

DOCUMENT RESUME

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Effectiveness of the Builder's Warranty on New Houses with Mortgages Insured by HUD or Guaranteed by VA]. B-114860; CED-77-20. January 5, 1977. 8 pp.

Report to Carla Hills, Secretary, Department of Housing and Urban Development; by Henry Eschwege, Director, Community and Economic Development Div.

Issue Area: Domestic Housing and Community Development (2100). Contact: Community and Economic Development Div.

Budget Function: Community and Regional Development: Community Development (451).

Organization Concerned: Department of Agriculture; Department of Housing and Urban Development; Veterans Administration.

Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs.

Authority: National Housing Act of 1949, as amended, sec. 518(a). Servicemen's Readjustment Act, sec. 1827.

Federal agencies can suspend or debar builders who refuse to repair warranted defects, but can not require compliance with warranty provisions. In some cases, the Department of Housing and Urban Development (HUD) and the Veterans Administration (VA) are authorized to correct defects or compensate home buyers. Findings/Conclusions: From an examination of 181 complaint files, it was determined that 48 builders had been suspended or debarred or had gone out of business. Defects in homes, mostly of a serious nature, were not corrected. Better protection for homeowners and the Federal Government could be obtained from a comprehensive warranty by a third party such as the National Association of Homebuilders. Other possible approaches are holding builders' funds in escrow to insure correction of defects, or requiring builders to obtain performance bonds. Recommendations: HUD should initiate a pilot program to test these protection alternatives. If results indicate that one is most effective, it should be expanded and its use encouraged. (H1W)

00548



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

COMMUNITY AND ECONOMIC  
DEVELOPMENT DIVISION

JAN 5 1977

B-114860

The Honorable  
The Secretary of Housing and  
Urban Development

Dear Mrs. Hills:

We have reviewed the effectiveness of the warranty required of builders who sell new homes with mortgages the Department of Housing and Urban Development (HUD) insures or the Veterans Administration (VA) guarantees.

Builders' warranties on new houses which the Federal Government insures or guarantees do not protect new home buyers when builders refuse to repair warranted defects or when builders go out of business before such defects are repaired. Under these circumstances, the Federal agencies can suspend or debar the builder from further participation in housing programs. This action, while protecting potential new home buyers from purchasing houses from the same builders, does not help the new home buyer who is still confronted with uncorrected housing defects. The Federal Government needs to test the desirability and effectiveness of protection afforded by alternatives and supplements to the builder's warranty to determine if a more effective method exists for insuring that repairs are made on new houses.

We examined files for 181 complaints made by new home buyers. These were filed and closed <sup>1</sup>/ <sub>during calendar year 1974 by HUD in three States--California, Illinois, and Oklahoma--and by VA in two States--Illinois and Oklahoma. Our review was made at the two agencies' headquarters in Washington, D.C.; HUD's area offices in Chicago, Illinois, Oklahoma City, Oklahoma, and San Francisco, California;</sub>

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<sup>1</sup>/<sub>A complaint file is closed when corrective action is taken, the agency determines the repairs are the homeowner's responsibility, or the agency has taken restrictive action against the builder.</sub>

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and VA's regional offices in Chicago and Muskogee, Oklahoma. VA's direct loan program was not included in our review because of the small number of loans outstanding.

The Department of Agriculture also administers a program to assist qualified persons in purchasing houses. However, we did not include complaints made by new home buyers involved in its housing program because separate complaint files were not maintained.

### BACKGROUND

HUD and VA assist qualified individuals in purchasing houses by administering home mortgage insurance or guarantee programs, under which mortgage loans made by private lending institutions are protected against losses. Also, VA has a direct home loan program which finances home loans. Although each program has the same purpose--to assist in the purchase of decent, safe, and sanitary homes--each agency operates under its own particular laws and regulations.

HUD and VA require the builder or seller of new houses to provide each new home buyer with a 1-year warranty covering the construction of the home. The Federal agencies are not a party to the warranty and have no legislative authority to require the builder or seller to comply with the provisions of the warranty.

The builder's warranty on new homes applies if there is substantial nonconformity with approved plans and specifications and the new home buyer has given the builder written notice of any housing defects. If the builder does not correct warranted defects, the Federal agencies may refuse to process additional applications for mortgage insurance, loan guarantees, or direct loans for additional houses it builds. Also, the Federal Government may become responsible to correct or compensate new home buyers for structural defects not corrected by the builder if the homes have federally insured or guaranteed mortgages.

Under section 518(a) of the National Housing Act of 1949, as amended, and section 1827 of the Servicemen's Readjustment Act, which was added in 1968, HUD and VA are authorized, under certain conditions, to correct or compensate new home buyers for substantial defects found in new one-to-four family homes approved for mortgage insurance or loan guarantees. Expenditures can be made for

(1) correcting such defects, (2) paying the property owner's claims arising from such defects, or (3) acquiring title to the property. As of September 30, 1976. HUD and VA have paid out about \$1,604,000 and \$114,000, respectively.

UNCORRECTED DEFECTS FOR WHICH SOME HOMEOWNERS HAVE NO EFFECTIVE RECOURSE

HUD and VA records showed that the builders of 48 of the 181 houses (27 percent) involved in complaints had been either suspended or debarred by the agencies or had gone out of business. The defects existing in 42 of the 48 houses were, in our opinion, serious because they represented hazards to the new home buyers' safety and health or affected livability. Although the agencies had determined that the defects existing in the 42 houses were covered by the warranty, the homeowners informed us that the builders had not corrected these defects. The following table summarizes the results of our review.

	<u>Complaining homeowner files examined</u>	<u>Serious defects</u>	<u>Minor defects</u>
HUD	115	30	4
VA	<u>66</u>	<u>12</u>	<u>2</u>
	<u>181</u>	<u>42</u>	<u>6</u>

Serious defects the agencies determined to be covered by the warranty but not repaired by builders before suspension, debarment, or bankruptcy included leaky basements, cracking foundations, inoperative electrical outlets, exterior bricks cracking, defective plumbing, inadequate floor supports, inadequate heating systems, and inadequate insulation.

The following examples illustrate the problems some homeowners have encountered in getting builders to correct defects in new houses.

Homeowner A

In September 1973 a new home buyer in Oklahoma complained to HUD about repairs needed to his house, which was purchased in 1972. He complained that moisture seeped through the kitchen and bathroom floors. HUD wrote the builder in

September and October 1973 requesting him to repair the floors. In late October 1973 HUD suspended the builder because he had not corrected the defects.

Homeowner B

In April 1973 a veteran new home buyer in California complained to HUD 1/ about repairs needed to his home which was purchased in April 1972. The new home buyer complained, among other things, of uneven, pliable floors which caused floor tiles to crack and break and stated that he had notified the builder several times of this defect. In May 1973 HUD personnel inspected the house and agreed that repairs were necessary and were covered by the builder's warranty and later notified the builder to strengthen the floor supports. In August 1973 HUD suspended the builder because he failed to correct the defect in this house, as well as similar defects in other houses which he had built. The suspension was lifted in February 1974 on the basis of the builder's promise to repair the floors when the ground was dry. However, in July 1974, before the defects in this house were corrected, the builder became insolvent.

Homeowner C

In July 1973 a veteran new home buyer in Illinois complained to VA about repairs needed to his house, which was purchased in March 1973. He complained that water pooled on the basement floor because the floor was not sloped to eliminate the water through the sump pump drain. In November 1973 VA suspended the builder because he refused to correct the defects in this house, as well as similar defects in another house which he had built.

ADDED PROTECTION FOR HOMEBUYERS  
AND THE FEDERAL GOVERNMENT FROM BUILDERS  
WHO DO NOT HONOR THEIR WARRANTIES

Warranties builders of new houses provide are designed to protect the buyer against defects for 1 year. As discussed above, this protection is not sufficient if the builder refuses to repair covered defects or if the builder goes out of

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1/HUD inspected the house and was responsible for handling complaints under a reciprocal agreement with VA.

business before such defects are corrected. In such cases the home buyer may suffer a loss as may the Federal Government if it insured or guaranteed the mortgage. Several possibilities are available that offer the new home buyer and the Federal Government better protection from builders which do not honor their warranties.

One such possibility involves obtaining from a third party a warranty more comprehensive than that commonly offered by the builder. The National Association of Homebuilders 1/ offers such a warranty program. The Association's program provides protection against builders who will not or cannot fulfill their warranty responsibilities. The warranty fee is included in the purchase price of the house at \$2 per \$1,000 with a minimum fee of \$50. The warranty provides that:

- During the first year, the builder warrants that materials and workmanship used in the home meet approved standards, usually based on local building codes for the area. Structural defects are also covered, and the builder is responsible for fulfilling the terms of the warranties on equipment and fixtures if the manufacturers do not honor them.
- During the second year, the builder warrants the overall performance of the systems, except when problems result from the failure of individual components within the systems. Structural defects are also covered.
- For years 3 through 10, coverage is limited to structural defects and is provided by the program's insurance carrier, not the builder.

If a builder cannot or will not honor the terms of the warranty during the first two years, the program's insurance company assumes the builder's responsibilities.

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1/An association of builders and others which, among other things, sponsors and conducts research on construction methods and material, collects and publishes data on current developments in home building, and conducts schools and conferences on building and building-related subjects.

Local councils of the Association administer the warranty program. During the first two years of the warranty, if both parties agree, the council can act as a mediator of disputed items between the builder and buyer. Anytime during the life of the warranty, parties in dispute--buyer-builder, buyer-council, or buyer-insurance carrier--may request binding arbitration from the American Arbitration Association. <sup>1/</sup> The complaining party must pay a \$75 fee, all or part of which may be refunded depending on the case's merits.

The National Association of Homebuilder's warranty program is open to all builders approved by the program's local councils. As of February 1975, 28 States had given the necessary approval for the program's insurance coverage to be offered. The Association expects that the program will be offered in all States within the next few years.

Another possibility for providing added protection to the new home buyer and Federal Government involves holding builder funds in escrow to insure that warranted defects are corrected. This approach would insure that funds are available to correct the warranted defects in new homes if the builder does not make the repairs. Once identified warranted defects are repaired, the funds held in escrow would be turned over to the builder.

At times, HUD holds funds in escrow from loan proceeds until all construction work has been completed. It holds these funds to insure that the builder completes such items as grading which are often deferred because of seasonal weather conditions until after loan closing. Once the builder completes the construction work, HUD returns the funds to the builder.

A third possibility for providing added protection would require the builder to obtain a performance bond insuring that defects covered by the warranty are corrected. The performance bond would insure that warranted defects the builder did not repair would be the responsibility of the bonding company. Once the new home buyer and the agency are satisfied that all warranted defects are repaired, the builder would be released from the performance bond.

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<sup>1/</sup>A public service, nonprofit organization dedicated to resolving disputes of all kinds through voluntary methods, including arbitration.

## CONCLUSIONS

In view of the inadequate protection afforded the new home buyers by builders' warranties on new homes with federally insured or guaranteed mortgages and the potential liability of the Federal Government for substantial defects in some houses, there is a need to test the desirability and effectiveness of the additional protection available which would either replace or add to the commonly used builder's warranty. We believe that HUD should take the lead in testing the possibilities available.

## AGENCY COMMENTS

In his July 2, 1976, response to our recommendations, the Assistant Secretary for Housing-Federal Housing Commissioner, HUD, stated that a separately operated warranty program designed to protect the new home buyer against unforeseen expenses or losses may be a practical alternative. Also, the homeowner warranty issue has been placed on the agenda of the departmental program and budget working group for fiscal year 1977-78.

The Assistant Secretary for Consumer and Regulatory Functions will be examining and reporting back to the working group on a variety of homeowner warranty options, including the possibility of a Federal Housing Administration warranty program which would be required. This forum will permit HUD to study supplemental warranty alternatives, including those discussed in this report.

## RECOMMENDATIONS

To protect new home buyers from builders who will not or cannot correct warranted defects, we recommend that the Secretary of Housing and Urban Development initiate a pilot program to test the desirability and effectiveness of the protection alternatives and supplements to the builder's warranty afford. The possibilities tested should include using alternate sources of warranty protection, such as the National Association of Homebuilders' warranty program; placing builders' funds in escrow to insure the availability of funds to correct warranted defects; and requiring builders to obtain a performance bond to insure that warranted defects not repaired by the builder will become the bonding company's responsibility.

If the results indicate that one alternative is more effective in protecting new home buyers, the Secretary should expand the use of the selected alternative and encourage VA and the Department of Agriculture to adopt it.

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We shall be pleased to discuss any of the above matters with you or members of your staff.

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 and Senate Committees on Government Operations not later than 60 days after the date of the report and 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 the report to the four Committees mentioned above; the Director, Office of Management and Budget; the Secretary of Agriculture; and the Administrator of Veterans Affairs. We are also sending copies to your Inspector General, Assistant Secretary for Housing-Federal Housing Commissioner, and Assistant Secretary for Consumer and Regulatory Functions.

Sincerely yours,



Henry Eschwege  
Director