

115317  
~~48275~~

REPORT BY THE U.S.

# General Accounting Office

## New-Home Buyers And Federal Agencies Benefit From Improved Warranty Protection

Insured warranties, which protect the new-home buyer if the builder does not take responsibility for faulty construction, now cover about 18 percent of all new houses built in the Nation.

The Departments of Agriculture and Housing and Urban Development and the Veterans Administration have taken steps to obtain insured warranties for some home buyers assisted by their programs. In addition to improved protection, insured warranties eliminate some Federal construction inspections and reduce Federal expenses for correcting structural defects.

Although most houses are not covered by an insured warranty, Federal housing programs provide federally assisted home buyers with some protection against construction defects. However, Federal structural defect compensation programs and the federally required builder's warranty are not as well known or as easy to understand as the new warranty programs. GAO recommends that Federal housing agencies provide better information to assisted home buyers concerning the protection available against construction defects.



GED-81-40  
MAY 26, 1981

017016

**Request for copies of GAO reports should be sent to:**

**U.S. General Accounting Office  
Document Handling and Information  
Services Facility  
P.O. Box 6015  
Gaithersburg, Md. 20760**

**Telephone (202) 275-6241**

**The first five copies of individual reports are free of charge. Additional copies of bound audit reports are \$3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are \$1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".**



UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC  
DEVELOPMENT DIVISION

B-202229

The Honorable John R. Block  
The Secretary of Agriculture

The Honorable Samuel R. Pierce, Jr.  
The Secretary of Housing  
and Urban Development

The Honorable Rufus H. Wilson  
The Acting Administrator of  
Veterans Affairs

This is our report on private and State warranty programs that were developed to protect home buyers from construction defects in new houses.

We made our review to assess the growth of these warranty programs and the protection they provide to the home buyer compared with that provided through federally assisted housing programs. We provided a draft of this report to your agencies for official comments; however, your officials informed us that comments could not be prepared within the comment period provided.

This report contains recommendations to you on page 29 concerning the structural defect compensation program and the 1-year builder's warranty required on new homes. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget.

A handwritten signature in cursive script that reads "Henry Eschwege".

Henry Eschwege  
Director



D I G E S T

In response to the persistent problem of construction defects and past congressional concern, several improved warranty programs for new homes have developed. Consistent with this concern, the Departments of Agriculture and Housing and Urban Development and the Veterans Administration have taken initial steps to provide insured warranty protection for some home buyers assisted by their programs.

A nationwide study by the Department of Housing and Urban Development and the Federal Trade Commission released in September 1980 indicates that defects in new homes are a widespread problem. Although most home buyers sampled said that they were at least somewhat satisfied with their new houses, 62 percent reported at least one problem costing \$100 or more to repair that was not resolved by the builder. The average estimated cost to buyers to repair these defects was \$1,411--either the owner corrected them or the house was not repaired. (See p. 10.)

EVOLVING NATURE OF  
NEW-HOME WARRANTIES

Until recently, new-home buyer's protection from construction defects was limited to that described in the purchase contract and the courts adhered to the rule of "let the buyer beware." This rule, however, has generally been replaced with warranties that define the builder's responsibility to correct construction defects. Many new homes are now covered by a written builder's warranty, and in most States implied warranties have developed by law or court decision. However, enforcing these warranties is difficult when builders refuse to or cannot make repairs. (See p. 1.)

The Federal Government also provides some warranty protection to new-home buyers. Since 1954, builders of federally assisted housing have been required to provide buyers with a 1-year written warranty stating that the house conforms with its plans and specifications. In addition, the Department of Housing and Urban Development established a program in 1964 to compensate home buyers if the house develops certain structural defects within 4 years of construction. The Veterans Administration and the Farmers Home Administration established similar programs in 1968 and 1977, respectively. This protection is not as comprehensive as that provided under the more recent insured warranty concept. (See p. 14.)

In response to congressional concern about construction defects in new homes in the early 1970s, the first warranty program backed with insurance was established by the National Association of Home Builders in 1974. This program, known as Home Owners Warranty (HOW), is the industry's attempt to resolve homeowner complaints and is the largest insured warranty program, covering about 200,000 new homes annually.

These new warranties (1) protect the home buyer during the builder warranty period if the builder cannot or will not stand behind the warranty, (2) provide 10-year insurance against certain major structural defects, and (3) include an inexpensive and independent process to settle claims. These are substantial improvements compared with warranties that cover most new homes. (See pp. 1 and 15.)

HOW warranty coverage is relatively inexpensive to the home buyer. As of February 1, 1981, its one-time premiums ranged between \$166 and \$250 on a \$63,900 house (the median price in August 1980). (See p. 18.)

About 4,000 claims averaging \$2,900 each and totaling about \$11 million have been settled or were pending as of February 1980. In some months claims have exceeded \$1 million. These claims do not include repairs performed by builders under their warranty responsibilities during the first 2 years a house is covered by this program. (See p. 15.)

As a result of this high claims experience, HOW is reevaluating its practices for approving builders entering the program and has revised its procedures to settle claims. It has also established a \$250 one-time deductible on claims in the first 2 years of coverage and a 1-percent deductible (based on the purchase price of the house) on each claim in years 3 to 10. (See p. 18.)

Another private program is offered in two States and has less than 10 builder members because of stringent entrance qualifications. (See p. 5.) Several other private insured warranty programs are being planned or are in operation.

New Jersey has the only State-sponsored program. Established in 1979, it is similar to the HOW program. Builders in New Jersey are now required by State law to offer an insured warranty, either through the State plan or a private program. (See p. 5.)

About 18 percent of the approximately 1 million new single-family houses built each year are covered by insured warranties. (See p. 19.) HOW is available for builder participation in all or some areas of 48 States. Its membership consists of about 16,000 builders who have voluntarily joined the program. (See p. 3.)

ADVANTAGES OF THE NEW  
INSURED WARRANTY ON  
FEDERALLY ASSISTED NEW HOMES

Federal agencies have taken initial steps to use insured warranties in their housing programs. If present trends continue, the

number of federally assisted home buyers receiving insured warranties should increase. (See p. 22.)

The advantages of using insured warranties on federally assisted houses include the following:

- The Federal desire to encourage improved home warranty protection is furthered.
- Home buyers using federally assisted housing programs receive improved warranty protection.
- Federal expenses for correcting structural defects are reduced. The initial recourse for correcting construction defects is through the insured warranty program--not Federal structural defect compensation programs. As of December 1979, Federal agencies had approved \$3.8 million in claims for defect compensation programs since the programs began. (See p. 23.)
- Federal construction inspections are reduced. When federally assisted homes have an insured warranty, Federal agencies reduce the number of Federal construction inspections required. (See p. 22.)

FEDERAL HOUSING AGENCIES SHOULD  
IMPROVE DISCLOSURE OF PROTECTION  
AVAILABLE TO HOME BUYERS

Although most new federally assisted home buyers are not covered by an insured warranty, they receive some protection against construction defects under Federal housing programs. However, GAO believes these programs need several improvements. In particular, Federal housing programs should meet the warranty disclosure standards specified in the Magnuson--Moss Warranty Act. (See p. 26.)

Although the act specifically excludes warranties required by Federal agencies from its provisions, GAO believes home



buyers would be better informed of available protection if the warranties provided under Federal housing programs more closely adhered to the act's disclosure provisions. For example, the builder's warranty, written by Federal agencies for use by participating builders, does not describe the defects covered and procedures to settle claims when defects occur. (See p. 27 and app. I.)

Also, Federal housing agencies do not adequately disclose to home buyers that a Federal structural defect compensation program is available. As a result, eligible home buyers may not benefit from this protection when it is needed. (See p. 27.)

#### RECOMMENDATIONS

The Secretaries of Housing and Urban Development and Agriculture and the Administrator, Veterans Affairs should revise the builder's warranty and structural defect compensation programs to meet the disclosure requirements of the Magnuson--Moss Warranty Act by clearly describing the defects covered and procedures used to settle claims. The availability to home buyers of Federal structural defect compensation programs should also be clearly disclosed. (See p. 29.)

#### AGENCY COMMENTS

GAO requested official comments from the Secretaries of Housing and Urban Development and Agriculture and the Administrator, Veterans Affairs. Officials of these agencies informed GAO that they could not prepare their comments within the time provided.



## C o n t e n t s

	<u>Page</u>
DIGEST	i
CHAPTER	
1	INTRODUCTION 1
	Most new-home warranties are not backed by insurance 1
	Recent move to insured warranties in the United States 3
	The National Association of Home Builders has the largest private insured warranty program 3
	Other private insured warranties 5
	New Jersey has the first State-insured warranty program 5
	Insured warranty programs in other countries 6
	Objective, scope, and methodology 8
2	MANY NEW-HOME BUYERS ARE FACED WITH UNEXPECTED, COSTLY REPAIRS 9
	Defects in new homes are a costly problem 9
	Causes of construction defects 12
	Conclusion 12
3	INSURED WARRANTIES BENEFIT FEDERALLY ASSISTED HOME BUYERS AND THE FEDERAL GOVERNMENT 13
	Role of the Federal Government in providing warranty and defect compensation for new-home buyers 13
	Home buyers are better protected by insured warranties 15
	Insured warranties now cover many new-home buyers 19
	Federal support for insured warranties is substantial 21
	Federal housing agencies benefit from insured warranties 23
	Requiring insured warranties on federally assisted houses is not supported 23
	Conclusions 25

		<u>Page</u>
CHAPTER		
4	NEED FOR BETTER DISCLOSURE OF FEDERAL STRUCTURAL DEFECT COMPENSATION PROGRAMS AND THE REQUIRED BUILDER'S WARRANTY	26
	Conclusions	29
	Recommendations to agency heads	29
	Agency comments	30

APPENDIX

I	Warranty of completion of construction in substantial conformity with approved plans and specifications	31
---	---	----

ABBREVIATIONS

FmHA	Farmers Home Administration
FTC	Federal Trade Commission
HOW	Home Owners Warranty Corporation
HUD	Housing and Urban Development
VA	Veterans Administration

## CHAPTER 1

### INTRODUCTION

A home is the largest purchase for most people, and financial and emotional distress may be experienced if the house develops serious defects due to faulty construction. Home buyers have some protection from construction defects through implied warranties provided by State courts and State legislation or through written warranties provided by the builder. However, these warranties are often ineffective. A recent study indicates that uncorrected construction defects in new homes are still a widespread problem.

Recently, warranty programs backed by insurance have developed. Several programs now operate and others are in the proposal stage. This new type of warranty provides the home buyer with protection when builders refuse or are unable to make repairs. These programs also provide longer coverage and improved procedures for homeowners to settle claims. The largest program was started in 1974 by the National Association of Home Builders, 1/ and in 1979 New Jersey established a similar program.

#### MOST NEW-HOME WARRANTIES ARE NOT BACKED BY INSURANCE

Although many new homes are covered by some type of warranty, most warranties are not backed by insurance. New-home buyers are protected by implied warranties developed by either statute or court decision in most States. Implied warranties promise that the product is in proper condition for sale and that nothing is significantly wrong with it, including latent defects. Previously, the buyer's warranty rights were limited to those stated in the sales contract and the courts adhered to the rule of "let the buyer beware."

The implied warranty creates problems for the builder and buyer. Builders may disagree with buyers and claim that defects were within normal tolerances or were caused by the owner's failure to adequately maintain the property. The buyer must therefore prove that the defect was caused by builder error. The buyer may have to hire a professional

---

1/The National Association of Home Builders is an organization of home and apartment builders, light commercial builders, and others associated with the building industry, such as developers, architects, and remodelers.

inspector as an expert witness and retain an attorney. If the builder is bankrupt or has no assets, it is unlikely that the buyer will be compensated for the defect. Also, in some States, the implied warranty is limited to the first buyer of the house.

Written warranties provided by the builder specify the type and length of coverage provided to the home buyer. Although in writing, buyers may encounter problems when asking builders to make repairs under these warranties. Builders sometimes refuse to correct defects, with or without explanation; ignore claims; or promise to make repairs but don't. Also, the builder may repair defects inadequately or delay considering or disposing of claims for so long that buyers drop their claims. The duration of most written warranties on new homes also seems to be limited, according to FTC officials. One-year warranties may be reasonable for most defects but are inadequate when defects occur after that time. Many defects that occur after the first year require structural repair, which can be expensive to correct.

Our report issued on January 5, 1977 (CED-77-20), found that uninsured warranties on federally assisted housing do not protect buyers when builders refuse to repair warranted defects or go out of business before such defects are repaired. The report concluded that the Federal Government should test the desirability and effectiveness of alternatives and supplements to the builder's warranty to determine if a more effective method exists for ensuring that repairs are made. HUD agreed, but as of November 1980 tests had not been conducted.

A December 1977 survey by the "Professional Builder" magazine <sup>1/</sup> of home buyers and builders showed that 79 percent of purchasers considered a new-home warranty "very important" in their decision to buy a new home. In contrast, only 22 percent of the builders recognized that warranties are important to their customers. The survey also showed that consumers would be willing to pay for private warranties and other means of reducing long-term costs. The survey found that nearly 70 percent of consumers would be willing to spend an additional \$1,000 at construction time to cut down on future maintenance costs, with some willing to pay even more.

---

<sup>1/</sup>A business magazine of housing and light construction, published by Cahners Publishing Company, Denver, Colorado.

RECENT MOVE TO INSURED  
WARRANTIES IN THE UNITED STATES

Due to growing public concern about the need for better warranty protection, the homebuilding industry initiated a new type of insured warranty program that is backed by insurance. New Jersey subsequently established a similar program.

The National Association of Home  
Builders has the largest private  
insured warranty program

The National Association of Home Builders established the Home Owners Warranty Corporation (HOW) in 1974 as the industry's attempt to resolve homeowner complaints without Government intervention. The association had sensed that growing public concern was going to prompt stringent construction requirements and initiated HOW to forestall such Government intervention. The HOW program is modeled after a similar program in Great Britain. (See p. 6.)

About 16,000 builders had joined HOW as of early 1980. To join, builders agree to follow local codes and quality standards adopted by HOW local councils. If an area's construction inspections do not satisfy HOW, builders agree that HOW may inspect construction. In the absence of local building codes, builders must use a nationally approved code.

The HOW standards have three parts: local building codes regulating structural, mechanical, plumbing, and electrical items; quality standards devised by HOW setting forth sound industry practices regarding specific defects (see example on p. 26); and special standards devised by HOW regulating construction in areas with unique building characteristics.

The HOW program is administered locally by about 130 councils. These councils screen applicant builders, help builders use the program, supervise the resolution of complaints and claims, monitor inspection procedures, and suspend or expel builders who fail to meet HOW requirements.

For the first year after construction, builders warrant the structure against defective material and workmanship; major structural problems; and electrical, heating, cooling, and plumbing defects. In the second year, builders warrant against major structural defects but workmanship and materials are no longer covered. The wiring, piping, and duct work on the electrical, heating, cooling, and plumbing systems are

also covered during the second year but the system's equipment no longer is warranted, although it may retain a manufacturer's warranty.

During the first 2 years, HOW's insurance company insures that the builder's 2-year warranty will be met. If the builder will not or cannot honor the warranty, the insurance company pays the cost and the local HOW council arranges repairs. (See p. 18 for recent changes in the program.) For years 3 through 10, the builder is no longer responsible but the insurance company insures the home against major structural defects.

Some areas of the home and normal deterioration are not covered by the HOW warranty. For example, detached garages, sidewalks, and swimming pools are excluded.

The warranty is paid for by the builder and included in the purchase price of the house. The premium remained unchanged at \$2 per \$1,000 purchase price of the house since the HOW program began in 1974. This amounted to a one-time cost of \$128, or about \$1.30 per month, 1/ on a \$63,900 house (the median price of a new house in August 1980). One-half of the premium goes to the insurance company to pay claims and HOW 2/ retains the other half for program administration. HOW and its local councils divide their half of the premium equally. We were informed that premiums collected in fiscal year 1979 totaled \$20.3 million.

In 1980 HOW's annual report showed revenues of \$8.8 million, mainly from premiums collected; its net income was \$0.4 million. Major expenses included salaries, \$2.8 million; advertising and local council development, \$0.6 million; fees to the National Association of Home Builders for promoting HOW, \$0.3 million; and Federal income tax, \$0.3 million. HOW does not gather information on the profit and loss of local councils. The insurance underwriter's financial position regarding claims and premiums collected is discussed on page 17.

---

1/Based on a 12-percent interest rate on a 30-year mortgage.

2/Local HOW councils are financially independent from the HOW Corporation.



## Other private insured warranties

In addition to HOW, other private insured warranty programs are operating or being planned. One program, Family Protection Plan, Inc., offered in New Jersey and Pennsylvania, has very selective builder entrance requirements. In operation since 1974, it had approved only five builders as of May 1980, with coverage on about 800 homes. According to a program official, only large builders with excellent reputations are accepted. At least two other private insured warranty programs are being planned, in Texas and California.

## New Jersey has the first State-insured warranty program

New Jersey began its insured <sup>1/</sup> warranty program with the passage, in 1979, of its New Home Warranty and Builders' Registration Act. The New Jersey Home Builders' Association, which is affiliated with the National Association of Home Builders, supported this law because it supersedes the vague implied warranty and several more restrictive municipal ordinances. The New Jersey Home Builders' Association also helped the State develop the regulations implementing the program.

Builders must register with the State and either belong to the State program or a State-approved private plan such as HOW; thus, the majority of new-home buyers in New Jersey now receive insured warranty protection. Builders are required to show their registration card to obtain a building permit, and a builder that sells a home without an insured warranty can be fined \$2,000 per day, per home. As of August 30, 1980, 4,307 builders had registered with the State program, 3,574 homes had been warranted, 162 claims had been received, and 30 claims settled, according to New Jersey officials.

An important difference between the State program and HOW is the severity of the penalty when builders refuse to repair or replace a defective part or refuse to offer a monetary award in accordance with the decision of the

---

<sup>1/</sup>Although the New Jersey program does not have an insurance underwriter, it operates like an insured warranty. New Jersey law gives the State authority to collect premiums, form a pool of money, and raise the premiums if necessary to replenish the warranty fund.

arbitrator or administrative law judge. Under the State program, builders may lose their registration and therefore their right to do business in New Jersey. In contrast, HOW builders can continue in business if they are expelled from the HOW program. New Jersey had revoked the registrations of 10 builders as of August 30, 1980.

Another important difference is the premiums charged. The State program charges \$4 per \$1,000 of the homes' selling price, a rate that is higher than HOW's premium. The premiums are higher because the State program does not screen applicant builders; private programs such as HOW may exclude high-risk builders. According to New Jersey officials, the average cost per house warranted in the State plan is \$82,500 and the average premium payment is \$330.

INSURED WARRANTY PROGRAMS  
IN OTHER COUNTRIES

Other countries have insured warranty plans. The chart below compares insured warranties and housing markets in five nations. This data was obtained from a published report of the First International Housing and Home Warranty Conference held in 1979.

Comparison of Insured Home  
Warranties in Five Nations

	<u>Number of houses warranted annually</u>	<u>Percent of all houses built for sale warranted annually</u>	<u>Duration of warranty</u>  (years)	<u>Are builders required to participate?</u>
Canada	95,000	50	5	No
Republic of Ireland	6,000	50	6	No
Netherlands	12,500	25	6-10	No
Great Britain	140-160,000	99	10	Yes
United States	250,000	20	10	No

The British program is the oldest, covers the most houses, and unlike other programs, has nearly 100 percent participation. It is operated by an independent, nonprofit council comprised of representatives from all phases of the

homebuilding industry; that is, architects, financiers, surveyors, consumers, and builders. This organization differs from HOW, which is operated by a profitmaking, subsidiary corporation of the National Association of Home Builders.

The British program's coverage is very similar to HOW's. It pays for major structural defects occurring between the 3rd and 10th year, and during the first 2 years, builders must comply with minimum standards of workmanship and material. Homeowners are also protected if builders go bankrupt or otherwise do not fulfill their responsibility for the first 2 years.

The British program employs a full-time inspection staff stationed throughout the country. Unannounced inspections are made with a goal to inspect every house at least once every 3 weeks during construction, or about six times in all. The program has about 250 inspectors, or approximately 1 inspector per 1,000 units constructed annually. Inspections are to safeguard the underwriters and promote better workmanship. A proposal is presently being considered whereby builders choosing program inspections need not also be inspected by local authorities. The program has staff to inspect defects that are not resolved in the conciliation stage. To prevent frivolous claims, homeowners are charged a reasonable inspection fee, which is returnable if claims are valid or if it was reasonable for the homeowner to pursue the claim.

British builders who lose their registration, in effect, are prohibited from doing business. Their registration may be lost for shoddy work, failure to remedy defects, or other breaches in program rules. Builders have the right to appeal any council actions to an independent body. According to the program's director general, the program has removed many shoddy builders from the industry and builders are more customer-conscious.

The British insured warranty program started as a purely voluntary program that achieved high participation only after outside stimulus. Today, virtually all new-home buyers in Great Britain receive an insured warranty. The program was established in 1936 but grew slowly. In 1951 less than 4 percent of the houses built were covered. During the mid-1960s, debates in Parliament concluded that unless voluntary efforts succeeded, legislative measures would be needed to provide better consumer safeguards. Publicity surrounding the debates enabled the program to increase its coverage from 20 percent of new-homes in 1964 to nearly 50 percent in 1966.

Although legislation was not enacted to require insured warranties, building societies (similar to savings and loan associations in the United States) now require that builders participate in the warranty program before financing is provided for home construction. As a result, more than 99 percent of the new homes constructed in Great Britain are now covered by the program.

#### OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess the current status of private and public warranty programs available to buyers of new single-family homes because new-home construction quality has been a congressional concern and insured warranties are the most recent attempt by the private sector and State governments to resolve the problem of construction defects.

We obtained information on (1) the extent to which housing defects are a problem in the United States, (2) insured warranty programs in the United States and other countries, and (3) warranty protection and defect compensation under Federal programs for new-home buyers. In chapter 2, we cite a report prepared for the FTC and the Department of Housing and Urban Development (HUD) that assesses the construction quality of new homes. The study's limitations and the sampling methodology used are described in that section.

We also analyzed the benefits to the Federal Government and new-home buyers using Federal housing programs if insured warranties are provided under Federal housing programs. To identify benefits to the new-home buyer, we compared the warranty coverage available in insured warranty programs with coverage under the Federal structural defect compensation programs and federally required builders warranties. We made this comparison by reviewing documents describing these programs and holding discussions with officials of private and State warranty and Federal housing agency programs. We identified the benefits to the Federal Government through discussions with agency officials.

We made our review at HUD, the Farmers Home Administration (FmHA), the Veterans Administration (VA), and FTC headquarters in Washington, D.C. We visited HUD field offices in Los Angeles and San Diego and the VA Los Angeles field office. We contacted officials and reviewed documents at HOW headquarters in Washington, D.C., and at its San Diego local council. We contacted officials of several other private warranty programs, either developed or being developed, and officials of the New Jersey and Great Britain warranty programs.

## CHAPTER 2

### MANY NEW-HOME BUYERS

#### ARE FACED WITH UNEXPECTED, COSTLY REPAIRS

Many owners of new homes are dissatisfied with construction quality, and many houses have construction defects that can be expensive to repair. Some buyers are without funds to correct defects or pay legal fees to pursue disagreements with builders. The causes for construction defects are many, including poor workmanship and materials.

#### DEFECTS IN NEW HOMES ARE A COSTLY PROBLEM

According to a study <sup>1/</sup> performed under contract with FTC and HUD, 62 percent of the 1,812 new homes sampled had at least one problem costing \$100 or more to repair that had not been resolved by the builder. This study was the first nationwide study of new-home defects and their costs, as well as the relationship between owners and builders. It does not distinguish between defects that must be corrected immediately and those that may not need to be repaired.

The study sampled buyers' views of the quality of their new houses. Sampled homeowners had lived in their houses between 12 and 30 months, having purchased them between February 1977 and November 1978. These buyers were from a random sample of about 37,000 households that had recently moved. The sample represents about 1/10th of 1 percent of the more than 1 million new houses constructed in the Nation during this period. The firm believes this sample was a representative cross section of new construction during the sample period. The study included an on-site inspection of 299 homes by professional inspectors who verified problems, estimated repair costs, and assessed defects that homeowners had not reported. Defects with an estimated cost of less than \$100 were excluded from the study.

The study found that 79 percent of the households reported at least one major defect. In 62 percent of the households sampled, at least one problem was not repaired by the builder, as shown in the following table.

---

<sup>1/</sup>"A Survey of Homeowner Experience with New Residential Housing Construction," Mathematica Policy Research, Inc., August 1980.

Houses With Defects of at Least \$100  
Not Corrected by the Builder

<u>Estimated cost</u> <u>of the defects</u>	<u>Percent of</u> <u>houses</u>
\$100 - \$700	32
\$701 - \$2,000	22
Over \$2,000	<u>8</u>
	<u>62</u>

The average repair cost for buyers with problems not resolved by the builder was estimated to be \$1,411. Eighty-one percent of the unresolved defects had not been repaired at the time of the survey. Because obtaining accurate repair cost estimates was difficult, the study says that they should be interpreted with caution and viewed only as general indicators of the financial burden of new-home purchasers.

According to the chief of HUD's architectural and engineering branch, repair costs on a new home are significant from the purchaser's standpoint because he or she typically faces other high costs for carpeting, draperies, furnishings, landscaping, maintenance tools, fencing, and often an expanding family. This official also said that the survey underreports defects that develop several years after the house is built because the homes in the sample were only 12 to 30 months old. In this regard, an FTC official believes another study should be performed involving houses that are up to 10 years old to determine if more serious problems develop, particularly structural problems. He believes the cost of this study could be reduced if the same houses that were used in the first study are used. For this reason, he believes the raw data from this study should be retained.

Forty-two percent of all homeowners sampled reported that they were very satisfied with the construction quality of their houses; 38 percent were somewhat satisfied, 5 percent were neutral, 12 percent were somewhat dissatisfied, and 3 percent were very dissatisfied. Twenty-two percent of all buyers seriously disagreed with their builders over one or more problems. One out of 15 consulted a lawyer and one out of 25 retained one. On the average, homeowners that seriously disagreed with the builder estimated that they spent 74 hours of their time, \$175 in direct costs, and lost 1 day of work trying to resolve the dispute.

Walls, ceilings, or floors were the most frequent problem not repaired by the builder, as shown in the following chart.

Approximate percent of buyers reporting this type of <u>problem</u>	<u>Type</u>
61	Walls, ceilings, or floors, including supporting beams and joists
42	Miscellaneous--primarily grading, driveways, and exterior concrete work
29	Plumbing
23	Roof
12	Foundation/basement
10	Heating
9	Cooling
8	Major appliances
7	Interior electrical
4	Contracted work not done

Seventy-two percent of the sampled home buyers purchased their homes with conventional financing; 18 percent used federally assisted loans (10 percent from VA and 8 percent from HUD); 5 percent paid cash; and 5 percent used other financing methods.

The National Association of Home Builders, responding to the study, stated that most new homes built in this Nation are well built. It emphasized that the study results also showed a large degree of consumer satisfaction with builders. The association also questioned the homeowners' ability to distinguish between a major problem and a cosmetic defect and said that it would have been difficult for homeowners to accurately estimate the cost of fixing a problem.

Based on the study's findings, the FTC Assistant Director, Bureau of Consumer Protection, concluded that some

housing industry members continue to do unsatisfactory work. As a result, the FTC staff plans to recommend that it continue its enforcement program against some problem builders. The HUD Deputy Assistant Secretary for Economic Affairs said that although the study did not concentrate on HUD-assisted housing, the experiences encountered by homeowners will be useful in the continuous process to improve HUD's own program.

#### CAUSES OF CONSTRUCTION DEFECTS

Houses have many components that can be defective for various reasons. They have intricate wiring, heating, and plumbing systems and concealed components that may hinder detecting defects. The extent of defects usually depends on the builder's skill, experience, and quality control. Most defects stem from improper design or poor workmanship and materials.

Various factors affect construction quality. The boom-and-bust cycle of the housing industry contributes to defects. During busts, skilled workers, supervisors, and building inspectors are laid off and some builders go bankrupt before they can complete construction. Boom periods then can attract unskilled workers and produce material shortages. External factors, such as extreme variations in climate, unusual soil conditions, and inflation, also affect construction quality. Some builders producing low-quality housing are unskilled or unscrupulous; some parts of the country have lax enforcement of building codes; and some builders are not licensed. Also, the increased use of prefabricated housing components can contribute to a builder using less skilled labor.

Many builders, however, maintain high construction quality. They know that their reputation is a source of future business, and they try to be fair to home buyers. Also, some builders believe correcting a serious defect is more expensive than building the house properly.

#### CONCLUSION

Although the severity, type, and number of defects occurring in new houses are difficult to establish, the recent study for FTC and HUD found that many new homes have them. While most buyers were at least somewhat satisfied with their new houses, the study found that a large percentage of defects (62 percent) are not corrected by the builder. Therefore, we believe many home buyers could benefit from improved warranty protection.



## CHAPTER 3

### INSURED WARRANTIES BENEFIT FEDERALLY ASSISTED HOME BUYERS AND THE FEDERAL GOVERNMENT

In response to the persistent problem of construction defects and past congressional concern, a warranty backed by insurance has developed. At a modest cost, this improved warranty protects the home buyer if the builder does not take responsibility for faulty construction, provides longer coverage than the traditional warranty, and includes improved procedures to settle claims. This warranty now covers about 18 percent of all new houses built in the Nation.

The Federal Government has had a historical interest in providing adequate warranty protection to home buyers. Most recently, Federal agencies have recognized the advantages of insured warranties and have taken steps to provide them to federally assisted home buyers. Insured warranties, when applied to Federal housing programs, also reduce Federal structural defect compensation expenses, Federal construction inspections, and complaint processing by Federal agencies because these functions become the responsibility of insured warranty programs.

The majority of federally assisted new homes are not yet covered by insured warranties. If present trends continue, the number of these home buyers receiving insured warranties should increase.

#### ROLE OF THE FEDERAL GOVERNMENT IN PROVIDING WARRANTY AND DEFECT COMPENSATION FOR NEW-HOME BUYERS

The Federal Government led in developing the warranty concept on new homes in the United States. Since 1954 HUD and VA have required that builders provide a 1-year warranty on new homes financed with Federal mortgage insurance or guaranty. In 1970 FmHA adopted a similar requirement. The purpose of mortgage insurance and guaranty programs are not only to stimulate the production of houses and to assist buyers to purchase them but also to assure that the house is properly constructed. Assuring proper construction also helps protect the Federal Government's position as the mortgage insurer. Many builders participate in Federal housing programs because they provide access to a unique section of the housing market and some lenders require the builder to participate in these programs before providing construction financing.

Under the 1-year warranty, builders must warrant that homes conform substantially with their plans and specifications. HUD, VA, and FmHA process homeowner complaints by inspecting the defect, trying to persuade builders to make corrections, and if necessary, suspending builders from further participation in Federal programs if warranted defects are not corrected.

Legislation also allows HUD, VA, and FmHA to compensate buyers if their new homes develop certain structural defects. The agencies may correct a defect, pay the homeowner to have it corrected, or acquire title to the property by buying it from the owner. Homeowners' claims must be filed with HUD or VA within 4 years of purchase or with FmHA within 18 months of purchase. The authority for HUD and FmHA to compensate buyers for structural defects is provided by sections 518(a) and 509(c) of the National Housing Act of 1949, as amended in 1964 and 1977, respectively. Section 1827, title 38 U.S.C., added in 1968, provided VA with its authority. Since inception of the programs, these agencies had approved 1,406 claims as of December 1979, totaling about \$3.8 million.

FTC has a housing defect program, and a number of builders have been or are under investigation. For fiscal year 1979 FTC budgeted 6 percent of its staff attorneys' time (about 50 work years) to address housing consumer protection and anti-trust issues. It administers the Magnuson--Moss Warranty--Federal Trade Commission Improvement Act (15 U.S.C. 2301), which was enacted in 1975 to enable FTC to improve its consumer protection activities.

The Congress has at various times considered other ways to increase the Federal role in providing warranty protection for new-home buyers using Federal homeownership programs. For example, an amendment proposed to the 1972 Housing Bill would have extended the builder's warranty under HUD programs to 3 years and required the builders to post a \$1,000 construction bond on each house. Also, the proposed Home Buyer and Home Owner Protection Act of 1973 would have extended the 1-year builder's warranty under HUD programs to 3 years and HUD's structural defect compensation program to 5 years. Also, S. 612, the proposed Condominium Act of 1979, included several provisions concerning consumer protection in condominiums. One provision included requirements that a developer provide a 1-year warranty against defects in a condominium unit and a 3-year warranty against defects in common areas. Another provision required compliance with the Magnuson--Moss Warranty Act. These provisions, however, were not retained by the conference committee when this bill

was incorporated into the Housing and Community Development Act of 1980.

HUD has also considered ways to improve warranty protection. For example, in 1979 a mandatory insured warranty was discussed within HUD for buyers using its mortgage insurance programs. Builders would provide 10-year coverage either from an actuarially sound HUD program or an approved insured warranty program. As of September 1980, HUD had not proposed that such a program be implemented.

HOME BUYERS ARE BETTER PROTECTED  
BY INSURED WARRANTIES

Insured warranties protect the home buyer if the builder does not honor his or her 2-year warranty responsibilities. They also provide 10-year insurance against certain structural defects and an independent system to resolve disputes. This protection is generally not available through implied warranties, traditional 1-year builder warranties, or the required 1-year warranty for builders using Federal programs. Since the program's inception, the HOW underwriter has reserved or paid \$11.3 million for claims settled or pending as of February 1980. At that time, the number of claims was about 1/2 of 1 percent of the 800,000 homes covered. But, the 10-year coverage on most of these homes has many more years to run.

If the builder cannot or will not perform warranty obligations, under the insured warranty concept, the insurance underwriter assumes the responsibility. Thus, homeowners have an additional recourse beyond what is available under an uninsured builder's warranty such as the federally required builder warranty. Homeowners under the HOW program have used this coverage extensively. Of the \$11.3 million in claims, the underwriter had paid or reserved \$6.4 million for about 2,500 claims (average of \$2,583) where builders did not fulfill their warranty responsibilities. A HOW vice president told us that builder bankruptcy caused most of these claims.

Insured warranties also cover certain structural defects for 10 years, compared with uninsured warranties that generally are limited to 1-year coverage or up to 4-year coverage under a federally assisted program (see p. 14). In addition to the \$6.4 million for claims to compensate homeowners where builders did not meet their 2-year warranty responsibilities, HOW has paid or reserved \$4.9 million for 1,425 structural claims when the builder is no longer responsible. The insurance underwriter is responsible for structural defects between the 3rd and 10th year of coverage. The

average cost of each claim was \$3,436. HOW officials told us that their claims experience to date indicates that the number of claims in the fifth and sixth years of coverage are just as great as in earlier years.

The most severe structural problem encountered by home buyers covered by HOW has been caused by active soil conditions. Active soils can severely damage homes through expansion or contraction (which this clay does when its moisture content changes). Colorado has active soil conditions, and HOW has paid or reserved \$4 million for claims in that State as of February 1980. This amount is about 35 percent of the claims paid or reserved by HOW even though HOW-covered homes in Colorado represent only 11 percent of all such homes in the Nation. In response to the high claims rate involving active soils, HOW has developed special standards for foundation design in areas where active soils exist.

Another advantage of insured warranty programs is the independent procedures to resolve disputes for homeowners that are dissatisfied with the builder's warranty performance. The federally required builder's warranty does not include these procedures. Under HOW, homeowners may complain in writing to the local HOW council. A third party, appointed by the council, visits the home to examine the defect and discusses the problem with the builder. If no agreement is reached, the builder or homeowner may request arbitration. If the arbitrator's decision is accepted by the homeowner, it is binding 1/ on the builder. After the HOW builder's 2-year warranty expires, claims against the insurance company are settled primarily by claims adjustors, but arbitration is available if the homeowner disputes the insurer's settlement offer. A HOW vice president told us that most arbitrations occur in disputes with builders rather than the insurance company.

In 1979 FTC surveyed homeowners' reactions to HOW's dispute settlement procedures to meet FTC's responsibilities under the Magnuson--Moss Warranty Act. The survey indicated that (1) 72 percent believed they were adequately notified about and instructed in the use of HOW's dispute settlement procedure, (2) 56 percent did not experience delays in the settlement process, (3) 73 percent felt the conciliator was

---

1/If the builder cannot or will not perform his or her warranty obligations, the insurance underwriter assumes responsibility. In this case, the builder is generally dropped from the HOW program.

impartial, (4) 95 percent that went to arbitration received an award in their favor, and (5) 59 percent were satisfied with the arbitration award. A 1978 audit report of HOW made similar observations and concluded that the system is moderately successful.

In addition to home buyers, builders were basically satisfied with the fairness of HOW's dispute settlement process, according to a 1979 audit report of HOW. However, about 100 builders have left HOW since its inception because they felt arbitration awards were being made on items not included under the warranty, according to a HOW official. Also, builders complained about the increasing number and accompanying cost of arbitrations, according to HOW. Builders paid an arbitrator \$200 to decide each case. Nationwide, arbitration cases increased from 176 in 1977 to 1,014 in 1978; about 3,000 cases had occurred from the program's inception through March 1980.

HOW developed a new process to settle disputes, effective in February 1981. While the old dispute settlement process required two meetings between the homeowner and builder for conciliation and arbitration, the new system combines this process. A dispute settler trained in HOW coverage presides over one meeting between the builder and buyer. If at this point the builder and buyer agree, the case is closed. If disagreement still exists, the dispute settler makes a decision. If the dispute is resolved in favor of the homeowner, the builder must perform unless he or she appeals the decision. The appeal procedure allows the builder to obtain a second ruling, which is binding on the builder. Builders are allowed one free HOW-managed dispute settlement annually, plus a free one for every 50 homes enrolled in the program. If the builder has more than the allowed number of disputes, he or she must pay \$150 for each one.

In early 1980 HOW claims began to exceed \$1 million per month. According to a HOW vice president, claims are about twice the amount of recognized premium income. HOW recognizes premium income by applying 10 percent of the premiums collected on each house against the claims recorded each year. The rationale for this method of recognizing premium income is based on the fact that the premiums are collected at the outset of the homes' coverage under the program but are accrued because the coverage lasts for 10 years. The vice president told us that, as of June 1980, about \$30 million had been paid to HOW's insurance underwriter since the program's inception and \$15 million had been paid or reserved for claims. He said that the primary

drain on program funds comes from claims for serious structural defects, particularly due to active soil, and from builders that go bankrupt during the 2-year builder warranty coverage.

This higher-than-expected claims rate prompted HOW to adjust the premiums it charges because the claims experience indicated that the premium was not sufficient to finance the current level of coverage. The initial HOW premiums were arbitrarily determined because no similar programs exist on which to base the premium, according to a HOW official.

The premium remained unchanged since 1974 at \$2 per \$1,000 price of the house. Under a new rate plan effective February 1, 1981, the premiums increased from 30 to 95 percent. The lowest premium is \$2.60 per \$1,000 price of the house and the highest \$3.90. The new premiums amount to a one-time cost of between \$166 and \$250, or about \$1.70 to \$2.50 per month, on a \$63,900 house. Premiums are based on loss experience in each area of the country. Also, individual builders with high claims will receive surcharges above the base premium in their areas. Builders with unacceptable loss experiences will be considered uninsurable and removed from the program.

HOW also established a deductible on claims. There is now a one-time deductible of \$250 on insurance claims in instances where builders do not meet their first and second year warranty responsibilities. According to HOW, this deductible will help reduce frivolous claims. Also, there is a 1-percent deductible on each claim in years 3-10. (Example: a \$75,000 home has a deductible of \$750 on each claim filed in years 3-10 of coverage.) HOW officials told us that they would have had to increase premiums another 15 percent if this deductible had not been established.

FmHA, VA, and FTC officials indicated that the recently announced changes in HOW's rate structure make HOW's program less attractive. An FTC official also expressed concern to us that the deductible reduces the benefits to home buyers in the event of a claim. This official believed that bad claims experience in a few areas of the country has resulted in the skewing of the whole program unnecessarily.

The responsibility for claims has also been shifted from the insurance carrier to the HOW Corporation in the first 2 years of coverage on each home. HOW now pays the claim itself if the builder will not or cannot. For the last 8

years of coverage, the homes are underwritten by the insurance carrier just as they were in the past.

HOW will also become more directly involved in the claim processing function. Claims were formally processed by the insurance carrier and HOW believes in some cases that claims were paid when they shouldn't have been or were excessive for the actual repair needed.

HOW officials also said that the HOW program will soon begin to review each builder in the program to determine if he or she continues to meet the program's standards. Builders that don't meet the standards will be dropped. However, a HOW vice president said that he did not believe that this review will substantially reduce the present number of builders in HOW. He stated that HOW has not as yet established the criteria it will use to evaluate members, but HOW will be looking at each builder's claims record and also will perform on-site observations of construction procedures and practices. Until recently, HOW relied on the local councils to approve builders for the program. HOW officials said that these evaluations needed strengthening because too many builders go bankrupt, leaving HOW's insurance underwriter responsible for their warranty claims.

#### INSURED WARRANTIES NOW COVER MANY NEW-HOME BUYERS

Many federally assisted houses are covered by insured warranties. Federal agencies assisted about 179,000 new-home buyers in fiscal year 1979. During that year the number of loans assisted by HUD, VA, and FmHA were 68,408, 87,560, and 22,876, respectively. No exact information is available on the percentage of federally assisted houses that are covered by insured warranties. However, we analyzed data at HOW's San Diego local council and HUD's San Diego field office and found that about 20 percent of the houses in projects that HUD was processing, as of May 1980, were covered by HOW. In addition, VA guaranteed about 14,000 new-home loans nationwide in fiscal year 1979 that were covered by HOW. A HUD official told us that, in his opinion, less than 20 percent of HUD-assisted houses are covered by insured warranties. According to an FmHA official, very few home buyers assisted by FmHA have an insured warranty, primarily because the new homes FmHA assists are concentrated in rural areas where an insured warranty program is less likely to be operating.

About 18 percent of all single-family homes built in the United States during 1979 were covered by the HOW

program. Insurance commissions in every State have approved the HOW program, and it has 131 local councils in 48 states, according to a HOW vice president. However, the program is not offered in parts of some States. HOW officials told us that its share of the market varies from area to area. In some areas the program covers the majority of houses being built while in others its coverage is much less. For example, in Atlanta, Georgia; Denver, Colorado; Washington, D.C., and its suburbs; and Dallas, Texas, the majority of houses constructed during the first 8 months of 1980 were enrolled in the program. In other areas such as Portland, Oregon, and Minneapolis/St. Paul, Minnesota, the program's market share is much less. The following information provided by HOW shows its growth.

	Number of houses covered (FY ending <u>June 30</u> )	Number of single-family housing starts ( <u>calendar year</u> )	Percent of housing starts covered by <u>HOW</u>
1976	77,791	1,162,400	7
1977	96,040	1,450,900	7
1978	166,793	1,433,300	12
1979	208,634	1,193,300	18
1980	246,415	Not available	

HOW is reasonably satisfied with its growth. According to HOW officials, it could have been difficult to administer the program initially if most builders had joined. HOW is trying to increase participation in its program. For example, it advertises in local media to persuade home buyers to consider HOW before selecting a builder. HOW would like 50 to 60 percent of the new-home warranty market, according to HOW officials, and welcomes competition from other private plans entering the field. A HOW vice president told us that HOW would not want to cover all new houses built in the Nation because it would have to include higher risk builders, which would result in more claims and increased program costs.

In addition to HOW coverage, other insured warranty programs cover some new-home buyers. All new-home buyers in New Jersey now receive an insured warranty. As of August 1980, the New Jersey program covered 3,574 houses, or about 1 percent of all homes constructed in the Nation. In addition, the Family Protection Plan, Inc. covers about 800 homes.



FEDERAL SUPPORT FOR  
INSURED WARRANTIES  
IS SUBSTANTIAL

Insured warranties have been supported by the Congress, the White House, FTC, and Federal agencies with housing programs. This support has been demonstrated in various ways including legislation, adjustments to Federal programs, and statements by Federal officials.

The Congress supports insured warranties. Individual members of Congress have made public statements in support of these programs. According to HOW, its program was started to forestall Government intervention. The Congress has also passed legislation to capitalize on the advantages of insured warranties. Also, the conference report on the Housing and Community Development Amendments of 1979 expressed concern about the problem of construction defects in FmHA-assisted housing and urged consideration of a warranty program to protect home buyers from construction defects.

The White House has also expressed support. The President's Special Assistant for Consumer Affairs in 1980 said that all new-home buyers are entitled to comprehensive protection against initial problems as well as long-term protection against major defects in housing. She said that the U.S. homebuilding industry, in creating and offering HOW to builders and consumers, is demonstrating a sense of responsibility that is commendable, and she encouraged all builders to embrace the warranty concept, whether through HOW or a competitive plan.

FTC supports the development of private insured warranty programs and has become somewhat impatient at their growth rate. In a 1979 speech before the National Association of Home Builders, for example, an FTC Commissioner said that unless homebuilders are more responsive to consumer concerns and independently decide to make self-regulation work, more Government regulation would be forthcoming. The Commissioner expressed concern that the HOW program has not attracted greater participation by builders, which means that many consumers are not adequately protected. The Commissioner said that by joining HOW, builders would be reacting positively to consumer concerns.

Federal agency officials support insured warranties. VA, FmHA, and HUD program officials said that insured warranty programs improve the home buyers' protection against construction defects and that the growth of these programs should be encouraged. VA officials told us that they fully

endorse the insured warranty concept and have been a leader in supporting its use. They would like to see all new-home buyers afforded this protection. Besides the HOW program, another insured warranty program has recently been approved by VA for use in conjunction with its housing program. A FmHA official said that FmHA has cooperated with HOW extensively and supports the further development of this type of insured warranty program. A former HUD Assistant Secretary for Housing/FHA Commissioner said in a speech to the First International Housing and Home Warranty Conference in 1979 that if government and the private sector have compatible goals, government can provide the atmosphere, whether by incentive, innovation, or leadership, to enable the private sector to fulfill its mission with a minimum of regulations. He said that, among other things, HUD will build HOW's performance standards into the federally required warranty, which has always been a very limited one. By expanding warranty coverage in a way that is compatible with HOW, the Federal Government hopes to reinforce the private sector at a time that may be quite critical in HOW's development.

Federal agency programs support the use of insured warranties. The agencies have established criteria for approving the use of insured warranties under Federal housing programs. The criteria are used to reduce Federal requirements on construction of federally assisted houses if covered by insured warranties. The criteria closely reflects the coverage of HOW's program. For example, approved warranty programs must provide 10-year coverage against structural damage, warranty insurance, and independent dispute resolution.

Federal agencies have found ways to reduce Federal requirements on construction if the house is covered by an insured warranty. For example, VA in 1977 began guaranteeing loans on new homes that had not gone through the Federal approval process if the homes were covered by an insured warranty. Previously, VA followed the long standing Federal policy that new-home loans would be guaranteed only if the plans and specifications were federally approved and three construction inspections were conducted. In fiscal year 1979, VA guaranteed 14,122 homes covered by the HOW plan that would not have previously been eligible for a loan guaranty. Legislation was subsequently enacted to provide HUD with the same authority.

FEDERAL HOUSING AGENCIES  
BENEFIT FROM INSURED WARRANTIES

Private and State insured warranties replace direct Federal involvement in assuring adequate warranty protection under Federal housing programs. As a result, the cost of operating Federal housing programs is reduced. These savings result from reduced structural defect compensation expenses, fewer construction inspections, and less complaint processing. When federally assisted houses have a HOW warranty, the settlement of home buyer/builder disputes and reimbursement for defects are the initial responsibility of HOW and its underwriter. Officials from HOW, HUD, VA, and FmHA said that the initial recourse for buyers under Federal programs is through HOW and not through Federal agencies and Federal structural defect compensation programs.

We did not estimate how much money Federal agencies would save by using insured warranties. Complete cost information was not readily available. Some of these savings are difficult to determine because they include the administrative costs of Federal employees' time spent to resolve disputes and settle structural defect compensation claims. As of December 1979, Federal agencies had approved 1,406 claims since the programs were established for structural defect compensation on new homes, as follows:

	<u>Number of</u> <u>claims</u>	<u>Amount of</u> <u>claims</u>
HUD	1,056	\$2,964,868
VA	34	285,002
FmHA	<u>316</u>	<u>518,711</u>
Total	<u>1,406</u>	<u>\$3,768,581</u>

REQUIRING INSURED WARRANTIES  
ON FEDERALLY ASSISTED NEW HOUSES  
IS NOT SUPPORTED

While Federal support for encouraging the use of insured warranties is substantial, most VA, HUD, FmHA, and private officials are opposed to requiring them on federally assisted new houses. The officials believed the benefits which could be obtained were outweighed by various obstacles and problems they foresee in such a requirement.

VA program officials believe that requiring insured warranties only on federally assisted homes would be an obstacle to builder participation in VA housing programs and therefore would reduce the buyer's choice of available housing. For example, VA officials said that when flood insurance was required on federally assisted houses, some builders stopped participating because a few builders leave the program every time a new requirement is added. They stated that this is difficult to prove or measure because VA's loan guaranty activity is also affected by cyclical aspects of the economy such as changes in interest rates and employment levels.

HUD officials stated that requiring insured warranty programs represents more regulation and increased costs. They also believed requiring builders to provide an insured warranty could be controversial because these programs are not offered in some areas of the country. As a result, HUD would be in the position of requiring some builders to offer the warranty but could not require other builders to do so. However, an official in HUD's Office of Neighborhoods, Voluntary Associations and Consumer Protection believed that an insured warranty should be required on new homes that receive Federal assistance.

FmHA officials pointed out that few FmHA home loans could be covered because insured warranty programs do not operate in many rural areas.

HOW Corporation officials, who administer the largest insured warranty program, told us that requiring insured warranty coverage on federally assisted housing programs would encourage the growth of these programs. However, they said that this could adversely affect some builders that presently build federally assisted new houses if they do not want to join an insured warranty program or cannot qualify for programs available in their areas.

According to HOW officials, the National Association of Home Builders established HOW as a voluntary program because its members did not support a mandatory program. HOW officials said that builders that chose not to join HOW resent interference in their business or are so concerned about satisfying customer complaints that they feel HOW is unnecessary.

However, most new houses in one State, including houses built with Federal mortgage assistance, are covered by insured warranties. In New Jersey, State law requires new homes to have this coverage.

## CONCLUSIONS

Insured warranty programs offer improved protection against the longstanding problem of construction defects in new homes. HUD, VA, and FmHA have taken initial actions to provide insured warranties to more federally assisted new-home buyers. We believe these actions are consistent with the past Federal concern for assuring quality construction and warranty protection. If present trends continue in the growth of the insured warranty industry, corresponding growth in the number of federally assisted home buyers covered by insured warranty protection should follow.

Federal agencies have been innovative in finding ways to provide insured warranties to more users of their programs. As a result, more home buyers receive improved warranty protection and direct Federal involvement and responsibility for assuring quality construction and providing warranty protection is reduced. This in turn reduces Federal Government expenditures associated with these activities.

## CHAPTER 4

### NEED FOR BETTER DISCLOSURE OF

### FEDERAL STRUCTURAL DEFECT COMPENSATION

### PROGRAMS AND THE REQUIRED

### BUILDER'S WARRANTY

Federal defect compensation programs and the federally required builder's warranty are not as well known or as easy to understand as the HOW program. As a result, buyers using Federal housing programs are not as well informed about protection available to them and therefore may not obtain the full benefit of this protection.

Unlike HOW, the federally required builder's warranty does not come under the disclosure provisions of the Magnuson--Moss Warranty Act. Warranties governed by Federal law are specifically excluded from the act's provisions, which also results in excluding Federal structural defect compensation programs from the act's coverage.

The Magnuson--Moss Warranty Act provides minimum disclosure standards for written consumer product warranties and defines minimum Federal content standards for such warranties. The act does not cover new homes specifically but applies to consumer products; therefore, any written warranty offered on a new home must conform to its requirements. It does not require companies to give a warranty but sets down rules if one is provided. Warranties must state what is covered for specific periods of time and what must be done to get a defective product serviced. Warranties must be simple and understandable, not disguised in legal jargon, or printed in small type. The act also encourages warrantors to establish procedures to settle consumer disputes.

In the HOW program, warranty and insurance provisions are fully disclosed when the home is purchased. The HOW documents, in accordance with the Magnuson--Moss Warranty Act, are written simply and describe defects covered and procedures for resolving disputes. HOW's quality standards include statements of possible housing defects, performance standards, and builder responsibility. For example, the standard for first year warranty coverage for workmanship and materials for a concrete basement floor illustrates HOW's disclosure of its warranty provisions:

- Possible deficiency: cracking of basement floor.
- Performance standard: cracks exceeding 3/16 inch width or 1/8 inch in vertical displacement shall be repaired.
- Builder responsibility: warrantor will repair cracks exceeding maximum tolerance by surface patching or other methods as required.

Disclosure of Federal structural defect compensation programs is not adequate and varies among agencies. For example, VA's policy does not include informing home buyers about its defect compensation program and VA documents provided to buyers do not mention the program. Also, while HUD's appraisal report states its authority to correct certain structural defects, it does not specify the program's name, include procedures to file claims, or define structural defect. The former HUD Deputy Assistant Secretary for Housing told us that the defect compensation program has not received enough publicity and probably has not been used to its fullest extent. In contrast to HUD and VA, FmHA makes an effort to notify home buyers about its defect compensation program. It requires its field offices to notify loan applicants about the program during a formal interview at or before loan closing.

The federally required warranty used by HUD and VA builders also does not equal disclosure of the HOW builder warranty. The warranty does not explain builder responsibility or describe which defects are covered. The only reference in the warranty of what is covered is a statement that the dwelling is constructed in substantial conformity with the plans and specifications approved by the Federal agency. In addition, the warranty used by HUD and VA is not easily understood. The opening sentence contains about 275 words followed by two sentences of 51 and 92 words, respectively. Also, the warranty contains confusing words such as "hereof," "thereof," "therein," "Provided further, however, That," and "notwithstanding any provision to the contrary." (See app. I.)

The warranty used by FmHA builders, while not equal to HOW's disclosure, is more readily understood and provides more information on what is covered than HUD's or VA's. Its sentences are shorter and less confusing words are used. In addition to stating that the dwelling is constructed in

substantial conformity with approved plans and specifications, the warranty provides information on the

- builder's responsibility for workmanship; materials; and the installation of equipment such as the heating system, water heater, range, refrigerator, and other appliances;
- specific number of days builders have to take corrective actions;
- recourse available to home buyers if defects are uncorrected by the builder;
- appliance warranties, including serial and model numbers, names, manufacturer's addresses, and length of coverage; and
- existence of a 5-year builder warranty on all plastic pipe.

HUD, FmHA, and VA program officials agreed with our assessment that the 1-year warranty that builders are required to provide on federally assisted new homes should be rewritten to clearly inform the home buyer of the protection it provides.

According to FmHA officials, the FmHA Administrator wants to fully comply with the Magnuson--Moss Warranty Act. FmHA is reassessing the warranty it requires with this in mind. FmHA officials said that while it will be difficult to write a warranty that discloses all the potential defects, it is possible to list examples that describe the type of coverage provided by the warranty. FmHA will consider including such a list with the revised warranty it will develop.

HUD and VA officials indicated that no decision has been reached on ways to improve the warranty's disclosure. They believed, as did FmHA, that a document could be attached to the warranty that provides examples of defects covered. However, they did not believe itemizing all the components covered by the warranty is feasible. HUD officials also expressed concern about the potential for a legal problem because of the difficulty in developing a complete list that anticipates the range of defects that may occur.

We agree that preparing an all-inclusive list of potential construction defects is difficult. However, we believe this problem should not prevent the agencies from disclosing



the defects covered as specified by the Magnuson--Moss Warranty Act. For example, the present HOW warranty includes a description of various defects that may occur (see example on p. 26). While we are not necessarily holding HOW's construction quality standards as a model for Federal agency programs, we believe HOW's standards would be a useful tool in rewriting the federally required builders warranty because HOW's standards have already been developed and apply to most areas of the house.

HUD, VA, and FmHA officials also agreed that the disclosure of their structural defect compensation programs should be improved. HUD is considering providing the home buyer with a separate document that more clearly describes the program and its coverage. FmHA told us that it is developing new procedures that require informing the home buyer at loan closing about the existence of and coverage provided by its structural defect compensation program. VA has not yet decided how its program's disclosure will be improved.

#### CONCLUSIONS

Federal structural defect compensation programs and the required builder's warranty are not fully disclosed or easily understood. In contrast, the existence of insured warranties is fully disclosed and the provisions are more specifically and clearly defined. Full disclosure is a sound principle for administering Federal programs and was adopted by the Congress when it enacted the Magnuson--Moss Warranty Act. In those instances where insured warranties are used in conjunction with federally assisted housing, disclosure of available protection is automatically improved. However, when insured warranties are not provided, the disclosure of Federal structural defect compensation programs and the federally required builder's warranty should be improved to fully and simply explain protection available, defects covered, and procedures the homeowner must follow to make claims and resolve disputes.

#### RECOMMENDATIONS TO AGENCY HEADS

We recommend that the Secretaries of Housing and Urban Development and Agriculture and the Administrator of Veterans Affairs revise the builder's warranty and structural defect compensation programs to meet the disclosure requirements of the Magnuson--Moss Warranty Act by clearly describing the defects covered and procedures used to settle claims. The availability to home buyers of Federal structural defect compensation programs should also be clearly disclosed.

AGENCY COMMENTS

We requested that the Secretaries of HUD and Agriculture and the Administrator, Veterans Affairs provide us with official comments. Officials of these agencies informed us that they could not prepare their comments within the allotted time.

**WARRANTY OF COMPLETION OF CONSTRUCTION IN SUBSTANTIAL CONFORMITY WITH APPROVED PLANS AND SPECIFICATIONS**

Property Location: \_\_\_\_\_ FHA/VA Case No. \_\_\_\_\_ Purchaser(s)/Owner(s): \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

For good and valuable consideration, and in accordance with section 801 of the Housing Act of 1954, and Public Law 85-857 (38 U.S.C. 1805), the undersigned Warrantor hereby warrants to the Purchaser(s) or Owner(s) identified in the caption hereof, and to his (their) successors or transferees, that:

The dwelling located on the property identified in the caption hereof is constructed in substantial conformity with the plans and specifications (including any amendments thereof, or changes and variations therein) which have been approved in writing by the Federal Housing Commissioner or the Administrator of Veterans Affairs on which the Federal Housing Commissioner or the Administrator of Veterans Affairs based his valuation of the dwelling: *Provided, however, That this warranty shall apply only to such instances of substantial nonconformity as to which the Purchaser(s)/Owner(s) or his (their) successors or transferees shall have given written notice to the Warrantor at any time or times within 1 year from the date of original conveyance of title to such Purchaser(s)/Owner(s) or the date of initial occupancy of the dwelling, whichever first occurs: Provided further, however, That in the event (1) the Purchaser(s)/Owner(s) acquired title to the captioned property prior to the completion of construction of the dwelling thereon, such notice of nonconformity to the Warrantor may be given any time or times within 1 year from the date of completion or initial occupancy of such dwelling, whichever first occurs, or (2) where it has been necessary to postpone improvements such notice of nonconformity to the Warrantor as to such incomplete items may be given at any time or times within one year from the date of full completion of each of such items.*

The term "dwelling" as used herein shall be deemed to include all improvements or appurtenances set forth in the plans and specifications upon which the Federal Housing Commissioner or the Administrator of Veterans Affairs has based his valuation of the property, excepting those constructed by a municipality or other governmental authority.

This warranty shall be in addition to, and not in derogation of, all other rights and privileges which such Purchaser(s)/Owner(s) may have under any other law or instrument, and shall survive the conveyance of title, delivery of possession of the property, or other final settlement made by the Purchaser(s)/Owner(s), and shall be binding on the Warrantor notwithstanding any provision to the contrary contained in the contract of purchase or other writing executed by the Purchaser(s)/Owner(s) heretofore or contemporaneously with the execution of this agreement or prior to final settlement.

IN TESTIMONY WHEREOF the Warrantor has signed and sealed this warranty this \_\_\_\_\_ day of \_\_\_\_\_, 19\_\_\_\_.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
(Warrantor's Address) BY \_\_\_\_\_ SEAL  
Warrantor (Signature and Title)

This warranty is executed for the purpose of inducing the Federal Housing Commissioner or the Administrator of Veterans Affairs to make, to guarantee or to insure a mortgage on the captioned property, and the person signing for the Warrantor represents and certifies that he is authorized to execute the same by the Warrantor and by his signature the Warrantor is duly bound under the terms and conditions of said warranty.

**WARNING**  
Section 1010 of Title 18, U.S.C., "Department of Housing and Urban Development and Federal Housing Administration transactions," provides: "Whoever, for the purpose of influencing in any way the action of such Department—makes, passes, utters, or publishes any statement, knowing that same to be false—shall be fined not more than \$5,000 or imprisoned not more than two years, or both." Other Federal Statutes provide severe penalties for any fraud as intentional misrepresentation made for the purpose of influencing the issuance of any guaranty or insurance or the making of any loan by the Administrator of Veterans Affairs.

**NOTICE TO PURCHASER: ANY NOTICE OF NONCONFORMITY MUST BE DELIVERED TO THE WARRANTOR within the period or periods set forth above.**

Receipt of this warranty is acknowledged this \_\_\_\_\_ day of \_\_\_\_\_, 19\_\_\_\_.

\_\_\_\_\_  
\_\_\_\_\_  
PURCHASER(S)/OWNER(S)





**AN EQUAL OPPORTUNITY EMPLOYER**

**UNITED STATES  
GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548**

**OFFICIAL BUSINESS  
PENALTY FOR PRIVATE USE, \$300**

**POSTAGE AND FEES PAID  
U. S. GENERAL ACCOUNTING OFFICE**



**THIRD CLASS**