataset on which insurance companies can identify builder quality, but the member organisations have data on the performance of their members. Insurance companies backing GIPs are doing so largely on the basis of the effectiveness of entry criteria to ensure quality. This may be reflected in the higher

---

<sup>29</sup> Each year's building projects would add expected costs of 1/10<sup>th</sup> of \$85 million and these would continue annually for the next 10 years. But if every year adds the same level of expected costs then any one year will face the risks from ten, nine, eight and so on years ago also.

prices of the independent products compared to member schemes (Table 7); in the absence of builder-specific risk information, risk might be assumed to be higher.

We would expect efficiency to improve over time as companies collect more information to understand risk.

### 3.4 Consumer Trust

Another way to examine the current problem is via assessments of trust in the building sector because of reported problems. In late 2016 MBIE's Consumer Protection team commissioned a national survey of consumers.<sup>30</sup> When asked about products and services they have purchased in the past two years, 24% had problems with building repairs or renovation. This made it the second highest area of concern, behind fixed-line telecommunications services (landline or internet) and followed by mobile telecommunications services and motor vehicle purchases through both private and dealer sales.

Complaints about quality were the most frequent problem amongst those having a problem with building services. Of those with problems, 46% reported these had been resolved. Levels of mistrust in builders, ie the percentage that "generally don't trust businesses in this sector" was reported to be 25%, close to the midpoint amongst goods and services included (10<sup>th</sup> highest of 17).

### 3.5 Current Decision Making

One area of concern, and part of the current problem is that of the decision-making process of those contracting building work, and their understanding of risks.

Colmar Brunton recently completed a survey of homeowners and builders for MBIE.<sup>31</sup> For homeowners, it addressed the process of finding and purchasing building services and the extent to which homeowners understand or take account of the risks, and their awareness of warranties and consumer protection measures. For builders it examined whether they understood and managed risks.

#### *Homeowners*

The authors classified homeowners along two dimensions: risk perception and rationality. They found:

- Risk awareness is low, both amongst those who perceive low and high risk in the process.
- Builders are chosen either following recommendations or research, but afterwards they are expected and trusted to be professional. A trusted builder, alongside the council inspection process, is generally regarded as sufficient to ensure problems will not arise.

---

<sup>30</sup> MBIE (2017) National Consumer Survey 2016 Summary Findings.

<sup>31</sup> Yockney and Field (2018)

- Awareness of builder guarantees or insurance is very low. Rather people rely on brands, such as Master Builders to provide assurance.

### **Builders**

They classified builders across two dimensions: risk perception and the extent to which they perceive what they are doing as running a business rather than simply being a good builder. They suggested:

- The risks as perceived by builders, including post-build failures and the associated reputation risk, can be managed largely by good building work and good customer relations. There is little perceived need for insurance because the risks are perceived as being controllable.
- There is a perception amongst some builders that the market does not value builder quality, apart from that signalled by personal recommendations and simple signals, such as membership of trade bodies.

We use these summaries in identifying the nature of market failures.

## 3.6 Market Failure Analysis

Because markets are assumed to be the most efficient way to allocate all resources, market failure (ie markets not producing what is socially desirable) is generally regarded as a necessary condition to justify government intervention. Analysis identifies market failures by comparing the existing market with a theoretically ideal market.

GIPs exist within an underlying building market. Potential sources of market failure include:

- **Information gaps** – as noted in Section 3.5, people choosing and employing builders often do not understand the associated risks, and builders do not necessarily know how to limit risks.

There are significant information gaps relating to GIPs also – buyers not understanding if they need one or what they are getting.

GIPs might be used to help signal high quality building (eg using differential pricing to reflect builder or project risk) or to eliminate poor builders from the market.

- **Incomplete markets** – when building companies close, including through voluntary liquidation, they (or their owners) can be more difficult to pursue (see *Transaction costs* below). This means the market fails to provide full incentives for risk-limitation.

Other incomplete market problems include the absence of an active retail market for GIPs. They are available from Stamford Insurance, but this is not widely known;

- **Competitive markets** – markets are most competitive when there are numerous buyers and sellers competing with each other. Competitive markets provide consumer benefits at least cost. The market for GIPs would be most competitive if they are widely available from several suppliers.

GIPs may make building markets less competitive if it is easier for large companies to provide them or to comply with their requirements.

- **Transaction costs** – there are costs associated with identifying risks when choosing builders and building designs, and if obtaining redress when things go wrong is not automatic. This includes the greater difficulty in pursuing a builder when the company has closed.

Transaction costs apply to GIPs also.

- those with low transaction costs would be those which help signal builder quality (thus reducing costs of finding a good builder); and
- those which provide certainty of redress, eg via first-resort insurance (thus reducing costs of pursuing builders, potentially through the courts).

We address these issues in the section 4.1 when we examine the characteristics of ideal GIPs.

### 3.7 Conclusions

The problem has been described in this section using different perspectives. The key issues are:

- The information constraints on homeowners and others which limit the extent to which decision makers take account of risks in choosing builders, building designs, materials and other factors affecting the risk of unexpected costs;
- The potential for those most responsible for faults being able to avoid liability such that it falls on others. This is both
  - **Inequitable** – it unfairly penalises those not responsible for the problems; and
  - **Inefficient** – it does not provide incentives for risk-limiting behaviour;
- The limited choice in building markets and the absence of competitive pressure to push out poor performers, which may mean decision makers do not have access to several suppliers of low-risk products (including builds and materials); and
- The transaction costs of pursuing those who cause problems.

GIPs are identified above as having the potential to reduce some or all of these problems, provided that they have the following characteristics:

- **Wide availability** either by being compulsory and/or widely recognised by consumers;
- **Incentivise building quality improvement** through differential pricing to reflect risk and/or having entry standards which limit high risk factors (bad builders and bad designs);
- **Do not reduce competition** eg by market entry barriers that result in market consolidation. This might happen if, to limit risks, only large companies with extensive track records can obtain cover; and
- **Certainty of redress** – they enable simple and easy redress without the need for high transaction-cost pursuit of those responsible for faults.

We explore the way in which these characteristics might be better supplied in the next section.

## 4 Policy Options and Analysis

---

### 4.1 Characteristics of Ideal GIPs

Policies to encourage better GIPs or their more widespread use are being considered for reasons of equity and efficiency.

- The **equity** issue is that the current allocation of risk is unfair. Costs from poor building work are being borne in a way that is not consistent with the responsibility for the problems causing those costs. This applies most to homeowners who are choosing builders and plans without understanding the associated risks.
- The **efficiency** issue is that joint and several liability, coupled with limited liability building companies, has led to costs falling on BCAs and homeowners. This has efficiency impacts in the form of:
  - reducing the incentives for building quality when builders are not necessarily held accountable for bad quality;
  - increased BCA risk-aversion, resulting in increased costs and delays in consenting, reducing incentives to build and/or renovate buildings; and
  - increased potential costs for homeowners, directly reducing incentives to build or renovate.

GIPs are desirable when they result in equity or efficiency improvements in the building market. The other desirable qualities of GIPs are that they are delivered efficiently, eg via a competitive market.

Below we examine the following desirable characteristics of GIPs:

- They provide incentives for desirable outcomes:
  - equity improvements through reducing homeowner risk;
  - efficiency improvements via the better allocation of risk and liability, including incentivising (or not disincentivising) building quality improvements;
- They are delivered efficiently, through:
  - pricing that is as low as possible and is risk-reflective;
  - being widely available; and
  - low transaction costs.

We outline these issues below before examining the policy options against these criteria.

#### 4.1.1 Limiting Homeowner Risk

GIPs differ in the extent to which they limit the risks borne by homeowners. Before comparing the different options, we first discuss the extent to which risk reduction is desirable.



### *How Much Should Homeowner Risk be Reduced?*

Although we characterise those hiring builders and at risk of building problems as “homeowners”, those at risk may well be developers. Recent history would suggest the risks may be greatest for larger developments, particularly multi-unit properties (terraced housing and multi-storey buildings).

GIPs insulate homeowners and developers from some of the potential costs of defects or company closures. However, by doing so they may reduce the incentive on a homeowner to research and identify the risks associated with individual builders and building designs. Here encouraging GIPs presents a trade-off between equity and efficiency. By addressing the equity problem there may be a reduction in efficiency.

However, the size of the efficiency problem is likely to be limited. Homeowners still have an incentive to find a good builder and good design, even if fully insured. When builds fail they still face the costs of disruption and delay, even if fully compensated for financial costs. In addition, as discussed below (Section 4.1.2), GIPs can both help to identify or isolate good builders within the market.

### *Risk Reduction*

GIPs differ in the extent to which they protect homeowners from risks. However, the risk equation needs to consider more than simply the GIP. The overall level of risk faced by the homeowner also includes the underlying risk associated with an individual builder and build type. In comparing GIP options, we are aware that the individual building company schemes, as an example, might appear to offer less protection but this might be because the underlying risk is lower also. However, protection is not provided against all risks by building company schemes, particularly the risk of company collapse.

The differences between the schemes relevant to homeowner risk are summarised in Table 9. They relate to:

- the comprehensiveness of cover;
- the level of financial backing; and
- the certainty of any remedy.

Table 9 Key criterion for homeowner risk limitation

Criterion	Low Protection	High Protection
Comprehensiveness	<ul style="list-style-type: none"> <li>• Cover limited to work for which builder is responsible</li> <li>• Low financial limits to cover</li> <li>• Short cover period</li> </ul>	<ul style="list-style-type: none"> <li>• Non-completion and defects</li> <li>• All defect risks</li> <li>• No financial limits</li> <li>• Long cover period</li> </ul>
Financial backing	<ul style="list-style-type: none"> <li>• Company reserves only</li> </ul>	<ul style="list-style-type: none"> <li>• Backed by insurance with large reserves</li> </ul>
Certainty	<ul style="list-style-type: none"> <li>• Guarantee only – builder must be pursued first</li> </ul>	<ul style="list-style-type: none"> <li>• First-resort insurance</li> </ul>

Below we discuss these criteria in more detail and provide a summary of the performance of the individual schemes in Table 10. Overall:

- the independent schemes provide a wider level of coverage (extending beyond defects for which the builders are responsible);
- the membership schemes have greater maximum levels of pay-out; and
- the insurance-backed schemes provide home-owners with more certainty of being provided with redress by providing first-resort insurance and high levels of financial backing. In contrast the other schemes have uncertain levels of financial backing and less certainty of redress.

Table 10 Homeowner protection provided by NZ GIPs

Scheme	Comprehensiveness	Financial backing	Certainty
Master Build Guarantee	Builder-responsible defects cover only High maximum pay-out	Uncertain, although assessed as adequate	No insurance
Halo Residential Guarantee Insurance	Builder-responsible defects cover only High maximum pay-out	Significant financial backing via Lloyds insurance	First-resort insurance
Independent (Stamford insurance) schemes	Comprehensive coverage of defects Lower maximum pay-outs than member schemes	Significant financial backing via Lloyds insurance	First-resort insurance
Building company schemes	Comprehensive in theory but do not clearly cover company collapses	Assessed as adequate for "normal" risks, but not for company collapse	No insurance

### Comprehensiveness

Comprehensiveness relates to the extent to which the GIPs protect homeowners against all possible causes of costs. This includes whether they cover:

- the risks of non-completion and defects;
- all potential causes of defects, including poor design, specification, materials or workmanship, or only the work of the builder;
- the financial limits to that cover, eg if they set maximum levels of pay-out and how high these maxima are; and
- the period of cover.

The member schemes (MB Guarantee and Halo) and independent schemes (Stamford and BuiltIn) all cover against loss of deposit, non-completion and defects. The building company schemes are harder to classify, as they cover all risks, provided the company itself continues to trade.

The independent schemes cover against all sources of defects, whereas the member schemes appear to protect against builder-caused defects, but explicitly exclude defects that are not the responsibility of the builder.

The financial limits of coverage are greater for the member schemes than for the independent schemes (Table 7).

The schemes differ somewhat in their coverage of structural and non-structural defects after completion. In particular, the Halo scheme extends coverage to non-structural defects for 10 years, whereas the others all limit cover to 2-3 years.

### **Financial backing**

The schemes differ significantly in terms of the level of financial backing, although this partly reflects the extent of the risk they are covering.

The greatest backing is provided by the schemes backed by Lloyds insurance (Halo and the independent schemes) with assets and reserves valued at NZ\$56 billion.<sup>32</sup>

RMBA suggests that the MB Guarantee has been independently audited to ensure it has sufficient cover, as do some of the building company schemes. We are not able to provide any independent assessment of this. The questions arise over whether the reserves are sufficient to cover significant problems covering multiple buildings simultaneously and/or the collapse of large (or several) building companies. RMBA notes that it was able to cover the liabilities it faced following the collapse of Stonewood Homes, which “left behind 110 homes under construction and another 150 with claims for remedial work.”<sup>33</sup> However, the adequacy of cover provided by the individual building company schemes, and the adequacy of separation of the financial reserves from the company (and its potential creditors), is less certain. Amounts set aside appear to be low compared to the total value of building work undertaken and at risk.

We note RMBA’s intention to obtain insurance coverage, which is possibly a response to the market’s perception of the adequacy of its cover, if not the reality.

### **Certainty of Redress**

The extent of protection for the homeowner is also affected by the certainty of any redress. If the homeowner faces considerable costs in first pursuing the builder to obtain redress, and no guarantee of an agreed solution, this reduces the level of effective protection. In contrast the insurance schemes offering first-resort cover (after an initial requirement to pursue the builder), provide significantly greater levels of protection. From this perspective the insurance-backed schemes operating in New Zealand appear to be well-designed, and better than many of the international schemes.

The certainty of redress under the other (non-insurance) schemes is highly uncertain. Commentators have provided anecdotal information about the delays and other

---

<sup>32</sup> Duncan Colebrook (personal communication)

<sup>33</sup> Slade (2017)

difficulties that Master Build Guarantee holders have experienced.<sup>34</sup> We do not have any data with which to confirm or refute these statements. RMBA and the building company schemes effectively operate to rules which they write themselves and this affects the automaticity of pay-outs. It is likely that the building company schemes would, under normal circumstances, act quickly to address issues that arise, because of the reputation risk, but the uncertainty remains over what protection is offered were the company as a whole to collapse. In summarising the schemes in Table 10 we use insurance cover to differentiate schemes with respect to the certainty of redress.

#### 4.1.2 Incentivising Building Quality Improvement

The underlying problem which requires the need for GIPs is the existence (or potential existence) of building failures, including building company collapses which leave homeowners with unfinished builds and post-completion defects. In an ideal market, good quality building is incentivised through:

- Information about builder quality being readily available so that those employing builders can identify good builders; and
- Liability regimes which mean builders face the consequences of poor work.<sup>35</sup>

GIPs which provide homeowners with protection from losses, may reduce the liability of builders if they are no longer pursued for damages. This has the potential for a moral hazard problem: if the potential liability on builders reduces, they may be less concerned about building quality.

However, the other player in the market is the insurance or guarantee provider. They have every incentive to ensure building quality as it reduces the likelihood that they will have to pay-out on their policy and/or allows them to sell policies at a lower price, with advantages in a competitive market.

Insurance companies and GIPs providers can ensure quality through:

- Restricting builder entry;
- Differential pricing based on builder quality;
- Limiting the range of acceptable building types; and
- Suing builders.

#### ***Restricting Builder Entry***

All of the current NZ schemes restrict builder entry.

- The membership schemes are available to members only. Members must meet criteria relating to building experience, qualifications, business and project management.

---

<sup>34</sup> Harcourt (2016); Slade (2017)

<sup>35</sup> For risk-averse builders this will be limited by professional indemnity (PI) insurance, although in a competitive insurance market premiums will reflect relative risk providing incentives for quality.

- The independent schemes set criteria for the builders to which the products are available.
- The building company schemes apply to their own builds only.

These measures do not guarantee quality, but they do provide some limits to potential risks. The extent to which the quality is assured is evident to some extent by the reinsurance backing made available to Stamford (Stamford and BuiltIn schemes) and Halo schemes. On the assumption that they have access to performance data (and see discussion in Section 3.3), insurance company backing is a useful way to ensure eligibility criteria are effective.

### *Differential Pricing*

New Zealand schemes do not currently provide financial incentives for continued improvement of builders as there is with schemes in the UK, US, New South Wales and Victoria, which include risk-based pricing. These schemes use historical data and information on qualifications and experience to risk-rate individual builders. These ratings are used as inputs to pricing formulae used in defining premiums (product prices) for those individual builders. In addition, under the UK NHBC scheme, if problems arise, individual builders can maintain a lower premium by fixing problems rather than letting the insurance company pay to have them fixed.

Developing risk-based pricing requires a comprehensive set of information which is not currently available, to our knowledge. Individual schemes have records relating to builders who have used their products, but ideally this information would be available to the market as a whole so all providers could use it for pricing purposes. This is unlikely to be possible without some additional (regulated) reporting requirement. It raises an important issue that, on the one hand GIP efficiency is improved by a competitive GIP market with multiple providers, but on the other hand, a single provider with access to information on all builders is better able to price builder-specific risk. The trade-off is either towards lower priced GIPs or better incentives for builder quality.

We would expect differential pricing to develop in New Zealand as schemes mature and more information is collected (and analysed) about the performance of individual builders and other factors that affect risk (see Section 3.3).

### *Limiting Building Types*

The UK NHBC scheme has set its own building standards which apply to all building work covered by the schemes.<sup>36</sup> These are additional to building standards that otherwise apply to building work in the UK.

New Zealand schemes have not added building standards to the eligibility criteria, although they apply to some extent to the schemes operated by individual builders who use a limited set of plans or products. For example, Golden Homes use aluminium framing for all their builds.

---

<sup>36</sup> <http://www.nhbc.co.uk/Builders/ProductsandServices/TechZone/nhbcstandards/>

Development of standards is a possible future development which would reduce risk at the possible expense of reduced innovation or building variety. There do not appear to be any current plans to introduce building standards to New Zealand schemes.

### *Suing Builders*

Without GIPs, homeowners can pursue builders through the courts. This can be costly, and builders can avoid it or make it more difficult through closing their companies, but the risk of pursuit provides an incentive for build quality to avoid such pursuit (and for professional indemnity insurance). Where GIPs are provided, this incentive is reduced to the extent that homeowners do not pursue builders, but remains to the extent that GIP providers pursue them. This differs with the schemes.

The building company schemes have more direct control over builders as employers or franchise owners. The homeowner can still pursue the builders directly.

Under the RMBA scheme, the Association can withdraw membership. And the homeowner can still pursue the builder.

However, the insurance-backed schemes enable builders to avoid being pursued.

- The Halo scheme include a *waiver of subrogation* under which builders are indemnified from the insurer recovering any claims costs against them from one year after completion.
- Stamford Insurance provides builders with the option of purchasing additional insurance which includes a *waiver of subrogation* from two years after completion.

With the insurance schemes, incentives for builder quality (beyond that incentive by eligibility criteria) are being traded-off to achieve greater homeowner certainty of protection.

#### 4.1.3 Efficient Pricing

Efficient pricing of GIPs would be cost-reflective, ie it would be equal to the expected costs borne by the GIP-provider. This would be the costs of a problem (company collapse or defect), were it to occur, times the probability of that event, plus administration costs (as discussed in Section 3.2). In a competitive GIPs market this would be the expected outcome, including homeowners purchasing the lowest cost insurance available and insurers providing cover that reflected builder- and project-specific risk.

This outcome is best achieved by ensuring GIPs are able to operate in a competitive market. This might include the following attributes:

- The separation of builder and insurance/guarantee – this better ensures prices reflect individual builder risk rather than being averaged across the market as a

whole;

- Comprehensive industry-wide information being available so that individual builder pricing is possible.

These components of a GIPs market are likely to be long-term desirables. In the shorter run, ensuring GIPs are more widely available and purchased appears to be a higher priority.

#### 4.1.4 Wide Availability

There are several schemes on the market in New Zealand which means they are relatively widely available, particularly amongst larger builders. The Stamford Insurance product is available as a retail product, so anyone using a builder that is approved by Stamford Insurance. GIPs are available to anyone using a builder who is a member of RMBA or NZCB, and those using any of the three builders with their own schemes have automatic access. The only people without access to a scheme are those using builders who have not been approved by Stamford Insurance (and who are not otherwise covered); this might be because they have failed the requirements or have not bothered to try because they do not see the value.

Retail availability appears to be a highly desirable attribute of GIPs.

Wider availability could be achieved by measures relating to:

- supply, eg making them compulsory; or
- demand, eg making GIPs more widely known and their value more clearly understood.

#### 4.1.5 Low Transaction Costs

Low transaction costs mean that obtaining redress is quick and automatic. This was discussed under *Certainty* in Section 4.1.1 above.

#### 4.1.6 High Quality GIPs

In this section we have identified the desirable qualities of GIPs in meeting equity and efficiency objectives. The key attributes are summarised in Table 11.

Ideally, GIPs would:

- Be of high quality. They would
  - Limit homeowner liability by being comprehensive in their cover, backed by scheme providers with significant financial resources and provide certainty of redress;
  - Incentivise building quality improvement by restricting builder entry to schemes and/or through differential risk-based pricing, which would also provide consumer benefits;
- Be widely used by being:

- widely available and purchased, for all building jobs, including as retail products; and
- widely recognised for their value; and
- Work simply and effectively, including through having low transaction costs so redress is automatic.

Table 11 Desirable attributes defining high quality GIPs market

Objective	Component	Desirable attribute
Limiting homeowner liability	Comprehensiveness cover	GIPs cover: <ul style="list-style-type: none"> <li>• loss of deposit, completion-failure and post-completion defects</li> <li>• all causes, whether the responsibility of the builder or others</li> </ul>
	High level of financial backing	Insurance-backing with significant available reserves
	Certainty of any remedy	First-resort insurance
Incentivising building quality improvement	Restricted entry	Builders meeting criteria relating to qualifications, experience, project and business management
	Differential pricing	GIPs priced to reflect builder- and project-specific risk
Efficient pricing	Competitive market for GIPs	Builder quality information (including defect history) widely available
Wide availability	Increased supply and demand	Available with all building work (above size threshold)
		GIPs available as retail products
		Known about and valued by consumers
Low transaction costs	Automaticity of redress	First-resort insurance

## 4.2 Analytical Approach

### 4.2.1 Costs and Benefits and the Limitations of Analysis

Ideally the analysis would include an assessment of the costs and benefits of the different options. From a societal perspective, GIPs largely result in shifts in who pays for faults which arise and when. The set of consumers with risks are effectively pooling their money, which is then paid out to any one of them who faces a problem. The problem is still fixed (and this is the cost to society); all that changes is that lots of households pay rather than only the one affected. GIPs have additional effects when they result in changes to resource allocation, such as by shifting building work towards better quality builders or better building designs (causing fewer defects).

However, the primary interest in this analysis is not in improving building quality. If that were so, we might consider a range of other policies with that specific objective, including changes to Building Codes or to builder registration. But this study is not a comprehensive analysis.



This is a limitation of the analysis. The rationale for GIPs is intimately connected to the existence of problems in the building industry leading to failures and defects. Correcting underlying problems in the building industry that result in failings would reduce the need for GIPs. Several people spoken to in undertaking this study have suggested that improving GIPs is getting a better ambulance at the bottom of the cliff rather than fixing the underlying source of the problems. However, this is not an entirely accurate picture; as noted above, GIPs can provide incentives for builder quality improvement. This study has emphasised the role of GIPs in protecting homeowners, but builder quality incentives are an important additional benefit.

#### 4.2.2 Homeowner Perspective

The primary focus of GIPs is on solving equity and efficiency issues from a homeowner perspective, while taking account of the wider benefits of building quality improvement. However, evaluating the costs and benefits to householders of taking out a GIP is somewhat complicated, as is the analysis of any insurance or other similar products.

##### *Efficient Pricing*

In a competitive market, the costs of purchasing a GIP (which provides full redress for a problem) would be expected to equal the costs of that problem, if it were to happen (the *Failure cost*), times the probability ( $p$ ), plus some additional amount to cover the (administrative) costs of the provider ( $x$ ).

$$\text{GIP premium} = \text{Failure cost} \times p + x \quad (1)$$

A risk-neutral person would be better off not purchasing a GIP as they would only face the expected cost and would avoid the administrative cost ( $x$ ).

$$\text{Expected cost} = \text{Failure cost} \times p \quad (2)$$

People purchase insurance because they are risk-averse. A risk-averse person is someone who prefers a lower return (or higher cost) with known risks to a higher return (or lower cost) with uncertain risks. They are willing to pay an additional amount to avoid the costs of a bad event occurring. Risk-aversion increases when the potential costs are high relative to income (or wealth). Thus, in a competitive GIP market, with full information about risks of building work, not everyone would purchase a GIP, but people would be more likely to purchase a GIP for larger projects with greater potential risks.

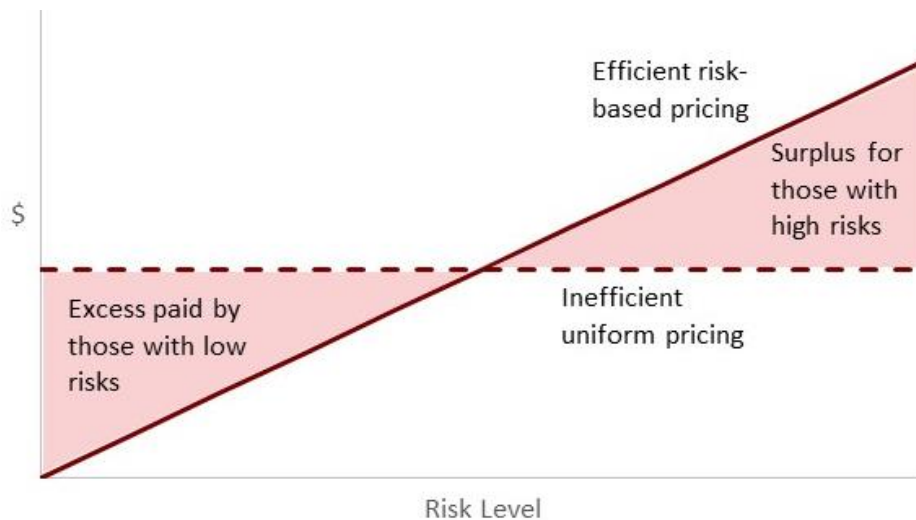
However, without full information (or the ability to process it), people under-estimate risk on average, as suggested in Section 3.5, and GIPs are likely to be under-purchased.

##### *Inefficient pricing*

The issues are slightly different when pricing is inefficient as illustrated in Figure 2. Efficient pricing has premiums which change with the level of risk (the upward sloping line). In contrast, if everyone pays the same price for their insurance premium, those

with low risks pay an excess, and those with high risks obtain a surplus. The insurance is transferring the costs for some as a benefit to others.

Figure 2 Pricing efficiency



When price is inefficient, the GIP pricing formula is:

$$\text{GIP premium} = \text{Failure cost} \times p + x + y \quad (3)$$

Where  $y$  represents an additional amount reflecting the excess paid ( $y$  is positive) or surplus received ( $y$  is negative) because of the pricing inefficiency.

Uniform pricing can encourage those with high risks to obtain insurance, because their costs are shared with those with low risks. However, it does not provide an incentive for risk reduction amongst builders and it does not ensure only the risk-averse purchase insurance. Some risk-averse people will not be able to obtain insurance for a price which would exist in an efficient market. And some risk-neutral people may obtain insurance because it costs less than their expected costs.

Policy would be optimal if it ensured all risk-averse people purchase GIPs and no risk-neutral people did. Policy might have net positive impacts if it:

- improved the information available to homeowners so that they understand the availability and benefits of GIPs;
- encouraged efficient pricing of GIPs; and/or
- made GIPs compulsory for some or all building types, corresponding to those for which people are likely to be risk-averse.

A variant on this might be making GIPs compulsory, but giving homeowners the option of voluntarily opting out if they are risk-neutral.

### 4.2.3 The Policy Questions

Taking account of the issues discussed above, the key questions for policy analysis are:

- Can information be provided adequately so that all risk-averse people purchase GIPs?
- Can risk-averse individuals be identified or approximated, eg using a project-size threshold?
- Would a compulsory GIP (above a threshold) be more likely to produce net costs for the risk-neutral or net benefits for the risk-averse?
- Would an opt-out be an effective way of identifying the risk-neutral?
- Is there sufficient potential supply for GIPs to be compulsory?

The policy questions are then addressed under a series of policy options:

1. Do Nothing – leave the development of GIPs to the market
2. Information provision only
3. Compulsory GIPs, including (a) with no opt-out, and (b) with an opt-out.
4. Government GIPs provision in case of under supply

### 4.3 Policy Analysis Criteria

Building on the discussions in Sections 4.1 and 4.2, Table 12 sets out the criteria that are used in summarising the analysis of the individual policy options. They address both equity and efficiency concerns.

Table 12 Policy Analysis Criteria

Criterion	Explanation
Reduced homeowner liability	This is addressing the primary equity objective
Increased total use of GIPs	Assuming current market failures limit use of GIPs, increased use is regarded as a benefit
GIPs targeted at risk-averse	Targeting at risk-averse people limits the costs falling on the risk-neutral
Increased quality of GIPs	Higher quality GIPs are those which provide better liability protection (as discussed in Section 4.1)
Incentives for improved builder/building quality	Building quality problems are the underlying reason why GIPs are required. GIPs policy should improve quality or not make it worse
Reduced BCA risk-aversion	BCA risk-aversion increases costs. GIPs which reduce liabilities for homeowners should not do so at the expense of BCAs
Costs to Government	GIPs policy should not involve significant regulatory costs which are not justified by significant benefits

The analysis is comparing options against the current situation and level of development of the market. This means even Option 1 (*Do Nothing*) results in some differences.

#### 4.4 Option 1: Do Nothing

The “do nothing” option means the Government would not intervene in the market, while continuing to monitor developments. It would leave the further development and use of GIPs to the market. Recent developments provide an idea of possible future trends. Chief amongst these are:

- The more widespread availability and use of insurance-backed schemes. Notably this has included the NZCB Halo scheme which appears to have encouraged RMBA to consider obtaining insurance backing for its product. Insurance-backing has the advantage of providing greater financial reserves to support possible future pay-outs.
- The development of first-resort insurance products which provide certainty to GIP purchasers. Both the Stamford Insurance schemes and Halo provide first-resort insurance. This is a positive feature of the New Zealand products in comparison with most of the Australian products. It is not clear that a revised RMBA Guarantee would include first-resort insurance.

We expect that, under Option 1, there would be further development and improvements of the RMBA product. However, it would not be likely to significantly extend the use of GIPs beyond the current estimated 50% of the new-build market (Table 4), or result in the extension of first-resort insurance cover.

There may be some small incremental improvements over the current situation, but Option 1 does not address the fundamental underlying problems. Table 13 summarises the expected effects relative to the criteria. Option 1 will have very little impact relative to the current situation, with the possibility of very small increases in total availability of GIPs and their quality (eg improvements in RMBA product).

Table 13 Analysis of Option 1 Against Criteria

Criterion	Impact
Reduced homeowner liability	
Increased total use of GIPs	Very small impact
GIPs targeted at risk-averse	No
Increased quality of GIPs	Very small impact
Incentives for improved builder/building quality	No appreciable impact
Reduced BCA risk-aversion	None expected
Costs to Government	None

#### 4.5 Option 2: Promotion of GIPs (that meet desirable criteria)

Option 2 seeks to encourage the risk-averse to purchase GIPs by providing additional information. Our analysis addresses the question (Section 4.2.3):

- Can information be provided adequately so that all risk-averse people purchase GIPs?

Under Option 2, there would be additional promotion of GIPs that meet desirable criteria. We have set out these desirable criteria above (Table 11). It would be useful to discuss and agree these with industry participants. Promoting the attributes of high quality GIPs would be expected to have impacts on:

- supply – increasing the quality of GIP offerings by making clear to the market the expectations of good GIPs; and
- demand – providing information to consumers on desirable qualities of GIPs and the desirability of having one.

The information that is required includes:

- the nature of risks faced by homeowners undertaking building projects; and
- the availability of GIPs, including their prices and levels of protection they cover.

The nature of the risks can only be described in very general terms. We are not aware of any information in the public domain on the relative risks of builders or building products, apart from those that have led to problems historically. Thus information provision is likely to be limited largely to information on GIPs and the generality of building risks.

Currently GIP promotion is largely in the hands of the building member organisations and building companies, who have some incentive not to promote them. Building companies and other organisations spoken to suggest that, from the builder's perspective, promoting GIPs may suggest that building work is risky. Suggesting to a homeowner that they should consider purchasing a GIP is perceived as being at odds with building companies' promotion of the high quality and low risk of their operations. In addition, for RMBA, the availability of guarantees increases the overall credibility of members, but the benefits may be in their advertised availability. They might be better off if they do not take on the risks by actually selling any. There may be an incentive to make them difficult to obtain. This is being addressed by RMBA moving to make them compulsory. The NZCB Halo product is already compulsory for members to provide.

Promotion of GIPs might be undertaken by MBIE, presumably involving some third-party media agency. It might alternatively (or additionally) be undertaken by a neutral third party, with Government funding. The right choice is likely to depend on the existence of channels for communication with homeowners.

In the UK, GIPs are not compulsory but banks and other mortgage lenders have made them compulsory. Investigations in New Zealand suggest this is unlikely here, especially as banks were not badly affected by the costs of the leaky building problems and see little need for additional protection measures, especially on top of the imposition by the Reserve Bank of loan to value ratios for lending.

The effectiveness of Option 2 will depend on the effectiveness of the information campaign and the extent of the alternative message that finding a good builder is an adequate way to limit risks (as suggested by builders in response to the Colmar Brunton survey – see Section 3.5).

Table 14 summarises the analysis against the criteria.

Table 14 Analysis of Option 2 Against Criteria

Criterion	Impact
Reduced homeowner liability	
Increased total use of GIPs	Small positive impact
GIPs targeted at risk-averse	Small positive impact
Increased quality of GIPs	Positive impact
Incentives for improved builder/building quality	Small positive impact
Reduced BCA risk-aversion	None expected
Costs to Government	Costs of promotion

Greater publicity would be expected to lead to:

- a small increase in total demand for GIPs and this would be focussed on the risk-averse. However, it is not clear that risk information can be adequately provided, especially when builders may provide an alternative view;
- an increase in GIP quality because of the focus on high quality GIPs in any information campaign;
- a small expected positive impact on builder quality because of the greater demand for GIPs, coupled with quality requirements for being able to supply them;
- the size of the market changes would be unlikely to reduce BCA risk-aversion. BCAs would still be at risk of significant building failures; and
- the Government would face costs for information collation and promulgation.

#### 4.6 Option 3: Compulsory GIPs

We examine this as two sub-options: without (3a) and with (3b) opt-out for consumers.

##### 4.6.1 Option 3(a) Compulsory GIPs with no opt-out

Under Option 3(a) the Government would identify the attributes of high-quality GIPs and would make it compulsory to have a GIP for projects above a certain (price) threshold. This could be focussed on new builds only or new builds and renovations.

Option 3(a) addresses the policy questions (Section 4.2.3):

- Can risk-averse individuals be identified or approximated, eg using a project-size threshold?
- Would a compulsory GIP (above a threshold) be more likely to produce net costs for the risk-neutral or net benefits for the risk-averse?

Compulsory GIPs would be likely to be enforced on builders, ie they would be required to purchase them and provide them for all projects which were above the threshold. Costs of GIPs would be expected to be passed on directly to homeowners. Ideally homeowners could purchase them directly as retail products, and the builder would only have to supply a GIP if the homeowner does not demonstrate that they have purchased one.

Compulsory GIPs would clearly increase their supply. This might be positive to the extent that there are large numbers of people who are risk-averse but who under-value the risks they face. However, as was noted above, even with perfect information, not all people would purchase GIPs. Some are risk-neutral, particularly when the size of the building project is relatively small.

We can think of the issue with respect to a two by two matrix relating to the actual level of risk and its perception (or level of aversion) (Figure 3).

Figure 3 Risks versus risk perception

	Perceive risk to be low or homeowners are risk-neutral	Perceive risk to be high or homeowners are risk-averse
Risk low	A	B
Risk high	C	D

With voluntary GIPs we might assume, those in cells B and D purchase GIPs, while those in cells A and C do not. The problem is:

- With voluntary GIPs,
  - those who think risks to be high, while they are low (cell B), will purchase GIPs when they do not need to;
  - those who perceive risk to be low while they are high (cell C) will not purchase GIPs.
- With compulsory GIPs,
  - Under-purchasing by those in Cell C is addressed;
  - Those facing low risks are forced to purchase GIPs they do not value (they are risk-neutral and the cost of a GIP is greater than the expected costs of defects/failures). This results in net costs for those in Cell A.

However, the size of the problem differs across the cells (Figure 4) and the overall equation will depend on the number of people in the different (theoretical) cells.

Figure 4 Impacts of compulsory GIPs

	Perceive risk to be low or homeowners are risk-neutral	Perceive risk to be high or homeowners are risk-averse
Risk low	Low cost per homeowner	No cost
Risk high	Possibly high benefit per homeowner	No cost

GIPs force costs on those with low risk projects (Cell A). The benefit they obtain from a GIP is only equal to their expected cost. The net cost is the additional cost of the premium, ie  $x$  from equation (1) above (page 38). We would expect this to be a low cost equal only to the administrative costs. It would be higher if the GIPs market is inefficient and without risk-reflective pricing (Figure 2). Then the costs will include the excess ( $y$  from equation (3) on page 40); this would be a transfer from some homeowners to others.

The impact on those who perceive low risks while they are actually high (Cell C) is different. We might assume that most people, if they knew risks were high and if the expected costs were high also, would be risk-averse; they would obtain a benefit equal to the amount they would be willing to pay (when given the risk information) above the premium. For an individual homeowner, the potential size of this surplus is greater than the potential costs to the risk-neutral (and those with low risk) discussed above.

Using project size-thresholds for compulsory GIPs would be one way to focus on the risk-averse. The larger the project the higher the expected cost associated with a defect and the more likely the homeowner is to be risk-averse about the project. The higher the threshold the more likely that all people captured will receive net benefits; however, a lower threshold may have greater total net benefits, even if it is capturing some homeowners from Cell A.

Currently, \$30,000 is used under the Building Act as a threshold which triggers the requirement for a contract. It is not clear that this would be the right threshold for a compulsory GIP requirement. The Australian schemes use thresholds varying from \$3,300 to \$20,000, all of which seem quite low. The threshold ideally would be set at a level which would indicate where most people would be risk-averse, eg a cost which people would find difficult to bear.<sup>37</sup> This is most likely if the threshold is relatively high, eg above \$100,000. This could also help in ensuring that compulsory GIPs policy does not drive small builders out of the market (eg if they found it difficult or costly to obtain a risk rating for insurance purposes).

Regardless, ideally GIPs would be available voluntarily to those with projects below the threshold.

### ***Impacts on the Building Industry***

Introducing compulsory GIPs would be likely to result in some builders not meeting quality criteria or facing large costs for insurance because of their risk profile. This is a

---

<sup>37</sup> A threshold based on project size is a proxy for the size of a failure, were it to occur



good outcome to the extent that it drives low quality builders out of the market, but it also raises the potential problem of reducing the total number of builders at a time when there is likely to be increased demand for builders, especially with the additional requirements associated with KiwiBuild.

The impact may be limited to the extent that the poor quality problem is limited to building company owners, rather than their workforce. The workforce, presumably, might be hired by other companies with higher quality management systems and improved training.

Regardless of the impact, the introduction of compulsory GIPs might be part of ensuring that increased building activity is not at the expense of lower quality or of increased homeowner risk.

### *Reducing BCA Risk Aversion*

Reducing BCA risk aversion is one of the criteria for assessment. GIPs can reduce liability falling on homeowners and can provide incentives for improved build quality thus reducing the probability of defects. However, if defects arise, insurance companies can still pursue BCAs if they have been negligent. Thus, some risks are reduced for BCAs but not all and they may still operate with undue risk-aversion.

Additional steps which might be taken include:

- Councils obtaining insurance against their liability for defects; or
- Insurance providers agreeing to relieve BCAs of liability (under the regulatory requirements for GIPs). This would then be factored into insurance premiums (effectively insurers would give councils the benefit of each policy).<sup>38</sup>

The impacts on premiums of insulating BCAs from liability would include the costs of not being able to recover damages from them and the additional market risks from removing one source of quality control, or requiring insurance companies to take on a greater quality control role.

We assess Option 3(a) against criteria in Table 15.

Table 15 Analysis of Option 3(a) Against Criteria

Criterion	Impact
Reduced homeowner liability	
Increased total use of GIPs	Significant impact – 100% coverage above threshold
GIPs targeted at risk-averse	Yes, to the extent that the threshold functions to isolate risk-averse
Increased quality of GIPs	Compulsory GIPs would also set quality criteria
Incentives for improved builder/building quality	Quality criteria for GIPs would isolate higher quality builders
Reduced BCA risk-aversion	Potential for insurance companies to pursue BCAs still exists (unless this option is removed by regulation)

<sup>38</sup> Duncan Colebrook, personal communication

Criterion	Impact
Costs to Government	Costs of regulation

- In reducing homeowner liability, compulsory GIPs achieve this substantially. However, the extent to which they target the risk-averse (and those who would rationally purchase a GIP under perfect information about project risk), depends on whether project value thresholds adequately isolate these people.
- The quality of GIPs would improve because the Government would be able to set the criteria, rather than leaving it to the market. This would also provide incentives for improved builder quality.
- Compulsory GIPs could reduce the likelihood of BCAs being pursued by homeowners or developers, but insurance companies might still pursue (unless this option is removed by regulation).
- The government would face costs of regulation. This is likely to involve consultation with industry and other affected parties in addition to legislative or regulatory change.

#### 4.6.2 Option 3(b) Compulsory GIPs with opt-out

Option 3(b) is a variant of Option 3. It would require builders to offer GIPs as standard parts of building contracts, but would allow homeowners to opt out of them if they perceived risks to be low and/or if they are risk-neutral. It addresses the policy question (Section 4.2.3):

- Would an opt-out be an effective way of identifying the risk-neutral?

In theory an opt-out would be an excellent way to isolate the risk-averse from the risk-neutral. However, it relies on:

- People having adequate information to understand their risks;
- Builders playing a neutral role, rather than influencing people against purchasing GIPs.

The outcome may depend on the way in which the regulations are specified, but it might also depend on the behaviour of builders, who as discussed above, might not have an incentive to encourage GIP purchase. The outcomes are either to improve the allocation to the risk-averse or to make this worse.

Table 16 summarises the assessment against policy criteria.

Table 16 Analysis of Option 3(b) Against Criteria

Criterion	Impact
Reduced homeowner liability	
Increased total use of GIPs	Significantly greater coverage expected but less than in 3(a) because of opt-out option
GIPs targeted at risk-averse	Yes, although this may be better or worse than in 3(a)

Criterion	Impact
Increased quality of GIPs	Compulsory GIPs would also set quality criteria
Incentives for improved builder/building quality	Quality criteria for GIPs would isolate higher quality builders
Reduced BCA risk-aversion	Potential for insurance companies to pursue BCAs still exists (unless this option is removed by regulation)
Costs to Government	Costs of regulation (as for 3(a))

Option 3(b) has many of the same expected outcomes as option 3(a). The key differences are:

- It would reduce total use of GIPs because of opt-outs, although whether this focuses use on the risk-averse is unclear and would depend on homeowner understanding of risks, information available and the actions of builders; and
- BCA risk would be greater because fewer homeowners would be covered by insurance.

#### 4.7 Option 4: The Government as GIP provider

Under Option 4, the Government would enter the GIPs market either to provide all GIPs (as in Australian schemes) or to be the GIP provider of last resort, eg if market participants did not fully supply the market. This option addresses the policy question (Section 4.2.3):

- Is there sufficient potential supply for GIPs to be compulsory?

One of the key issues is identifying the potential reason for any supply shortage. Is the reason:

1. The total market being too large for current (or potential future) players to cover, eg because of capital constraints; or
2. Because some builders cannot obtain cover because of the high perceived risk of their work (because of the absence of track record or a poor track record).

The responses are quite different. If the problem is (2), the GIPS policy may well be working as anticipated, to drive poor quality builders out of the market. However, if it is (1) then compulsory GIPs may not work because of supply shortages and GIPs may function as constraint on total building activity in New Zealand.

Our assessment of the market is that capital constraints are unlikely to limit total supply. As discussed in Section 2.3.4, Stamford Insurance believes the insurance-backed schemes could be extended to cover the whole market, without reaching any constraints, eg relating to reinsurance. New Zealand is a small market and the risks associated with home warranties are significantly lower than for other forms of insurance offered in New Zealand.

Despite their implied willingness to cover the rest of the market, this is by no means certain. Extending coverage is likely to bring in builders with potential or actual higher risk, including larger numbers of small builders and new entrants. This will either increase premiums for all insurance holders or require Stamford to use differential pricing. Differential pricing would improve market efficiency, as discussed earlier.

However, Stamford is only one supplier and there is a greater risk of market power and higher prices under these circumstances. The Government acting as an alternative supplier provides a possible means to limit the exercise of market power and a supplier were Stamford to decide not to cover the whole market. It would require the Government to take on the role of risk assessment and insurance in a similar way to the Earthquake Commission (EQC). It could also apply more innovative risk-based pricing were the rest of the market to fail to do so.

Table 17 summarises the assessment against policy criteria.

Table 17 Analysis of Option 4 Against Criteria

Criterion	Impact
Reduced homeowner liability	
Increased total use of GIPs	Ensures 100% coverage can be achieved
GIPs targeted at risk-averse	Depends on settings under Options 3
Increased quality of GIPs	Government as provider can design high quality GIPs
Incentives for improved builder/building quality	Yes through designing GIPs with quality criteria and/or differential pricing
Reduced BCA risk-aversion	Potential for insurance companies to pursue BCAs still exists (unless this option removed by regulation)
Costs to Government	Costs of regulation and for establishing and operating a GIP-providing entity (less revenue from premiums)

#### Option 4:

- Ensures 100% coverage can be achieved by ensuring someone is in the market willing to cover any builder that meets the criteria for a GIP;
- Enables the Government to directly improve GIP quality, thus providing incentives for improved build quality, by designing a product including first-resort insurance and risk-based pricing;
- Increases the total costs and involvement of the Government, although it also enables it to recover costs directly through premium pricing.

#### 4.8 Summary

Table 18 summarises the analysis above. Options 1 to 3 increase in their expected costs and effectiveness. Option 4 does not function on its own, but alongside Options 3(a) or 3(b).

- Option 1 (*Do Nothing*) would see small incremental developments in the GIPs market over time but these are not expected to fundamentally change the

underlying problems. This might be an appropriate option if the Government is considering other policies which would be expected to reduce the level of underlying homeowner (and BCA) risk.

- Option 2 (*Promoting Good GIPs*) would have uncertain effects because of uncertainty over the effectiveness of any campaigns. It would be expected to have small impacts both on the supply side (improving GIP quality) and demand (encouraging purchase). If successful, GIP purchase would be focussed on risk-averse homeowners.

Ideally, information campaigns would be accompanied by risk communication also, but there are constraints on the extent to which risk information is available, eg relating to builder or build-type risk.

- Option 3(a) (*Compulsory GIPs with no opt-out*) would be a significant intervention in the market. The costs and benefits depend on the extent to which the policy is making risk-neutral homeowners purchase GIPs they do not want (even with full information) or forcing risk-averse homeowners to purchase GIPs they did not realise were available or needed.
- Option 3(b) (*Compulsory GIPs with opt-out*) would be likely to improve the allocation of GIPs to the risk-averse, so long as people understand risk and are not influenced by builders against purchasing.
- Option 4 (*Government as GIP provider*) could operate alongside a compulsory GIPs policy (Option 3) to ensure there is supply. It enables the Government to directly influence GIP design and, by doing so, to provide incentives for build quality. The costs increase for the Government to match the improved benefits, but some (or all) can be recovered via product premiums.

Table 18 Analysis of Options against Criteria

Criterion	Option 1	Option 2	Option 3(a)	Option 3(b)	Option 4
Increased total use of GIPs	Very small impact	Small positive impact	Significant impact – 100% coverage above threshold	Significantly greater coverage expected	Would ensure 100% coverage
GIPs targeted at risk-averse	No	Small positive impact	Yes, to the extent that the threshold functions to isolate risk-averse	Yes, although this may be better or worse than in 3(a)	As for 3(a) and (b)
Increased quality of GIPs	Very small impact	Positive impact	Compulsory GIPs would also set quality criteria		As for 3
Incentives for improved builder/building quality	No appreciable impact	Small positive impact	Quality criteria for GIPs would isolate higher quality builders		Yes if it involves quality criteria and/or differential pricing
Reduced BCA risk-aversion	None expected	None expected	Potential for insurance companies to pursue BCAs still		As for 3

Criterion	Option 1	Option 2	Option 3(a)	Option 3(b)	Option 4
			exists (unless this option is removed by regulation)		
Costs to Government	None	Costs of promotion	Costs of regulation		Costs of regulation & of establishing and operating insurance

## 5 Conclusions

---

### 5.1 Overall Costs and Benefits of Options

The analysis of policy options for GIPs does not allow a simple assessment of net benefits. GIPs primarily function to change who pays for building problems which arise. The social costs of building problems are the costs of fixing them; GIPs shift these costs from the homeowner or BCA to the insurance company, builder or membership organisation, and ultimately via premiums, to all people who contract for building work. This has equity benefits and has wellbeing net benefits to the extent that risk-averse people purchase GIPs that they would not otherwise, and that this benefit exceeds the sum of GIP premiums paid by the risk-neutral.

Additional social benefits are obtained when GIPs policy results in improved build quality and if it enables BCAs to be less risk-averse, eg if regulation of compulsory GIPs requires that insurance companies relieve them of liability.

The analysis of the potential costs of building problems which GIPs address was estimated to be approximately \$85 million per annum. With GIPs covering a little over 50% of the market, this would suggest an annual expected cost of approximately \$40 million. Compulsory GIPs would shift this some of this cost (that from projects exceeding a threshold) from a small number of homeowners and spread it across the market as a whole.

### 5.2 Compulsory or Not?

It is notable that many other countries have adopted compulsory GIPs. If New Zealand was to do the same there are local examples that are currently as good as, if not better than many of the international schemes. In particular we believe the NZ schemes are preferable to those on offer in Australia.

Whether compulsory GIPs is a good policy depends on whether a significant proportion of people are expected to be risk-averse with respect to building problems. As discussed above, it is more likely that the risk-averse will be covered by the policy if the threshold for compulsory GIPs is relatively high.

Currently there is only one player in New Zealand who could step in to provide GIPs to the market as a whole: Stamford Insurance. The others are either limited by membership or by company. This provision would need to be overseen by the Government to ensure against the exercise of market power, unless as suggested above, additional players could be encouraged to enter the market. A further option is the Government's direct involvement in the market as a GIP provider. This is worth serious consideration, especially if further discussions with the industry suggest full coverage is unlikely or if extension to cover the whole market would be unlikely to be done efficiently (through differential risk-based pricing).

### 5.3 Next Steps

The analysis in this project does not lead to a clear case for or against compulsory GIPs or for the involvement of the Government. However, we believe it is worth assessing further, particularly in consultation with the industry. Issues to explore further include:

- Desirable qualities of GIPs. We have provided some suggestions in this report, but it would be useful to obtain additional comment and feedback before promoting any Government expectations of high quality GIPs. This would include issues relating to differential pricing, including the data needs.
- The expectations for full coverage of the market under compulsory GIPs. We have received some assurances of market willingness to cover all builders (meeting some quality criteria), but additional assurance (or a Government GIP option as a back-up) would be needed before any decision to make GIPs compulsory.
- The appropriate level for a threshold for compulsory GIPs. This would need to consider levels below which damage costs would be reasonably tolerable and the current distribution of build costs.



## References

---

- Consumer NZ (2018) Building guarantees. 26 Mar 2018.
- Curtis MD and Norman DS (2014) Client and designer choices and their effect on new housing costs. BRANZ Study Report SR 319.
- Harcourt G (2016) A Better System. Home Building Warranties – New Zealand and the UK compared.
- Hardy G (2016) Does liquidating your company protect you from liability? Available (September 2018) at:  
<http://madisonhardy.com/publications/ArtMID/417/ArticleID/211/Does-liquidating-your-company-protect-you-from-liability>
- Law Commission (2012) Review of Joint and Several Liability. Law Commission Issues Paper 32. NZLC IP32.
- Law Commission (2014) Liability of Multiple Defendants. Law Commission Report 132. NZLC R132.
- Local Authority Building Control (undated) LABC Warranty. Policy Document New Homes. V6.
- Minister for Building and Construction (2011a) Building Act review: Regulation of guarantee products and services. Paper to Cabinet Economic Growth and Infrastructure Committee.
- Minister for Building and Construction (2011b) Building Act Review: Review of Joint and Several Liability. Paper to Cabinet Economic Growth and Infrastructure Committee.
- Ministry of Business, Innovation and Employment (2013) Residential Construction Sector Market Study: Issues Paper.
- Ministry of Business, Innovation and Employment (2015) Guidance: Guide to tolerances, materials and workmanship in new residential construction 2015.
- Ministry of Business, Innovation and Employment (2017) Draft Working Paper on Strengthening Risk Management in the Building Sector.
- NHBC (2018) M114 Buildmark Policy Brochure. Applies to newly built, converted or renovated homes registered with NHBC from 1 April 2018.
- NZ Productivity Commission (2012) Housing affordability inquiry.

Office of the Mayor of Auckland (2017) Mayoral Housing Taskforce Report Prepared for the Mayor of Auckland.

Premier Guarantee (undated) Policy Document New Homes. Volume 7.

PwC (2009) Weathertightness – Estimating the Cost. Department of Building and Housing.

Slade M (2017) Houses of Cards. Listener, October 2017, pp12-21.

Yockney C and Field J (2018) Risk, Responsibility and Liability in the Building Process. Draft report: An exploration of the behaviours of homeowners and builders. Prepared by Colmar Brunton for Ministry of Business, Innovation and Employment.

# Glossary

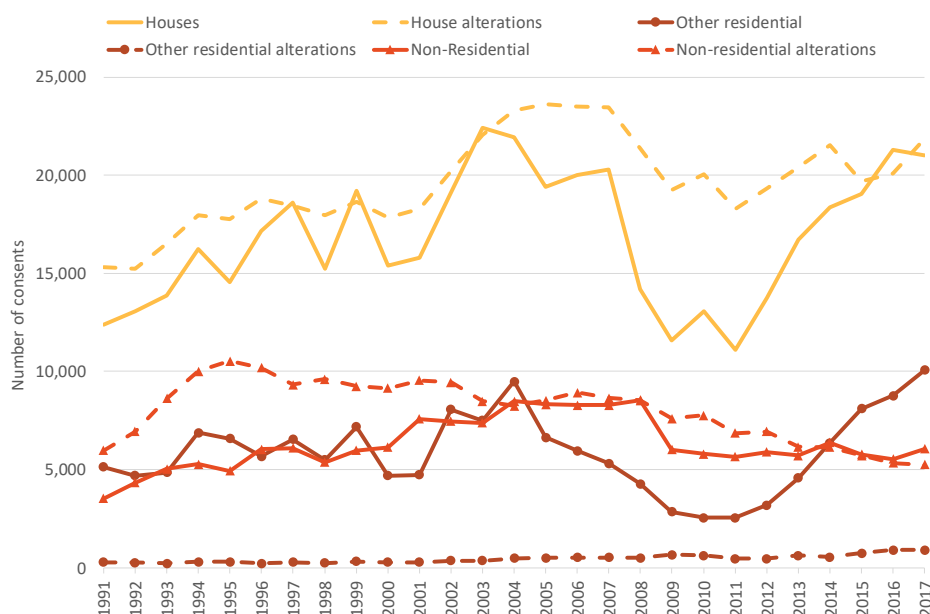
---

ACT	Australian Capital Territory
APPG	All-Party Parliamentary Group for Excellence in the Built Environment (UK)
BCA	Building Consent Authority (a local authority)
BWRS	BrokerWeb Risk Services Ltd (the insurance broker for the Halo scheme)
FHA	Federal Housing Administration (US)
FSCL	Financial Services Complaints Ltd (dispute resolution service for BuiltIn)
GIP	Guarantee or Insurance Product
GST	Goods and Services Tax
LABC	Local Authority Building Control (UK)
MB	Master Builder (same as RMB)
MBIE	Ministry of Business, Innovation and Employment
MSC	Minimum Solvency Capital
NHBC	National House Building Council (UK)
NHBRC	National House Building Research Council (UK)
NT	Northern Territory (Australia)
NSW	New South Wales (Australia)
NZCB	New Zealand Certified Builders Association
NZIA	NZ Institute of Architects
NZS	New Zealand Standard
PCC	Professional Consultants Certificate (UK)
QBCC	Queensland Building & Construction Commission (Australia)
QLD	Queensland (Australia)
RMB	Registered Master Builder
RMBA	Registered Master Builders Association
RIL	Residential Indemnity Limited (company established to manage funds for Signature Homes)
RWL	Residential Warranty Limited (company established to manage funds for Golden Homes)
SA	South Australia
SNZ	Standards New Zealand
VIC	Victoria (Australia)
WA	Western Australia

## Annex A Building Activity in New Zealand

The levels of current and future building activity determine the potential demand for GIPs. Statistics NZ (StatsNZ) publishes data on consents, including numbers and value. Figure 5 shows historical data from 1991 to 2017. By number, houses dominate the building consents, with approximately equal numbers of new builds (21,022 in 2017) and alterations (21,854); there is a rising number of new builds for other building types (including apartments, townhouses and units). Numbers of non-residential building consents fell at the time of the global financial crisis and have not risen since. Non-residential alterations have been falling in number since the mid-1990s.

Figure 5 Number of Building Consents (1991 - 2017)



Source: Statistics NZ – Infoshare

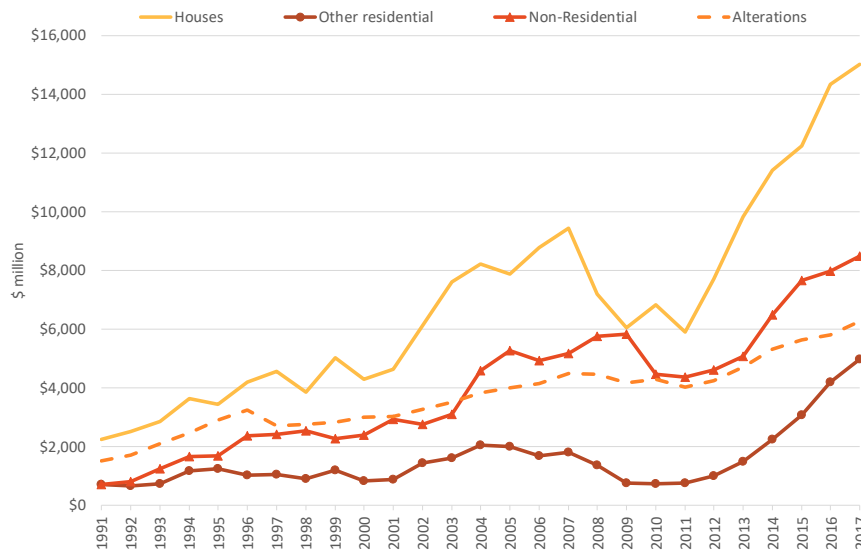
The value of consents is shown in Figure 6 using building consent values reported by StatsNZ modified to produce gross fixed capital formation numbers, as used by MBIE in its national construction projections.<sup>39</sup> This estimates the final cost of the construction to the final user, including:

- costs prior to the application for consent, such as any feasibility studies and professional fees; and
- outlying costs, including subdivision works, costs of financing, legal / real estate fees, and any developer profit.

Pacifecon and BRANZ estimate these numbers from consent values using a multiplier of 1.74, based on historic ratios of fixed capital formation / consents values.

<sup>39</sup> Pacifecon and BRANZ (2017) National Construction Pipeline Report 2017. A Forecast of Building and Construction Activity. Appendix C. MBIE.

Figure 6 Value (gross fixed capital formation basis) of Building Consents (1991 - 2017)

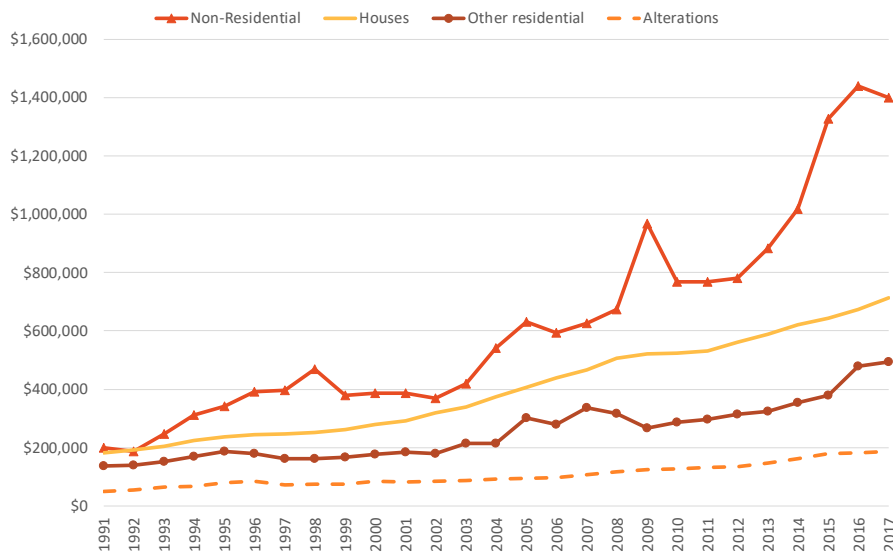


Source: Modified from data from Statistics NZ – Infoshare

The value (on a gross fixed capital formation basis) of all building work has been increasing, particularly for new housing projects; they have increased in value by nearly 200% since 2011 to \$15 billion in the year to December 2017. The value of all building work was \$28.4 billion and non-residential building, \$8.5 billion. The value of alterations is significantly less than for new builds; combined across all building categories it totalled \$6.3 billion in 2017.

Figure 7 shows the value per consent across the different categories. The value of the average new house has risen to \$714,000 in 2017, and for other residential buildings, to \$493,000. The average value of non-residential building consents is over \$1.4 million and it is \$187,000 for alterations.

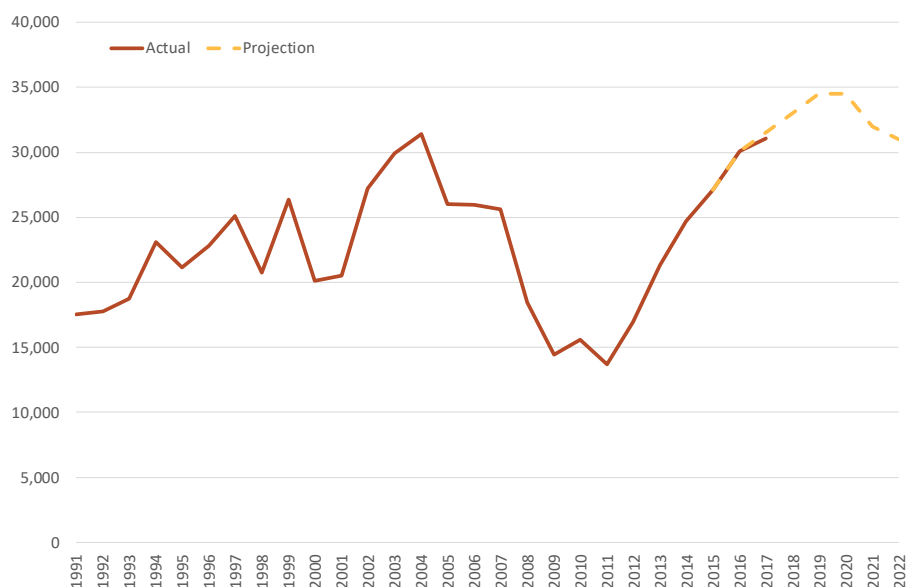
Figure 7 Value per consent



Source: Data from Statistics NZ – Infoshare

Figure 8 shows MBIE’s projections of future residential consents. They are forecast to peak in 1019/2020 and then fall again to current levels. These numbers were forecast prior to the change of Government and the announced Kiwibuild policy.

Figure 8 New residential building consents



Source: MBIE <http://constructionprojections.mbie.govt.nz/>

Figure 9 Consent numbers and values (2017)

	Houses	Apartments	Retirement village units	Townhouses, flats, units, and other dwellings	Total residential	Non-residential	Total
Number							
New	21,022	3,239	1,951	4,875	31,087	6,063	37,150
Alterations	21,854	210	38	653	22,755	5,251	28,006
Total	42,876	3,449	1,989	5,528	53,842	11,314	65,156
Value (\$million)							
New	\$8,624	\$1,148	\$539	\$1,163	\$11,475	\$4,875	\$16,350
Alterations	\$1,472	\$186	\$4	\$94	\$1,756	\$1,624	\$3,380
Total	\$10,097	\$1,334	\$543	\$1,257	\$13,231	\$6,499	\$19,730
Value (fcfb) (\$million)							
New	\$15,006	\$1,998	\$938	\$2,024	\$19,967	\$8,482	\$28,449
Alterations	\$2,562	\$323	\$7	\$163	\$3,055	\$2,826	\$5,882
Total	\$17,568	\$2,321	\$945	\$2,188	\$23,022	\$11,309	\$34,331
Value per consent (\$)							
New	\$410,250	\$354,524	\$276,415	\$238,658	\$369,136	\$804,032	\$440,112
Alterations	\$67,368	\$884,942	\$105,295	\$143,692	\$77,167	\$309,331	\$120,696
Total	\$235,482	\$386,820	\$273,145	\$227,440	\$245,742	\$574,434	\$302,818
Value per consent (fcfb) (\$)							
New	\$713,835	\$616,872	\$480,962	\$415,265	\$642,296	\$1,399,015	\$765,795
Alterations	\$117,220	\$1,539,799	\$183,213	\$250,025	\$134,270	\$538,236	\$210,012
Total	\$409,739	\$673,066	\$475,273	\$395,746	\$427,591	\$999,515	\$526,903

Source: Data from Statistics NZ – Infoshare

## Annex B Consumer Protection under Law

---

Some degree of consumer protection is available under the Building Act and the Consumer Guarantees Act (CGA). The CGA applies to services provided by the building industry but not to buildings and building materials, which are covered by implied warranties under the Building Act.

### Consumer Guarantees Act

The Consumer Guarantees Act says:<sup>40</sup>

- tradespeople need to work with reasonable skill and competence;
- tradespeople need to fix work that isn't competently and skilfully done, at no extra cost;
- if tradespeople can't or won't fix work, building owners can get another tradesperson to do the work, passing on the cost to the original tradesperson, if it isn't fixed within a reasonable timeframe.

### Building Act

Under the Building Act 2004, key measures protecting people having building work done are:<sup>41</sup>

1. Builders and clients are required to have a written contract for residential building work costing \$30,000 (including GST) or more. Amongst other things, the contract will address how defects in the building work will be remedied and the dispute resolution process to be followed, if required.
2. Before signing a contract for work costing \$30,000 or more, or if the client requests it, the contractor must provide:
  - a. a disclosure statement with information about their skills, qualifications, licensing status, and the insurance or guarantees they provide; and
  - b. a checklist that outlines stages of the build and how the client can be protected.
3. Once the building work has been completed, and regardless of the size of the job, the contractor must provide the client with information or documents related to the building work, including ongoing maintenance requirements, guarantees or warranties and any ongoing insurance policies.
4. Clients have an automatic 12-month defect repair period when contractors have to fix any defects the client has informed them of in writing.
5. Certain warranties about the quality of the building work and the materials used are implied and are taken to form part of the contract. Clients can take action as

---

<sup>40</sup> <https://www.building.govt.nz/resolving-problems/resolution-options/activate-your-consumer-rights/>

<sup>41</sup> Building Act 2004 and MBIE (2017) *Know your rights. A homeowner's guide to the consumer protection measures when building or renovating.*

a result of warranties not being met There are implied warranties in which clients can take action in a period of up to 10 years if warranties have not been met, even if they are not in the contract.

6. Contractors can be fined if they do not comply with the law.

Consumer New Zealand notes that many building companies and individual builders will have their own form of contract, but that other sources of standard contracts include:<sup>42</sup>

- Standards New Zealand (SNZ);
- Certified Builders Association of NZ (CBANZ);
- Registered Master Builders Association (RMBA);
- NZ Institute of Architects (NZIA)

MBIE has sponsored the SNZ standard contract (NZS 3902:2004 Housing, alterations and small buildings contract) so anyone can download a copy for free. CBZLNZ and RMBA contracts (RBC1-2016 Building Contract) are only available to members, and the NZIA contract is available for purchase.

#### Implied Warranties

Implied warranties apply whether there is a written contract or not.<sup>43</sup> The implied warranties, as set out in Section 362I of the Act, are:

- All building work will be done properly, competently and according to the plans and specifications in your approved consent.
- All the materials used will be suitable and, unless otherwise stated in the contract, new.
- The building work will be consistent with the Building Act and the Building Code.
- The building work will be carried out with reasonable care and skill, and completed within the time specified or a reasonable time if no time is stated.
- The home will be suitable for occupation at the end of the work.
- If the contract states any particular outcome and the homeowner relies on the skill and judgement of the contractor to achieve it, the building work and the materials will be fit for purpose and be of a nature and quality suitable to achieve that result.

Under the Building Act, a builder must provide certain information if the value of the work is \$30,000 or more (including GST), or if it is requested. If they don't supply this information the builder can be fined.<sup>44</sup> The disclosure statement includes:

---

<sup>42</sup> Consumer New Zealand (2015) The contract document. 17 June 2015.

<sup>43</sup> <https://www.building.govt.nz/projects-and-consents/why-contracts-are-valuable/implied-warranties-and-defects/>

<sup>44</sup> <https://www.building.govt.nz/projects-and-consents/why-contracts-are-valuable/consumer-protection-disclosure-and-checklist/>



- their name and/or the legal name of their business entity
- whether they are trading as an individual, partnership or Limited Liability Company
- their business address and contact details and when the business was formed
- information about the key contact person (for example, the project manager or site foreman) who will be involved in carrying out or supervising the building work, including their relevant qualifications, skills and experience
- information about insurance policies the contractor has, or intends to have, in relation to the building work – they must specify the amount of the cover and any relevant exclusions on policy coverage
- information about any guarantees or warranties the contractor offers in relation to the building work – they must specify the time period the guarantee or warranty is offered for and any limits or exclusions on coverage.

The standard checklist includes information about:<sup>45</sup>

- managing building projects
- hiring contractors
- essentials in a written contract
- ways to protect yourself, including:
  - becoming informed
  - agreeing on project structure and management
  - hiring competent building contractors
  - agreeing on price and payments
  - having a written contract
  - taking control
  - resolving disputes.

### Builder Licensing

A system of builder licensing has existed in New Zealand since 2012 with the objective of ensuring builders undertaking certain types of work are sufficiently competent. The licensing scheme also provides customers with confidence in the work.

The Building Act 2004 requires certain restricted building and design work to be done (or supervised) by a Licensed Building Practitioner (LBP). 'Restricted building work' is residential design, construction or alteration work that requires a building consent and involves or affects a home's primary structure, weathertightness or certain fire safety design.

---

<sup>45</sup> <https://www.building.govt.nz/projects-and-consents/why-contracts-are-valuable/consumer-protection-disclosure-and-checklist/>

## Annex C Insurance Industry Regulation

---

The Insurance (Prudential Supervision) Act 2010 (IPSA) has the purpose (s.3(1)) to:

- (a) promote the maintenance of a sound and efficient insurance sector; and
- (b) promote public confidence in the insurance sector.

The Act applies to all insurers carrying on business in New Zealand (as defined by the Act). It is administered by the Reserve Bank and it:<sup>46</sup>

- establishes a system for licensing insurers;
- imposes prudential requirements on insurers; and
- confers certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

Specific requirements under the Act include compliance with:

- a fit and proper standard; and
- a solvency standard.

A fit and proper standard is used to specify the qualifications, requirements, and other criteria, including matters relating to a person's character, competence, and experience (Box 2).

### Box 2 Fit and Proper Standard

The matters that are relevant to the consideration of whether a person is a fit and proper person to be appointed to, and continue to hold, a position as director or relevant officer of a licensed insurer are outlined below:

- (i) whether the person has the qualifications and experience reasonably expected for the position;
- (ii) whether the person has been concerned with or taken part in the management of a person that has—
  - (a) been put into liquidation, receivership, voluntary administration, or another insolvency procedure or has otherwise been wound up or dissolved on the basis that it could not pay its debts when due; or
  - (b) been declared to be subject to statutory management or judicial management; or
  - (c) been subject to an arrangement or process under the laws of an overseas jurisdiction that corresponds, or is similar, to any of those specified in subparagraph (a) or (b); or
  - (d) entered into any procedure or arrangement with its creditors on the basis that it is unable to pay its debts when due, for example a moratorium arrangement;
- (iii) whether the person has, in any civil or criminal proceedings, been found by a court or tribunal to have—
  - (a) engaged in an act, omission, or course of conduct that constitutes serious wrongdoing; or
  - (b) aided, abetted, counselled, or procured any other person to engage in an act, omission, or course of conduct that constitutes serious wrongdoing;
- (iv) whether the person has at any time been adjudged bankrupt or otherwise entered into a procedure provided for under Part 5 of the Insolvency Act 2006 and, if the person has been discharged from bankruptcy or any other procedure provided for under that Part, the time that has elapsed since the person was discharged;
- (v) whether the person—
  - (a) is the subject of current disciplinary action in respect of a profession or occupation (being disciplinary action taken by a regulatory or disciplinary body for persons engaging in that profession or occupation); or
  - (b) has been the subject of disciplinary action of that kind that has involved a finding of guilt, however expressed;

---

<sup>46</sup> <https://www.rbnz.govt.nz/regulation-and-supervision/insurers/regulation>

- (vi) whether the person has at any time been prohibited from 1 or more of the following under an order made, or a notice given, under New Zealand law or the law of an overseas jurisdiction:
  - (a) being a director of an entity; or
  - (b) being a promoter of an entity; or
  - (c) being concerned or taking part in the management of an entity;
- (vii) whether the person has at any time—
  - (a) failed to comply with the directions of the Reserve Bank given by or under this Act or any other enactment; or
  - (b) failed to comply with the directions of an overseas supervisor given by or under the law of an overseas jurisdiction; or
  - (c) obstructed or hindered the Reserve Bank in its exercise or performance of a power, function, or duty under this Act or any other enactment; or
  - (d) obstructed or hindered an overseas supervisor in its exercise or performance of a power, function, or duty under the law of an overseas jurisdiction;
- (viii) whether the person has any conflict or potential conflict of interest (direct or indirect) that affects, or may affect, the person's proper performance of the duties of the position;
- (ix) whether the person has been convicted of an offence and, if so, —
  - (a) the nature of the offence; and
  - (b) the circumstances in which the offence was committed (including the time that has elapsed since the offence was committed and the person's age when the offence was committed)

Source: Reserve Bank of New Zealand (2011) Fit and proper standard. Licensed insurers.

The solvency standard requires a licensed insurer to maintain a Minimum Solvency Capital (MSC) and a Solvency Margin. These reflect the level of risk the insurer is exposed to.<sup>47</sup>

---

<sup>47</sup> Prudential Supervision Department (2014) Solvency Standard for Non-life Insurance Business 2014. Reserve Bank of New Zealand.

## Annex D International GIPs

---

In this section we describe GIPS available in a number of other jurisdictions.

UK

Home building warranties were first introduced in the UK in the 1940s by the National House Building Regional Council (NHBRC). The NHBRC was established by the building industry a decade earlier in response to Government concern about poor house building standards. To address these concerns NHBRC developed a set of building standards and inspected their members' work to monitor compliance. The NHBRC began offering a two-year builder's warranty in the 1940s and in 1965 this evolved into a 10-year warranty which is the form of warranty that is most common in the UK today.

### *Major providers*

In the 1970s the NHBRC changed its name to the National House Building Council (NHBC) and became an insurance company independent of builders and the Government. In 1985 NHBC was certified as an Approved Building Inspector so was able to offer building inspection services under UK Building Control Regulations in addition to home warranties. With approximately 80% of the home warranty market, NHBC is by far the largest warranty provider in the UK today.

NHBC is a private, not-for-profit company limited by guarantee. It is run by a board of directors who are accountable to a council of members comprising representatives from mortgage lenders, law societies, consumer groups, architects, surveyors and house builders. Surpluses following re-investment in the business are returned to NHBC's registered builders under a premium refund scheme.

NHBC is backed by Aviva Insurance, one of UK's largest insurers. NHBC still sets technical standards for builders registered with it and monitors compliance with these standards through inspections at multiple stages of the building process. The validity of a builder's warranty depends on passing these inspections.

Other significant providers of home warranties include Premier Guarantee which entered the market in 1997 and the Local Authority Building Control (LABC) Warranty which entered in 2007. Premier and LABC offer home warranties as well as Building Control inspection services. In addition to these companies, approximately 10 smaller providers have entered the warranty market since 2009.<sup>48</sup>

### *How warranties work*

Most UK home warranties (also known as 'structural warranties') provide homeowners with protection against building defects that arise within 10 years of construction. Warranties are regulated as insurance products and while they are not compulsory

---

<sup>48</sup> See, Competition & Markets Authority (CMA), 'NHBC Structural Warranties Undertakings Review', Final Decision, 18 Oct 2017, p. 13.  
<https://assets.publishing.service.gov.uk/media/59e7144d40f0b61ab3d08849/nhbc-undertakings-review-final-decision.pdf>

under the law they are 'de facto mandatory' for new builds and conversions since lenders require a warranty in order to provide finance.<sup>49</sup>

Warranties are taken out by builders who are responsible for payment of premiums. NHBC determines its premium levels based on a builder's claims history and the length of time it has been registered with NHBC. This system rewards builders for high quality work and longevity in business. In addition to premiums, NHBC charges its registered builders an initial application fee and an annual registration fee.

Most UK warranties offer the following types of cover, which vary depending on when the claim arises:

- **Loss of deposit:** During construction, if a builder goes insolvent or is otherwise unable to complete the home, the warranty covers loss of deposit;
- **2-year defects warranty:** If a defect (structural or non-structural) is discovered during the first two years post-construction, the builder is required to fix the defects in the first instance with the warranty providing cover if the builder fails to do so.
- **Structural insurance:** During years 3 to 10 the homeowner can seek redress directly from the warranty provider for damage resulting from the builder's failure to build specific parts of the home to the provider's building standards. Cover typically only applies to major faults to the structural and weather-proofing parts of the home eg roofs, ceiling, walls, stairs, glazing and foundations. Generally NHBC will offer the builder the chance to fix the problem at this stage; by doing so the builder will protect their premium (if they don't they will subsequently have to pay more for the Guarantee).
- **Building Regulations Insurance:** During years 3 to 10 the homeowner can also claim against the warranty if the builder breached UK Building Regulations resulting in 'an imminent danger to health or safety', provided that the Building Regulation inspections were carried out by an Approved Inspector from the warranty provider.

The limits under the UK warranties are set out in Table 19. The price varies with the size of the project, but the average cost for a warranty is £2,000.<sup>50</sup>

Table 19 Guarantee Scheme limits – NHBC, Premier and LABC schemes

Time	Financial limits
Before completion	Protection for purchaser's deposit between exchange of contracts and legal completion Up to 10% of the original purchase price or £100,000, whichever is lower
After completion	New build warranty and insurance cover up to £1m, and up to £500,000 for conversions

Source: NHBC (2018); LABC (undated); Premier Guarantee (undated).

<sup>49</sup> As required in the *UK Finance Mortgage Lenders' Handbook*

<sup>50</sup> <https://www.homebuilding.co.uk/self-build-warranties/>

NHBC only offers warranties that are taken out at the outset of construction. Other providers offer retrospective warranties, with premiums increasing the later in the building process the warranty is taken out. Warranties transfer to the new owner upon the sale of a house.

### *Warranty and insurance periods*

The degree to which homeowners are required to engage with their builder to rectify defects depends on how many years have passed since building completion. During the first two years post-construction, the homeowner is required to contact the builder in the first instance and ask them to remedy the defects. If the builder refuses, the homeowner can then use the warranty provider's dispute resolution service which culminates in the provider issuing a 'resolution report' that directs the builder to carry out specified work. If the builder still refuses, the warranty provider will complete the work itself or compensate the homeowner for the cost of having the work done elsewhere. If the homeowner disagrees with provider's resolution report it has the option to take the matter to court.

During years 3 to 10 post-construction the warranty operates like an insurance policy. The warranty provider is directly responsible for fixing the defects or providing equivalent compensation to the homeowner. The homeowner is not required to pursue the builder during this period, however the scope of defects covered during this period is more limited than in the first two years.

### *First resort v last resort*

Most UK providers offer 'first resort' insurance during the insurance period of cover. This means that, to be able to claim under the policy, the homeowner does not need to:

- show that the builder has died, disappeared or become insolvent; or
- take the builder to court.

This is a material difference between UK warranties and the 'last resort' insurance that is offered in most Australian states (see section 0 below).

### *Virtuous circle*

The system works with a kind of virtuous circle in which the warranty provider sets standards which need to be adhered to by the builder to be eligible for the warranty. The provider will monitor builder performance and the performance of different building techniques or materials. It uses this information to adjust the premiums charged to individual builders and the standards which apply and which can limit risk.

### *Parliamentary review*

A 2016 review by the All-Party Parliamentary Group for Excellence in the Built Environment (APPG) identified two main areas of concern with building warranties in the UK:

1. customer confusion regarding the scope of coverage; and
2. the lack of a straightforward means of resolving a dispute with a builder -- although warranty providers offer dispute resolution services for homeowners

and builders, homeowners too often need to resort to court to establish their rights.

The APPG recommended the following changes to provide greater safeguards for consumers (the changes are currently being considered by the House of Commons):<sup>51</sup>

- the establishment of a New Homes Ombudsman to provide an independent and affordable dispute resolution service for homebuyers, funded by a levy on the construction industry;
- the introduction of standardised contracts for sale;
- a right of inspection for buyers prior to completion;
- the provision of a comprehensive information pack by builders to improve transparency around design and the building and inspection process; and
- a review of laws governing consumer rights when buying new homes (current consumer rights statutes do not cover immovable objects).<sup>52</sup>

### *Choice and innovation in building types*

The UK's structural warranty scheme may have contributed in part to the growth in 'cookie-cutter' building developments. In a 2017 review, the Competition & Markets Authority observed that "*NHBC's warranties appear well suited to large volume developments of similar properties as it can offer 'type' approval, ie approval of the house design which can then be repeated across different projects.*" It also noted that "*according to many parties, NHBC warranties are less well suited to developments which use bespoke or more innovative construction methods.*"<sup>53</sup> These observations reflect the higher costs involved in assessing the level of risk associated with multiple bespoke homes compared with a portfolio of identical homes.

### *Consumer perception*

Despite the criticisms, consumers are generally satisfied, although this might reflect a lack of experience with problems. A 2017 Homeowner Survey conducted by the UK Homeowners Alliance and BLP Insurance<sup>54</sup> showed that 64% of respondents who built a new home within the last 10 years were satisfied with their warranty cover, 12% reported that they were dissatisfied (the remaining 24% answered 'n/a'). In addition, 43% of respondents consider warranty cover to be an advantage of buying a new build over an older home. However, most nonetheless said they preferred to buy existing homes over new builds. Twice as many UK adults (47%) said they would prefer an older home that is more than 10 years old to a new build home (21%).

---

<sup>51</sup> HOC 'New-Build Housing: Construction Defects – Issues and Solutions (England)', 9 August 2018, pp 20-21.

<sup>52</sup> "The homeowner has far more consumer rights and protection for a new kettle in their kitchen than they do for the new building that houses it." Steve Double, Westminster Hall Debate, HC Deb 16 October 2017 c691

<sup>53</sup> Competition & Markets Authority (CMA), 'NHBC Structural Warranties Undertakings Review', Final Decision, 18 Oct 2017, p. 26.

<sup>54</sup> <https://hoa.org.uk/2017/05/new-build-warranties/>

The survey also identified a mismatch between the cover that consumers think they are getting and the cover they are entitled to under their warranty. Nearly half (46%) of new build property buyers in the last 10 years expected the full 10-year warranty to cover minor, non-structural issues in their home whereas most policies only cover non-structural defects for the first two years.

### ***Warranty alternatives***

Because warranties are not compulsory, there are alternatives, including a Professional Consultants Certificate (PCC) signed by a professionally qualified architect, chartered surveyor or similar. By signing the certificate the consultant confirms that they have designed and/or monitored the construction of the property and that they will remain liable to the owner and any lenders for a minimum of six years.<sup>55</sup> PCCs are lower cost than warranties and are not insurance policies, so any problems need to be claimed against the consultant's professional indemnity insurance, and homeowners will need to be able to prove negligence to be successful. They do not provide cover for the insolvency of the builder, and many lenders do not accept them.<sup>56</sup>

### Australia

Home building insurance schemes are mandatory in every Australian state except Tasmania. Builders are required to take out insurance for new builds and renovations above a certain contract amount (ranging from \$3,300 in Queensland to \$20,000 in New South Wales and Western Australia).

Each of the schemes provides cover for non-completion of work (loss of deposit) as well as for building defects, with most policies providing a shorter period of cover for non-structural defects and a longer period for structural defects. See Table 20 for a comparison of the different state schemes.

### ***Public vs Private providers***

Warranties in Queensland, New South Wales and Victoria are provided by Government-run entities. In South Australia and Western Australia, providers are private sector insurers underwritten by the Government. In Australian Capital Territory warranties are offered by private insurers and the Master Builders Association Fidelity Fund and in Northern Territory, the sole provider is the Master Builders Association Fidelity Fund which is underwritten by the Government for the first five years of the Fund while it builds up its cash reserves.

### ***First resort vs last resort***

Every Australian state except Queensland provides 'last resort' insurance. This means homeowners are only able to claim on the policy if the builder is unable to remedy the problem because it is dead, disappeared or insolvent. Victoria and New South Wales have added a right to claim where a builder has been ordered by a court or tribunal to compensate a homeowner or carry out work and refuses to do so.

---

<sup>55</sup> <http://www.architectscertificate.co.uk/services/professional-consultants-certificates/>

<sup>56</sup> <https://www.homebuilding.co.uk/self-build-warranties/>



Queensland is unique in offering a ‘first resort’ scheme. It is operated by the government-run Queensland Building & Construction Commission (QBCC); it provides cover where a builder cannot or will not finish the work or fix a defect. Homeowners in Queensland are required to try to get the builder to remedy the defect before being able to lodge a claim however they are not required to take the builder to court as a prerequisite for claiming. Once QBCC has paid a claim, it pursues the builder to recover the claim amount.

Table 20 Comparison of Australian state schemes (excluding Tasmania)

State	Name of scheme	First/ Last resort	Provider	Project value requiring insurance	Period of cover for defects (structural/non-structural)	Maximum claim value
ACT <sup>57</sup>	Residential Building Insurance	Last	Private Insurers (CGU, QBE, Vero) and Master Builders Association Fidelity Fund	\$12,000	6 years/2 years	\$85,000
NSW <sup>58</sup>	Home Building Compensation Scheme	Last	Government-operated icare and private providers backed by Government fund	\$20,000	6 years/ 2 years	\$340,000
NT <sup>59</sup>	Residential building insurance	Last	Master Builders Association Fidelity Fund underwritten by Government	\$12,000	6 years/ 1 year	\$200,000
QLD <sup>60</sup>	Home warranty insurance	First	Government-operated QBCC (Queensland Building & Construction Commission)	\$3,300	6 years/ 6 months	\$200,000
SA <sup>61</sup>	Building indemnity insurance	Last	Private insurer (QBE) underwritten by Government	\$12,000	5 years/ 5 years	\$150,000
VIC <sup>62</sup>	Domestic Building Insurance	Last	Government-operated VMIA (Victorian Managed Insurance Authority)	\$16,000	6 years/ 2 years	\$300,000
WA <sup>63</sup>	Home Indemnity Insurance	Last	Private insurers (mainly QBE) underwritten by Government	\$20,000	6 years/ 6 years	\$100,000

QBCC’s comprehensive builder licencing regime is seen as critical to its ability to manage builder risk under its first resort system. QBCC has overall responsibility for builder licencing, dispute resolution and home warranty insurance in the state of Queensland. To qualify for a licence a builder must meet experience and qualification criteria as well as specified financial criteria, and licences are required to be renewed annually.<sup>64</sup>

<sup>57</sup> <https://www.mbais.com.au/home-warranty/australian-capital-territory/>

<sup>58</sup> <https://www.sira.nsw.gov.au/insurance-coverage/home-building-compensation-insurance>

<sup>59</sup> <http://www.fidelityfundnt.com.au/>

<sup>60</sup> <http://www.qbcc.qld.gov.au/home-warranty-insurance/home-warranty-insurance-explained>

<sup>61</sup> <https://www.safa.sa.gov.au/SAicorp/building-indemnity-insurance>

<sup>62</sup> <http://www.dbi.vmia.vic.gov.au/>

<sup>63</sup> <https://www.commerce.wa.gov.au/publications/home-indemnity-insurance>

<sup>64</sup> <https://www.qbcc.qld.gov.au/contractors/apply-licence/apply-builder-licence>

The Institute of Actuaries of Australia emphasised the importance of builder licencing in a 2005 paper: *“Given the experiences of the past, it would appear that a first resort system requires a monopoly insurance provider with strong controls over builder licensing. Recent experience suggests that last resort systems are sustainable but the price signals to ensure proper licensing are weak...”*<sup>65</sup>

Australia’s last resort schemes are often criticised for not providing consumers with sufficient protection. The following is typical of commentary from consumer rights groups: *“Home warranty insurance is supposed to protect homeowners from incompetent builders. Unfortunately, it doesn’t do much to protect against unscrupulous ones.... If the builder simply refuses to repair the shoddy work or return your money, your only option is to take them to the consumer affairs tribunal in your state, and that can be a lengthy and costly process.”*<sup>66</sup>

Tasmania abolished its compulsory last resort builders warranty insurance scheme in 2008 because the Government felt it did *“not provide the resolution or security that people expect...It is not the sort of insurance cover that the consumer thinks they are buying, and often leaves home owners with no option but to turn to the courts, which can be both time consuming and costly.”*<sup>67</sup>

Western Australia reviewed its home indemnity insurance scheme in 2013, including consideration of whether to adopt a first resort system like Queensland’s. The Western Australia Economic Regulatory Authority (ERA) recommended against moving to a first resort scheme for the following reasons:<sup>68</sup>

1. A first resort insurance scheme may bring about perverse incentives (moral hazard on the part of builders and homeowners) and an excessive amount of nuisance claims.
2. The ERA felt that Western Australia’s existing dispute resolution mechanisms in the residential building sector were broadly effective in providing an avenue for consumers to pursue in the event of a dispute with an active builder. And moving to a first resort scheme would require the restructure of the existing dispute resolution system at high administration and transition costs to the government.
3. There was a lack of interest from private sector insurers.

---

<sup>65</sup> Smith, D., Institute of Actuaries in Australia, ‘First Resort or Last Resort, Does it Really Matter?’, October 2005, p. 34. [https://actuaries.asn.au/Library/gipaper\\_smith\\_paper0510.pdf](https://actuaries.asn.au/Library/gipaper_smith_paper0510.pdf)

<sup>66</sup> <https://www.choice.com.au/money/insurance/home-and-contents/articles/home-warranty-insurance>

<sup>67</sup> Parliament of Tasmania, Legislative Council Select Committee Accreditation of Building Practitioners and Administration of the Building Act 2000, 2009 p. 20; quoting Hon Steve Kons, Minister for Justice and Workplace Relations, January 2008. <http://www.parliament.tas.gov.au/ctee/Council/Archived/Reports/bpr%20rep%20091204%20rpd%20prntversion%20%20sm%20001%20d.pdf>

<sup>68</sup> Western Australia Economic Regulation Authority, Final Report - Inquiry into Western Australia’s Home Indemnity Insurance Arrangement, June 2013, p.75-78.

On the last point the ERA noted “Other jurisdictions have shifted from first to last resort schemes primarily as a result of a lack of private sector interest in the provision of first resort home indemnity insurance services. In conjunction with the shift to last resort these jurisdictions have sought to strengthen the consumer protection mechanisms in circumstances where the builder is still trading and available. For example:

- Victoria and New South Wales both shifted to a last resort scheme shortly after the collapse of HIH Insurance in 2001 and the withdrawal of other insurers from the market;<sup>69</sup> and
- Tasmania shifted to a last resort scheme in 2003 and subsequently to a voluntary scheme in 2008.”

In a 2010 Parliamentary inquiry, the Victorian State Government recommended against adopting the Queensland warranty model on the grounds that to do so would be likely to “...increase costs for taxpayers, good builders and consumers. It would prevent competition, increase premiums, would lead to good builders subsidising bad builders – as the Queensland model does not take into account differing quality among builders in setting its premiums - and would need to be structured around an alternative licensing regime.”<sup>70</sup>

### **Premium pricing methodology**

In Queensland and Northern Territory, individual premiums are calculated solely based on the contract value of the construction work. Premiums in Victoria are based on the value of the work and the characteristics of the builder. Recent reforms in New South Wales introduced risk-based pricing whereby premiums are required to be calculated in accordance with the following principles:<sup>71</sup>

1. Premiums should be fair and reflect each contractor’s level of risk -- the risk factors that may be considered are contract value, construction type, location of premises, and contractor risk factors approved by the State Insurance Regulatory Authority, ie length of time contractor licence held, business structure, trading history, net assets, profit and external audit record.
2. Premiums should not be excessive or inadequate.

---

<sup>69</sup> According to a 2005 analysis by the Institute of Actuaries of Australia, NSW and Victoria moved away from first resort insurance “in effect...because the [private] insurers could not, or would not, provide the cover at an affordable price.”

[https://actuaries.asn.au/Library/gipaper\\_smith\\_paper0510.pdf](https://actuaries.asn.au/Library/gipaper_smith_paper0510.pdf), p. 21

<sup>70</sup> NSW Parliamentary Library Research Service, Home Warranty Insurance, p. 10, March 2010, citing January 2010 Victorian Government Submission, p. 13.

<https://www.parliament.nsw.gov.au/researchpapers/Documents/home-warranty-insurance/home%20warranty%20insurance.pdf>

<sup>71</sup> NSW Government, Homebuilding Compensation (Premium) Insurance Guidelines, January 2018 [https://www.sira.nsw.gov.au/\\_\\_data/assets/pdf\\_file/0006/327183/HBC-premium-insurance-guidelines.pdf](https://www.sira.nsw.gov.au/__data/assets/pdf_file/0006/327183/HBC-premium-insurance-guidelines.pdf)

3. Premiums should not be unreasonably volatile year on year.<sup>72</sup>
4. Premiums should provide incentives for risk management and good business practices (insurers may offer contractors discounts or load premiums based on their risk management practices).
5. Premiums should be consistent with the insurer's approved capital management plan.

### *Relative Premiums*

The consumer advocacy group CHOICE analysed home warranty premium data for six Australian states in 2016 (Table 21). According to its data, average premiums in 2016 were higher in Queensland than they were in other states. This is consistent with the expectation that the costs of operating a first resort scheme are typically higher than the costs of operating a last resort scheme.

Table 21 Australian scheme costs

State	QLD	NT	NSW	VIC	SA	WA
Premium as % of average build cost	1.06%	0.64%	0.58-0.72%	0.41-0.77%	0.38%	0.70%

Source: CHOICE Consumer Advocacy, February 2016.<sup>73</sup>

Detailed premium data are not readily available in most states, however we were able to access premium schedules for the warranty schemes in Queensland (Figure 10) and Northern Territory (Figure 11). In both cases, to calculate premiums as a percentage of contract value we have subtracted the lowest premium<sup>74</sup> as an assumed fixed cost for each premium.

The premiums are higher than for New Zealand schemes (Table 7); a A\$350,000 build has a premium of A\$2,718 in Queensland and A\$2,450 in Northern Territory. Queensland's premiums range from \$184 for a \$3,300 build to approximately \$20,000 for a \$3 million build. Premiums in Northern Territory range from \$700 for a \$12,000 build to \$8,300 for a \$3 million build.

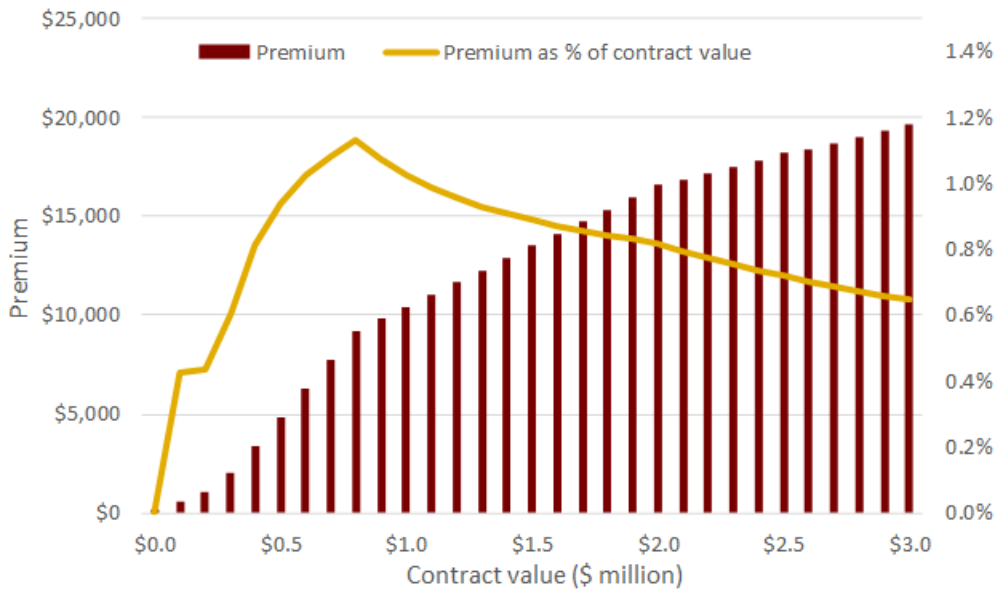
Both states have similar maximum claim values and periods of cover (see Table 20). While one would need to control for state-specific factors such as labour and materials costs to understand the drivers behind the difference in premium levels, we would expect the difference to be at least partly explained by the fact that Queensland operates a first resort scheme whereas Northern Territory operates a last resort scheme.

<sup>72</sup> Premiums should consider experience over the entire building cycle but should not vary according to the phase of the building cycle

<sup>73</sup> <https://www.choice.com.au/money/insurance/home-and-contents/articles/domestic-building-insurance>

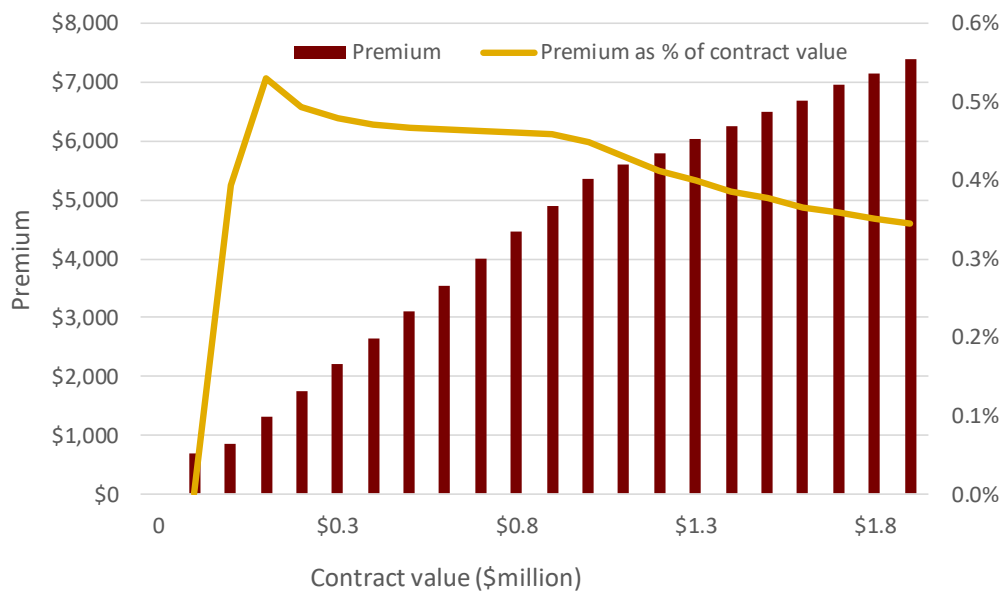
<sup>74</sup> \$184 for a \$3,300 project in Queensland and \$700 for a \$12,000 build in Northern Territory

Figure 10 Queensland premiums (absolute value and % of contract value), 2018.



Source: QBCC premium table<sup>75</sup>

Figure 11 Northern Territory Premiums (absolute value and % of contract value), 2018



Source: Master Builders' Fidelity Fund Contribution Rate Scale<sup>76</sup>

## United States

Like New Zealand, most US States have a set of statutory warranties that are implied in building contracts. The period of cover under these implied warranties ranges from 1 to

<sup>75</sup> [http://www.qbcc.qld.gov.au/sites/default/files/Insurance\\_premium\\_table\\_from\\_1\\_July\\_2018\\_-\\_new\\_home\\_construction.pdf](http://www.qbcc.qld.gov.au/sites/default/files/Insurance_premium_table_from_1_July_2018_-_new_home_construction.pdf)

<sup>76</sup> <http://www.fidelityfundnt.com.au/builders-information/>

10 years, with some states allowing the implied warranties to be modified in the contract between homeowner and builder. If the builder fails to honour an implied warranty the homeowner has the option to take it to court, however the homeowner will be unable to recover if the builder is insolvent.

In most US states, participation in warranty insurance plans is voluntary. It is up to the builder to decide whether to rely on that State's implied warranties, offer a written warranty of its own, or purchase a third-party warranty from an independent insurance company.<sup>77</sup> There are several private insurers offering structural home warranties. Typical policies offer 1-year coverage for workmanship defects (eg doors and trim, drywall and paint), 2 years for systems defects (HVAC, plumbing, and electrical systems) and 10 years for structural defects. Policies typically provide dispute resolution processes and are transferrable to a new homeowner.

Under most private structural warranty policies, the builder is primarily responsible for remedying issues during the first two years post-construction, with the insurer acting as primary obligor in years three to 10. According to one of the leading providers, 2-10 Home Buyers Warranty, structural claims tend to be heavily weighted towards the latter years of the policy, with only 10% of 2-10's structural claims occurring in the first two years and more than 70% occurring in years five through ten. Of 2-10's structural claims, 75% are caused by the impact of shifting soils on foundations.<sup>78</sup>

#### *The New Jersey New Home Warranty Scheme*

There are only a handful of states that require builder warranties. The most well-known is New Jersey which operates a compulsory first resort scheme. All builders are required to register with the State of New Jersey and to provide written warranties on all new homes built. Coverage is as follows:<sup>79</sup>

- 1 year for workmanship, materials, appliances, fixtures, and equipment;
- 2 years for mechanical, electrical, and plumbing systems;
- 10 years for major structural defects.

Policies are available from the State Warranty Plan or from private insurers who have been approved by the State. Any builder not participating in an approved private warranty plan is automatically enrolled in the State Plan.

The premium for each home under the State Plan is based on the length of time a builder has been enrolled with the State and the number of times a payment has been made to a homeowner under either the State plan or a private plan as a result of a claim against the builder (see Table 22). Settlements reached between the builder and homeowner do not count against the builder for the purposes of premium calculations.

---

<sup>77</sup> It is worth noting a feature of terminology in the US: "Home warranty" most commonly refers to a home service contract that covers home systems such as the home's plumbing or electrical, and home appliances like dishwashers. Warranties that cover building defects and structural faults are referred to as "Structural home warranties" or "builders' home warranties".

<sup>78</sup> Short A (2015) Presentation to IHHWA American Housing and Home Warranty Market. January 2015, Las Vegas

<sup>79</sup> [https://www.nj.gov/dca/divisions/codes/offices/nhw\\_for\\_builders.html](https://www.nj.gov/dca/divisions/codes/offices/nhw_for_builders.html)

Table 22 Contribution rates (premiums) under New Jersey State Warranty Plan (% of contract value)

No payments for more than 10 years	No payments for 7-10 years	No payments for 5-7 years	No payments for 2-5 years	Builder registered for less than 2 yrs and no payments made	1 Payment within last 2 years	2 or more payments within last 2 years OR builder in bankruptcy proceedings
0.17%	0.213%	0.255%	0.298%	0.319%	0.425%	0.595%

Source: [https://www.nj.gov/dca/divisions/codes/offices/nhw\\_for\\_builders.html](https://www.nj.gov/dca/divisions/codes/offices/nhw_for_builders.html)

During the first two years post-construction, the builder is the warrantor. When a homeowner becomes aware of a defect, they are required to contact the builder first to try to resolve the issue. If the builder fails to remedy the defect, the homeowner may file a claim with the New Home Warranty Program, which is responsible for providing a free dispute resolution service culminating in a binding arbitration award or a decision by the Bureau of Homeowner Protection which is appealable through the courts. The liability of a builder under a warranty is limited by law to the fair market value of the home on its completion date.

If a builder refuses to repair or replace defects as directed by an arbitration award or the Bureau decision, the State New Home Warranty Security Fund covers the cost of the repairs. In this case, the program will take administrative action against the builder, such as revocation or suspension of its registration.

For claims filed during the third through 10th years of the warranty, the builder is no longer obligated to perform the repairs. Instead, the state will send out a claims adjuster to determine if the claim is valid. If it is, the adjuster will authorise the homeowner to have the necessary repairs made. The work is funded by the State Fund, which is replenished by the fees builders pay for warranties.<sup>80</sup>

### ***Federal requirements***

In addition to the State law requirements described above, United States Federal law requires builders to purchase a third-party warranty for all homes financed by Veterans Administration (VA) or Federal Housing Administration (FHA) mortgages. FHA mortgages are available for buyers with low credit scores who would be otherwise shut out of the conventional mortgage market.<sup>81</sup>

### Canada

In four of the 10 Canadian provinces (British Columbia, Alberta, Ontario and Quebec), builders are required by law to provide home buyers with a third-party new home warranty. Manitoba will join this list when it begins mandating new home warranties in January 2020. In the rest of Canada new home warranties are voluntary, although members of the Canadian Home Builders' Association are required to offer a warranty

<sup>80</sup> <https://www.nytimes.com/2000/07/30/realestate/your-home-warranties-for-new-houses.html>

<sup>81</sup> <https://www.consumer.ftc.gov/articles/0186-warranties-newly-built-homes>

as a condition of membership.<sup>82</sup> Details of the warranty schemes in the different provinces are provided in Table 23.

Table 23 Comparison of Canadian warranty schemes

Province	Type of scheme	Provider	Period of cover for defects (after completion)	Maximum claim value
Quebec <sup>83</sup>	Mandatory, First resort	Garantie de Construction Residentielle (private non-profit organisation licensed by Govt)	1 year (visible non-structural) 3 years (hidden non-structural) 5 years (structural)	\$290,000
Ontario <sup>84</sup>	Mandatory, First resort	Tarion Warranty Corporation (private corporation created by Govt, financed by fees of member builders)	1 year (non-structural) 2 years (water infiltration, systems defects, roof and siding) 7 years (major structural)	\$300,000
British Columbia <sup>85</sup>	Mandatory, First resort	Private insurers licensed by Govt	2 years (non-structural and systems defects) 5 years (building envelope, foundations, roof, windows & doors) 10 years (major structural)	\$200,000
Alberta <sup>86</sup>	Mandatory, First resort	Alberta New Home Warranty Program (private non-profit association of builders, licensed by Govt) and other private insurers	1 year (non-structural) 2 years (systems) 5 years (building envelope) 10 years (major structural)	\$265,000
Manitoba <sup>87</sup>	Currently voluntary. Mandatory, first resort from 1/1/2020	Currently non-profit association of builders; mandatory scheme provider tba.	1 year (non-structural) 2 years (violation of Building Code and defects to systems, cladding, windows, door & building envelope) 7 years (major structural)	Currently \$50,000; mandatory scheme tba
Maritime Provinces <sup>88</sup>	Voluntary, First resort	First Atlantic Home Warranty (non-profit association of builders)	1 year (non-structural) 7 or 10 years (major structural)	\$50,000
Saskatchewan <sup>89</sup>	Voluntary, resort	First New Home Warranty Program (non-profit association of builders)	1 year (non-structural) 2 years (water infiltration) 5 years (major structural) +option to extend to 10 years	\$100,000

<sup>82</sup> [http://www.chba.ca/CHBA/BuyingNew/Your\\_New\\_Home\\_Warranty.aspx](http://www.chba.ca/CHBA/BuyingNew/Your_New_Home_Warranty.aspx)

<sup>83</sup> <http://www.garantie.gouv.qc.ca/en.html>

<sup>84</sup> <https://www.tarion.com/homeowners/your-warranty-coverage/outline-your-warranty>

<sup>85</sup> <https://www.bchousing.org/licensing-consumer-services/new-homes/home-warranty-insurance-new-homes>

<sup>86</sup> <https://www.anhwp.com/mandatorywarranty/>

<sup>87</sup> <http://www.mbnhwp.com/> (existing programme);

[http://www.gov.mb.ca/justice/cp/cpo/info/home\\_warranty\\_protection.html](http://www.gov.mb.ca/justice/cp/cpo/info/home_warranty_protection.html) (new programme)

<sup>88</sup> Maritime provinces are Newfoundland, Labrador, Nova Scotia, New Brunswick, Prince Edward Island ( <http://www.ahwp.org/>)

<sup>89</sup> <http://www.nhwp.org/about/about-what-is.htm>



Warranty providers in states with mandatory schemes include a mix of private corporations and non-profit organisations, all of which are licensed to operate the schemes by the provincial government. In states with voluntary schemes, warranties are provided by non-profit associations comprised of member builders. Coverage under Canada's warranty schemes ranges from 1-3 years for non-structural and systems defects, and from 5-10 years for structural defects.

### *First resort schemes*

Canada's warranty schemes are all 'first resort', which means that a homeowner is entitled to lodge a claim after giving the builder an opportunity to remedy the problem and the builder failing to do so within a specified amount of time. Homeowners are not required to take builders to court, or prove they have disappeared or become insolvent, in order to claim against a warranty.

Once a claim has been referred to the insurer by the homeowner, the insurer will issue a formal ruling setting out its view of the merits of the claim and directing the builder to take specific actions to resolve it (eg carrying out remedial work or providing compensation to the homeowner). If the builder cannot or will not comply, the insurer will compensate the homeowner directly or arrange to have the work completed by another contractor. In most cases, homeowners and builders have the right to challenge the insurer's ruling via mediation, arbitration or the courts.

### *Membership and performance standards*

Each of the Canadian warranty schemes sets performance standards which builder members are required to adhere to, the violation of which can give rise to claims by homeowners. These performance standards are complementary to (not in place of) standards set under the applicable Build Code.

Most warranty programs set minimum criteria for membership including technical qualifications, financial capacity and in most cases an approved customer service record. The Alberta scheme requires builders to participate in industry-specific education and conducts annual membership reviews that evaluate technical achievement, warranty performance, customer satisfaction, business practices and resources, and financial performance.<sup>90</sup> The Atlantic Home Warranty Program (which applies in the five Maritime provinces) requires its builder members to maintain a minimum of \$1,000,000 in liability insurance.<sup>91</sup>

### *Premiums*

According to homewarrantyreviews.com, the average premium across all provinces is \$C\$319.<sup>92</sup>

---

<sup>90</sup> <https://www.anhwp.com/membership/>

<sup>91</sup> <http://www.ahwp.org/membership-process/>

<sup>92</sup> <https://www.homewarrantyreviews.com/home-warranty-companies-in-canada>