



February
2018



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Mandatory building warranties: Putting risk where it belongs

- Auckland Council has paid out \$600 million in leaky building claims because New Zealand's current legislation does not align risk and responsibility for building work.
- The current liability framework forces councils to regulate and monitor as much as they can in an attempt to reduce risk.
- Auckland is now building more homes than at any time since the leaky homes era. There is evidence of poor quality work and shortcuts, creating risk of similarly large liabilities arising, despite council's efforts at monitoring building activity.
- The best way to resolve this is through a legislative switch to proportional liability, and a mandatory builders' warranty scheme.

We've been here before

Auckland is consenting more new homes annually than at any time since 2005. Last time the region built this many homes, it did not end well; thousands of homes were constructed that have since begun to leak, or are expected to.

This outcome was bad for homeowners and for ratepayers. While many builders disappeared into the night, councils, central government and the hapless homeowner picked up the bill, in large part because they were still around. Claims against Auckland Council, for example, have already reached \$600 million, or \$1,000 per ratepaying household. Some private law suits against materials manufacturers remain before the courts, but little has been recovered from builders of leaky homes.

How this slows delivery of housing

At times of unusually high demand for construction like we have today, people who probably shouldn't be building enter the market, and shortcuts are taken. Auckland Council has highlighted a frightening array of shoddy building practices and materials.¹

¹ See [here](#) and [here](#) for instance.

With the leaky buildings precedent, councils have adopted the economically rational approach of strongly regulating the build process: if they can monitor it, there's a greater chance that they can prevent another round of poor quality building and avoid the huge resultant liability.

As a result, far more detail is required for a building consent application, and the number of onsite building inspections has risen sharply. These inspections need to be booked in advance, and each time the builder must estimate in advance when they will be ready for the next inspection, so as to avoid downtime before they can proceed. This extra design and inspection work adds costs and time delays. But at present, a more hands-off approach is seen as too risky by councils.

Despite councils' efforts at monitoring, they can't catch everything, which means the risk of liability from building failure cannot be negated fully in the current system.

Annual new residential dwellings consented highest since 2005



A better approach

There is a classic market failure here. Those who carry the risk (mostly homeowners and councils) don't have the best information about those risks. Those with the best information – the ones doing the work and getting paid for it, and who know what quality work they are doing or what shortcuts they may be taking – do not carry the risk. ***This is bad economics.***

There is a risk of another leaky homes-**scale** blow-up unless we better align risk with responsibility. So how could we do this?

Step One: Legislate for proportional liability

New Zealand currently operates in a "joint and several liability" environment. This means that any party involved in the construction of a home can be held liable for the full cost of repair. This is the system that has left the last man standing (government and the homeowner) to pick up the bill for bad building or materials.

The Law Commission has determined that a prerequisite for a system that better aligns responsibility and risk is a legislative shift to proportional liability.² This means each party in the process is only liable based on its share of responsibility.

Step Two: Mandate building warranties

Several jurisdictions around the world have mandatory building warranty systems, including Queensland in Australia, and the United Kingdom. The schemes vary, but the broad principle is the same: to carry out significant building work, builders must offer a third party warranty that protects the homeowner.

New Zealand currently has two significant voluntary 10-year warranty schemes – the Master Build Guarantee and the Certified Builders Guarantee – that have both operated for many years. It would be relatively simple, starting with this model, for central government to approve four or five privately run warranty schemes, possibly including versions of the two already in place. A small central government team would be responsible for monitoring the financial hygiene of these approved providers, not unlike reviews of Kiwisaver schemes and evaluation of appropriate default providers there.

Allowing several warranty providers would ensure market choice for builders and homeowners, and increase the opportunities for innovation.

The Building Act 2004 would be amended to require that all building work over a minimum contract value be covered by one of the approved warranty schemes. This would line up with the Act's existing requirement for all building work over a minimum value (currently \$30,000) to be covered by a written contract. There would need to be a lead-in time of probably two to three years to allow the industry time to comply.

This approach would improve on the Queensland model, for instance, which is government run and thus lacks a competitive element, and which also has a far lower dollar threshold, which may be too onerous and imposes big percentage increases in price on lower value projects.

Step 3: Introduce centralised testing of materials

New Zealand currently lacks a centralised register of approved building materials.³ Instead, individual councils decide whether to approve a certain building material. This is inefficient and discourages innovation because individual councils lack the resources to invest in researching new products. As a result, councils often reject applications to use products they don't know.

² See [here](#).

³ It has Codemark, a voluntary programme, which has had limited success.

Manufacturers can commission organisations like BRANZ to appraise their products, but that is a voluntary process. Instead, a central agency could be responsible for approving and random testing materials for nationwide use, with stiff penalties such as removal from the New Zealand market for products that make inaccurate claims.

This will still not overcome instances of builders substituting poorer quality materials for those specified, but in those cases the builder would be at fault and their warranty provider would bear the risk. These builders probably wouldn't remain in business for long as they could not maintain insurance.

Step 4: Step back from current regulation levels

With primary liability back where it belongs, councils could and should step back. Their main concern would be that the proposed building complies with the district plan (Unitary Plan in Auckland's case). Even ensuring that a building was watertight and structurally sound could be the responsibility of the warranty provider, not the council or the homeowner.

Councils would be able to dramatically reduce inspections and associated costs currently charged on to the builder.

Who benefits from this approach?

Many parties would benefit from this approach.

- **Home purchasers:** Greater peace of mind knowing that all new homes are covered by insurers whose licence to operate and financial hygiene are monitored.
- **Ratepayers / taxpayers:** No more paying out for bad work or materials by businesses that then disappear, leaving liabilities for ratepayers and taxpayers to settle.
- **Good builders:** A competitive warranty system will reward good builders with fewer hoops to jump through and lower insurance costs, resulting in big time and cost savings.
- **Good materials producers:** An independent materials testing regime will reward good materials manufacturers by removing poor quality "substitutes" from the market.

Who benefits	Benefit
Homeowners	Greater certainty Mortgage or rent savings
Ratepayers / taxpayers	Reduced liability
Good builders	Fewer time delays and costs
Good materials producers	Less competition from inadequate "substitutes"

There will be some who don't benefit – those who habitually do a bad job. They will either leave the industry, improving the quality of work in the sector, or will work for builders who are approved and who can monitor their performance. Those entering the construction industry, who may struggle to get insurance with no track record, would cut their teeth working with an approved builder before heading out on their own.

The usual suspects

There are two common objections raised by opponents of this proposal.

- **Won't this cause a shortage of builders?** No. It will cause a shortage of bad builders and materials producers who impose further costs on homeowners and ratepayers if left unchecked. The economy is better off not filling jobs with those incapable of doing them if the quality of the work imposes costs down the track for homeowners or ratepayers. Good builders will be insured and will enjoy a steady stream of work.
- **Won't this push up the cost to build?** No. Queensland's government-run scheme, without the benefits of private competition, carries an insurance premium of less than 1% on building work of \$30,000 or more. A competitive market plus a decline in regulation required by councils due to their reduced liability would lead to big time and cost savings. Savings to builders are likely to exceed the 1% of build cost attributable to insurance. Further, because homes will be completed more quickly, new home purchasers will not carry two mortgages, or rent and a mortgage, for as long.

Auckland Economic Commentary

Harshal Chitale

Senior Economist, Chief Economist Unit

- Historical GDP growth has been revised upwards. This means per capita GDP and productivity growth were better than previously reported, a better fit with the observed growth in key industries.
- Unemployment rate is at its lowest in about 10 years, which may stimulate some wage inflation, although we note that underemployment remains high.
- House prices are expected to remain flat in the short to medium term, with policies aimed at cutting demand and boosting supply balanced against the still-increasing underlying demand.

Key economic trends

Net long term migration into Auckland has flattened and may be on a slightly declining trajectory. Both the six-month and 12-month figures to December 2017 were broadly the same as the year before. Auckland is likely to have added about 40,000 people to its economy in the 2017 calendar year, including natural growth.

Demand for goods and services, including housing and infrastructure, thus remains strong. The new government has announced plans to cut immigration, but we will have to wait for more detail before forecasting the likely impact of net migration numbers in 2018.

Statistics NZ revised its historic GDP figures upward, which meant the Auckland economy grew faster in 2015 and 2016 than previously reported. This fits better with the observed growth in our key industry drivers.

Residential consents showed an encouraging upward trend and nearly 10,900 new dwellings were consented for the year to December 2017. The proportion of multi-unit consents (townhouses and apartments) increased steadily to reach 51% for the calendar year.

Non-residential building consents also showed strong growth. The non-residential floor area consented was up 26% in the calendar year and 24% in nominal dollar terms. The building industry expects to increase employment in the next quarter while expecting a small decrease in orders, according to NZIER's Quarterly Survey of Business Opinion (QSBO). The industry will remain one of the economic drivers going forward, but is expecting some increases in average building costs in the coming quarter.

Retail sales for the 2017 calendar year were up 4.5% in nominal terms or about 2.9% in real terms. This slower growth reflects the lack of recent house price growth.

Annual guest nights in Auckland – a measure of tourism

Strength – fell 1% for the year to December 2017, led by a large decrease in domestic guest nights and a sharp decline in the growth rate of visitors from China. Visitor growth from other major markets such as Japan, Korea and the US has also slowed from very strong growth in 2016. This has been partly offset by increased growth rate of visitors from the UK over this period.

Employment and wages

Auckland's unemployment rate was 4.1% for the December quarter – the lowest rate in 10 years. Around 12,000 jobs were added in the quarter, which was fewer than last quarter. But the working age population increased at a slower rate than during the previous quarter, which likely explains the lower unemployment rate. A further lowering of unemployment, as the Reserve Bank expects, would likely lead to wage inflationary pressures, while proposed immigration policies may make it harder for employers to find workers, stoking wage inflation.

On the other hand, while unemployment has been low, underemployment – defined as those with the desire to work more hours but unable to find those hours – is running high, at 4.3% of the total number of people employed. This spare capacity in the labour market may keep a lid on wage inflation for the rest of the year if these people can be used effectively by employers.

Inflation was lower than expected, at just 1.6% for the 2017 calendar year, well below the Reserve Bank's mid-point target of 2.0%. This meant that the average salaried worker in Auckland saw their wages increase by 2% in real terms over this period, given strong nominal growth in ordinary and overtime weekly wages.

Housing

Multi-unit dwellings accounted for a little over half of all dwellings consented in 2017. Although annual consents have been steadily rising for the last five months, with population growth of about 40,000 for the year, the rate of building needs to be even quicker to keep up.

We expect house prices to remain steady for the rest of the year. They are unlikely to increase much due to the macro-prudential policies that have created a restricted credit environment, the limit on ability to pay imposed by people's incomes, and the new government's policies on immigration and foreign buyer rules that could have some impact on demand once they are in place.

But given the supply shortfall that already exists, we do not expect house prices to fall substantially either, with short term interest rates holding steady and the Reserve Bank likely to keep the OCR unchanged for the rest of the year due to lower than expected inflation.

The government's Kiwibuild programme will take a while

to ramp up and ongoing construction capacity issues will likely mean we have our work cut to achieve higher rates of building. December quarter labour utilisation for construction was at 93.2%, according to the QSBO.

House sales volumes declined steadily and were 22% lower in the 2017 calendar year than in 2016. The median house price has remained almost unchanged in January 2018 from a year ago. Rental inflation, however, is back

as rents have increased much faster than inflation, at 5.1% for the year to December 2017.

The Reserve Bank has loosened loan-to-value ratio restrictions slightly and investors now need 35% equity in property. We do not see this having a significant impact, apart from possibly shifting the profile of property purchases within the investor category to those borrowing more.

Data analyst

Ross Wilson - Analyst, RIMU

Indicator	Latest	Last quarter	12 months ago	5-year average	Rest of NZ latest
Employment indicators					
Annual employment growth (%pa)	3.4%	5.5%	7.6%	4.6%	3.8%
Unemployment rate (%)	4.1%	4.6%	5.1%	5.5%	0.0%
Unemployment rate among 20 to 24 year olds (%)	9.2%	9.5%	9.0%	10.2%	7.8%
Unemployment rate among 15 to 19 year olds (%)	17.5%	21.5%	19.4%	22.3%	20.1%
Earning and affordability indicators					
Annual nominal wage growth (%pa)	3.6%	2.4%	0.7%	2.3%	3.3%
Annual geometric mean rent growth (%pa)*	5.1%	2.1%	5.1%	4.8%	4.9%
Geometric mean rent to median household income ratio (%)*	28.6%	27.4%	29.4%	29.2%	26.8%
Annual median house price growth (%pa)*	1.8%	0.4%	9.9%	9.9%	5.8%
Mortgage serviceability ratio (relative to Dec-06)	-8.0%	-6.9%	-11.2%	-4.1%	NA
Construction					
Annual new residential building consents growth (%pa)	8.4%	2.9%	8.4%	18.9%	0.9%
Annual m2 non-residential building consent growth (%pa)	25.8%	-4.5%	-24.4%	6.0%	0.9%
International connections					
Annual guest night growth (%pa)	-0.9%	0.4%	4.4%	2.8%	3.3%
Annual net migration	36,152	36,404	33,916	26,796	33,864
Confidence					
Annual retail sales growth (%pa)	4.5%	4.9%	8.6%	6.5%	4.7%
Quarterly Survey of Business Opinion (net optimists)	-9.3%	2.3%	23.9%	25.0%	-12.2%
Westpac Consumer Confidence*	107.5	114.6	111.8	116.6	107.4

Sources: Chief Economist Unit, Auckland Council; Statistics New Zealand; Ministry of Business Innovation and Employment; Real Estate Institute of New Zealand; New Zealand Institute of Economic Research; Westpac; Reserve Bank of New Zealand. * Rest of New Zealand figures are for all of New Zealand including Auckland. Data is not seasonally-adjusted.

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