

Making the
Quality Connection:
Improving the Building Industry
Insurance Situation Through
Quality Assurance Programs



Roundtable

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About the NAHB Research Center

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Roundtable



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A quality assurance program for trade contractors and builders is under development by the NAHB Research Center, with the support of the public-private PATH program administered by the U.S. Department of Housing and Urban Development (HUD), and other industry sponsors. A trade contractor certification program has been field tested and evaluated, and demonstrates substantial benefit to all participants. The pilot for the National Housing Quality (NHQ) Certified Trade Contractor program was conducted in Las Vegas and has been expanded to Raleigh, N.C., the Washington, D.C.-area, and the upper mid-west. Initial work on a builder quality assurance program is currently underway with program requirements and training approaches in the design stage. There has already been interest by a number of builders to participate in a pilot test of that NHQ Certified Builder program as it becomes available in their area. (Brief summaries of these programs are provided in Appendix A.)

During this same time, dramatic changes have been occurring in the insurance field as builders and trade contractors are finding it increasingly difficult to obtain general liability insurance on reasonable, or any other, terms. This begs the question whether a quality assurance program would benefit builders and trade contractors in their search for affordable insurance. Similarly, the question arises whether any favorable consideration of premium costs by insurers might be a significant incentive for firms to adopt a quality assurance program.

Against this backdrop, HUD authorized the NAHB Research Center to conduct a roundtable between the insurance and home building industries to determine what synergies might exist. The purpose of this roundtable was to gain a broader perspective of problems that the insurance industry faces; to identify what home builder actions might be productive to address these problems; and to specify needed steps for both industries to take advantage of an effective new construction quality assurance program.

The NAHB Research Center found that some insurance companies, who have elected to continue coverage of builders, are looking at risk management techniques to lessen their risk exposure. The following is an excerpt from an article in the summer 2002 issue of *The Real Estate Finance Journal*, authored by Jeffrey D. Masters and Sandra C. Stewart, partners in the Los Angeles office of Cox, Castle & Nicholson LLP:

“[S]ophisticated builders have taken a cue from Total Quality Management initiatives used in other businesses, such as the automotive industry. That is, each step in the risk reduction program is regularly evaluated and upgraded so that the builder achieves a ‘continuous loop’ of process improvement. Currently, two of the very few insurers willing to consider builders in California and other high-risk states expect to see at least the following elements in place as part of the builder’s construction defect risk management program: risk transfer provision in trade and design, professional contracts, quality control during design and construction, effective contract administration, protective provisions in project documents, and a proactive customer service program.”

The NAHB Research Center proposed to HUD a three-part description of an insurance industry research task which covered (1) Background Research and Problem Identification; (2) Option Assessment and Evaluation; and (3) Evaluation Program, Education Efforts, and Final Report. This document reports on the status of activities under the first stage of this research—Background Research and Problem Identification.



Gathering the Stakeholders

During December 2002 and January 2003 contacts were made with a variety of individuals and organizations to determine who might be appropriate to invite to the first insurance/quality roundtable, scheduled for January 23, 2003, at the NAHB International Builders' Show in Las Vegas.

A series of phone calls and site visits were made with representatives of insurance companies and insurance brokers to obtain their views of the relevant issues to discuss during the roundtable. Views were also solicited from builders, trade contractors, and others affected by the current insurance situation. In addition, several recent reports were made available to would-be participants, which provided useful insight and a framework for the roundtable discussion. These reports included:

- "Residential Construction Defects: Exposures, Coverage and Risk Mitigation," prepared by Karen A. Reutter, CPCU, ARM, Senior Vice President, Willis, Inc. (Summer 2002);
 - "Report of the General Liability Insurance Task Force," National Association of Home Builders (September 26, 2002).
- Those who attended the January 2003 roundtable are listed in the Acknowledgements section of this document.
- "The Liability Insurance Crisis for Builders: Reasons and Responses," prepared for the National Association of Home Builders by Jeffrey D. Masters, Sandra C. Stewart, and R. Jane Lynch of Cox, Castle & Nicholson LLP, Los Angeles, Calif. (December 2001);



Identifying the Issues

The purpose of the initial phase of research was to gain a better understanding of the nature of the insurance problems facing the home building industry and identify how a quality assurance development and certification program might address these problems. This initial step was seen as part of defining the research agenda and, where possible, identifying specific actions the industry might take.

The dual-industry roundtable was designed to address the following questions:

- What are the important issues?
- Which insurance issues might be addressed by a quality assurance program?
- How might a more informed insurance industry evaluate building companies using a quality assurance program?
- What actions might home building trade associations and other affected entities take to address insurance issues?

Insurance-Related Issues

The NAHB General Liability Insurance (GLI) Task Force identified many insurance-related issues prior to convening this roundtable. These were reviewed and expanded upon during the January 2003 meeting. The following insurance-related issues were identified:

1. GLI is inadequate for builders and trade contractors reflecting problems of availability, affordability, and coverage.

- In some regions, coverage is not available.
- Costs for GLI policies are skyrocketing (2000 and 2001 were two of the worst underwriting loss years).
- There have been declining coverage limits.
- There is a growing number of exclusions (e.g., mold, EIFS) due to product failures.
- Excess and surplus policies have become expensive and of limited availability.
- There have been increasingly restrictive terms that favor insurers (e.g., “your work” exception and claims made vs. occurrence triggers).
- Many trade contractors are uninsured or underinsured. Where coverage exists, it is often inadequate for complete operations coverage.

- Some builders feel that insurance companies do not adequately defend builders against construction defect claims.
- Payouts/judgments by insurance companies are strongly influenced by a desire to reduce risks and avoid any possibility of large jury awards. Builders believe this is the result of incorrect or incomplete knowledge of the building industry, and insufficient concern for the adverse long-term industry impact of settlements for items that may not be the fault of the builder or the industry.
- Timing of coverage has become a problem (i.e., the difference between “occurrence” and “claims made” as the triggers for coverage). The insurance industry shift has been toward “claims made” coverage.
- Some builders feel that insurance companies are quick to settle and this practice leads to a bad claims history for all builders and for the entire industry.
- Some insurance companies believe that uniform national construction standards are needed in the residential industry.
- Some trade contractors have no specific project or long-term GLI unless required by the builder-customer, thus both present and future claims must be absorbed by the builder’s coverage.

2. Increasing litigation (in the form of class actions by groups of injured parties) for construction defects has dramatically driven up costs for defense, settlements, and awards.

3. Some insurance companies are dropping out of the residential market.

In some cases, insurance companies do not sufficiently differentiate between builders and trade contractors.

4. Insurance companies are unable to assess, or reliably calculate, the risk in the building and construction industry.

Many or most companies are perceived as the same, from a risk point of view, and the insurance industry is unable to separate high-risk clients from lower risk clients. Coverage in the residential industry will not expand under these circumstances.



- Insurers do not have, or have not previously had, specific risk assessment procedures to qualify the risk of insuring individual companies based upon their individual practices and claims history.
- Some individual insurance companies are moving to a more formalized risk assessment model for building companies.
- The building industry could play a role in assisting the insurance industry in developing means of identifying “lower risk” building companies.
- Addressing this issue may relate to the GLI Task force objective to adopt “construction performance standards at the state level (to) give guidance to courts in dealing with construction defects.”

5. If insurance companies are going to assess the industry as a whole, the efforts of a single residential construction firm to demonstrate low risk in its operations will not necessarily benefit that firm.

Such a demonstration probably will not hurt, but it may not help that firm either obtain insurance, or obtain insurance at beneficial or preferential rates.

6. There are often conflicts between the builder’s and trade contractor’s GLI policies.

Too few builders provide for the contractual allocation of risks between themselves and their trade contractors.

7. Many builders and trade contractors have an inadequate understanding of insurance matters.

Many builders do not understand whether the certification of insurance provided by a trade contractor offers effective protection.

8. Few insurance policies are tailored to the residential market.

While there is some evolution of non-traditional insurance products for small, medium, and very large firms, it is not pervasive.

9. The insurance industry reserves are low because of a recent history of poor, or even negative, investment returns.

One insurance industry issue, outside of the builder’s direct area of influence, is general national economic recovery. Economic recovery is a key component of a more expanded availability of insurers re-entering the residential construction market.

10. There is inadequate public data available about the insurance situation affecting builders and trade contractors that might result in a residential industry effort to ask for corrective action by state insurance regulators.

11. The focus of most reforms is on the building industry, rather than expecting the insurance industry to change in response to the residential building industry needs.

This is understandable but some thought could be given to what reforms, if any, the insurance industry is willing to make. For example, there is a perception within the building industry that insurance companies quickly settle and/or make payouts on claims because it is in their economic interest to do so, rather than on the merits of the claim. It is also clear that the insurance industry is not always completely knowledgeable in the details of a particular claim, or of the industry impact of settling on cases without any actual fault of the involved builder.

Quality-Related Issues

Roundtable participants identified the following issues related to quality assurance in the home building industry:

1. There is uneven quality of construction.

Builders sometimes choose trade contractors based on whether they have insurance or the price of their work, not the quality of their work or the way they run their businesses. Trade contractors use inconsistent construction processes, making quality difficult to achieve for the builder.

2. Product and design failures have given rise to class action litigation.

Some possible reasons are: (a) products are not adequately tested; (b) there are inadequate installation requirements; (c) there are too many manufacturers who do not give train-



Identifying the Issues

ing in the use of their products; and (d) many field installers are inadequately trained. Training that is given is often not documented or evaluated for effectiveness.

3. There are few effective quality assurance programs available to builders and trade contractors.

This has been a long-standing problem within the residential construction industry, which precipitated the development of the initial quality assurance programs at the NAHB Research Center. Currently, the most advanced is the NHQ Certified Trade Contractor program, and an NHQ Certified Builder program is being developed and piloted.

4. There is no clear roadmap for instituting a national quality assurance program.

Building and trade contractors do not recognize the risks they face by not using quality programs. There is a false confidence that building to the codes covers liability.

5. There is currently not a complete and widely accepted set of construction performance standards for use in a national quality assurance program.

Many builders and contractors believe that compliance with local building codes meets quality requirements. However, local building codes do not cover all aspects of housing, just health and safety considerations. While such a simple quality test as code compliance might be desirable, customers have gone to court and won against builders and trade contractors despite compliance with the code. There is an industry need for consistent new home building practices that will yield high-quality new construction results. Part of the problem may be state and regional differences in codes and laws.

6. There is no adequate monitoring mechanism to catch quality deficiencies before they get out of control.

There is a general hesitancy by firms to publicly expose their own quality problems out of fear of litigation.

7. The multiplicity of parties in the construction process gives rise to finger-pointing when something goes wrong.

Few involved in the home building process will admit how their part in the process contributes to poor quality and what they might do to improve the situation.

8. Parties seek to shift the risks of construction defects to others without getting to underlying causes.

Some courts are unwilling to enforce full transfer of builder risk to trade contractors and are assigning a percentage of loss to the builder for such reasons as deficient contractor supervision and lack of quality guidance provided to the trade contractor.

9. Customers are not involved during the construction process, the post-settlement period, or the warranty period.

Customer expectations sometimes exceed builder performance due to lack of information on or understanding of how their home is built or how to maintain their home.

10. While there are many inspections in the construction process, inspections alone do not necessarily equate with quality.

There is widespread use of relatively unskilled labor in new home construction. Unfortunately there are few skills training programs widely available for industry workers to provide the necessary skills. While builders may have provided this training in the past when workers were in their direct employ, most work is now done by trade contractors rather than employees of the builder. Builders are not likely to provide training for independent trade contractors, in part because that training will also benefit other builders who use those contractors but do not fund training.



Vision

When participants were asked how they would define the existing situation and their vision of how it could be improved, they identified the following distinguishing characteristics of an “ideal” future scenario.

- Builders and trade contractors make effective use of quality assurance programs and insurance companies recognize their value.
- Trade contractors deliver a quality product to the builder.
- Coverage against litigation is adequate and comprehensive whether protection is afforded through insurance mechanisms and/or warranty programs.
- Builders and trade contractors are knowledgeable consumers of insurance and warranty programs.
- Industry-wide construction standards are in place as a result of a unified industry effort.
- Litigation is used only as an exceptional remedy for construction defect matters.
- A credible new home care and maintenance document, which includes the transfer of responsibility for maintaining the new home to the homeowner, is available and in use.
- Builders actively support the quality system process as a way to improve the overall industry profile.
- Consumers see builders (and the industry) as providing a quality new home product. Quality new home construction is the rule, not the exception.
- Builders and trade contractors recognize the National Housing Quality training and certification programs as tools to improve quality.
- Home builder associations look to the National Housing Quality programs as a means of providing service to their builder members, providing added value to trade contractor members, and generally improving the image of the industry.
- When customer issues arise, they are quickly resolved to the satisfaction of all parties.

- Communication between the insurance industry, the legal community, and the building industry results in a broader understanding of the negative implications for the residential industry of settling construction defect disputes out of convenience.
- General liability insurance is widely available at affordable costs. Insurance companies base premiums on a builder or a trade contractor’s documentation, quality, and safety records.
- There is a collaborative problem solving approach by insurance and building industry participants. Insurance industry practices are freely discussed and changes are made that consider residential construction industry issues, not only policies that minimize case-by-case insurance litigation costs. As a problem arises, there is a mechanism for the parties to come together to analyze and resolve the problem.

This is a formidable list of characteristics for an ideal future and requires a fully cooperative and comprehensive collaboration between the various participants in the construction and insurance processes to achieve.

During the meeting held at the 2003 International Builders’ Show, participants discussed a preliminary statement of objectives for both insurance and quality assurance matters, and identified possible actions to be taken. These objectives and actions are described below.



Insurance Objectives and Actions

Objective #1: To create capacity in the insurance industry at both the primary and reinsurance levels. Action steps recommended:

- Publicize the industry’s commitment to quality. Teach builders how to write effective contracts.
- Create a certified quality builder program that includes uniform use of quality certified trade contractors.
- Establish right to repair laws with limits on awards in all states.
- Bring reinsurers to the discussion table. Building industry representatives could partner with insurers to reach reinsurers.
- Make use of non-traditional insurance products to provide additional options for home builders.
- Improve the quality of the typical new housing product to reduce construction defect litigation risks for insurers.
- Bring Managing General Agency (MGA) brokers to the table.
- Create new insurance products that reflect market needs for high-quality and consistent long-term performance in new homes.
- Where feasible, use building industry captive entities to provide insurance when private carriers leave voids in the market.
- Develop and group risk rates for each type of trade.
- Make use of the wrap-up, or wrap-around type of builder’s insurance product.

Objective #2: To reform limits of liability to limit the frequency of litigation and reduce excessive punitive damage judgments while still providing consumer protection. Action steps recommended:

- Establish laws providing for the right to repair, or the right to cure construction defect claims in each state.
- Include binding arbitration clauses in all builder/trade contractor contracts.
- Develop suggested binding arbitration language that is equitable for builder/homeowner contracts.

- Evaluate and report on best/worst elements of “right to repair” or “right to cure” strategy to assist HBAs in their state-by-state efforts.
- Provide written warranty that waives implied warranty laws (where allowed) in lieu of building industry adherence to strong performance standards.

Objective #3: To create reliable industry data about insurance matters, both nationally and regionally. Action steps recommended:

- Identify a method to track geographically consistent data including indices such as:
 - consumer satisfaction
 - reduction in construction defects
 - reduction in warranty claims
- Pilot a data collection program.
- Implement a data collection program on a regional/national level to track industry efforts to improve new home construction quality.
- Find sponsors who would financially support the data collection and analysis effort.
- Get data for claims history from insurance companies and educate home building industry members about them. Work closely with state insurance regulators to utilize the loss data they already require insurance companies to provide.
- Create dialogues between builders/trade contractors and insurance companies.
- Encourage NAHB to assemble a team or task force to act as a catalyst for guiding industry improvements in reducing claims and reasons for litigation.
- Encourage creation of an action plan to collect and utilize residential construction industry data for top insurance members.
- Publish national and regional impact statistics relating the impact of quality improvement efforts by the home building industry.
- Establish a national benchmarking process to track quality improvements in the industry.



Identifying the Issues

- Form retail insurance agent task forces in each state (2 to 4 members each) to monitor activity and forward quarterly reports to NAHB.

Objective #4: To improve the relatively low level of sophistication by many builders and trade contractors on matters of risk management, contractual risk transfer, and insurance purchasing. Action steps recommended:

- Prepare and issue an insurance industry or NAHB document on the legal responsibility of the trade contractor after work has received building code approval. (Consider a complementary consumer piece or magazine article, as well.)
- Promote NAHB's risk management workshop as a valuable and worthwhile service for builders.
- Evaluate and implement formal risk management programs for builders and trade contractors.
- Evaluate the benefits and costs to builders of adding third party forensic inspection services to their standard business practices. This could be an engineering consultant or other option as specified in a builder's quality plan.
- Encourage builder and trade contractor participation in risk management training and education programs offered by the insurance industry.
- Request that the insurance industry not increase rates for builder general liability coverage due to damage from natural causes.
- Identify the way builders and trade contractors use standards, model codes, local codes, and industry guidelines of good practice in the new home building process. Evaluate the advantages of developing a uniform national guide to good practices that focuses on the construction of a high-quality new home.



Quality Assurance Objectives and Actions

Objective #1: To design and implement effective builder and trade contractor quality assurance programs. Action steps recommended:

- Expand the NHQ Certified Trade Contractor Program to include 150 certified firms in 2003.
- Evaluate and revise, as appropriate, the Certified Trade Contractor Program by the end of 2003.
- Pilot test a Builder Certification Program with five builders to include training for all in 2003 and certification for at least one builder by the end of the calendar year.
- Evaluate and expand the Builder Certification Program nationally beginning in 2004.

Objective #2: To create a collaborative problem-solving processes between insurance and building industry participants to catch and resolve problems at an early stage. This would be a proactive, early warning system to identify problems before they become widespread and adversely affect insurance coverage. Action steps recommended:

- Meet with insurance industry leaders to define the proposed collaborative process.
- Establish a set of working procedures for this proposed collaborative process.
- Bring reinsurers and design professionals into the discussion.

Objective #3: To create construction performance standards. Action steps recommended:

- Review and revise existing industry guidelines by working with members of the building industry and with insurers. Work could be based upon NAHB's, "Residential Construction Performance Guidelines, Second Edition – Contractor Reference," and local or state HBA documents such as the new construction guideline published by the Atlanta HBA.
- Identify any "beyond code" items that reflect quality building practices and consider including them in the national uniform guidelines (i.e., shims at door hinges, or back priming wood siding).

- Distribute new guidelines to industry members for possible use in individual company quality plans.

Objective #4: To create "good" science about construction defects as guidance for construction practices and litigation. Action steps recommended:

- Develop and promulgate construction defect research results that are objective and based on independent research on construction practices, product performance, and product failures.
- Identify and secure funding to do the research.

Objective #5: Address the relatively low level of sophistication by many builders and trade contractors on training, implementation, and monitoring of quality assurance programs. Action steps recommended:

- Gain support of key builders to promote and support job skills training.

Objective #6: To educate consumers about their responsibilities for maintaining quality housing. Action steps recommended:

- Develop a homeowner guide that sets forth obligations and practical advice for maintaining their homes. Provide an easy and efficient way for homeowners to report regular maintenance to their builder as a part of keeping their warranty (or their extended warranty) current.
- Identify sponsors to work with the industry to develop a guide that includes necessary maintenance actions and is credible with the new homebuying public.
- Link new homes and their maintenance history to the builder's warranty records for the same new home.



Conclusions and Recommendations

It was clear from the trade contractors who were certified through the National Housing Quality program and spoke at the International Builders' Show that a quality assurance program provides significant value and benefits to their businesses. For the most part, however, those benefits are not necessarily translating to improved insurance rates or consideration. Discussions with some of the insurance and warranty companies assembled during and prior to the roundtable suggest that there may be a powerful relationship between insurance availability and/or rates and quality assurance programs. Part of the problem may be the lack of understanding by insurance companies and brokers of the established NHQ Certified Trade Contractor program and the emerging Certified Builder program.

Based on these limited discussions with insurers and insurance brokers, it appears that the insurance industry would view the implementation of a risk management program, to include quality assurance programs, by builders and trade contractors as a major step toward resolving many of the insurance problems in the home building industry.

While there are other major factors that lie outside of the building industry's ability to control—e.g., capacity in the reinsurance industry, the after-effects of September 11th, and the recent economic downturn—there are good reasons for both industries to work together to reduce risks both to builders/trade contractors and insurers.

It would be highly productive for the NAHB Research Center to pursue discussions with individual insurance companies to (1) refine its understanding of the forces that drive insurance decisions; (2) specify what joint actions might make sense to reduce the risk exposure of all involved; and (3) identify joint actions that might be undertaken to gain maximum value from quality assurance programs.

There needs to be an overall strategic collaboration that brings the various participants in the two industries together in order to develop better understanding between all parties and make efficient use of their resources to implement agreed upon actions. To move in this direction, discussions with the parties should continue to refine the strategic approach initiated under this first task.

It is recommended that the process of creating a strategic collaboration building upon the roundtable held at the International Builders' Show be continued. This would entail the refinement of the issues, preferred vision of success, listing of objectives and specification of actions. Decisions need to be made as to which party (i.e., insurance industry, home builders, trade contractors, or the NAHB Research Center) is best suited to pursue specific actions, what resources are required, and what timeline should be set.

Judging by reactions of roundtable participants at the International Builders' Show, there appears to be a demand for both a builder and trade contractor quality assurance program. A number of builders have volunteered to pilot the builder program. While this interest will likely grow without the full collaboration/cooperation of the insurance industry, this pace will likely be accelerated if insurance companies play a meaningful role and/or recognize the results of quality assurance programs. Not only will this be favorable to industry interests, but also beneficial to homebuyers.

It is recommended that the NAHB Research Center continue with Parts II (Option Assessment and Evaluation) and III (Evaluation Program, Education Efforts and Final Report) as soon as possible to build on emerging base of support for quality assurance within the building industry and the emergent interest expressed by some insurers.

In order to identify other industries and association that have successfully brokered discounted rates or other incentives from the insurance industry and evaluate how those efforts might be applied to the home building industry, the NAHB Research Center is currently investigating a program for a reduced rate structure secured by law enforcement groups who employed a quality system. The reported reductions were in the range of 12 to 14 percent discount on premiums. Similar programs from other non-residential industries are being evaluated, as well.



Description of the NHQ Certified Trade Contractor Program

Trade contractors are encouraged by their builder-customers to participate in the training and certification program. This program is based on national program requirements that apply to all trade contractors in all areas of the United States. Training is conducted in small groups of five or fewer trade contractors, and consists of 16 hours of training. Each trade contractor is guided through a process of developing a unique and company-specific quality assurance system. The heart of the system is a quality manual that each trade contractor develops from a standard template provided by the NAHB Research Center. At the end of the training, each trade contractor has developed a quality manual that is approved as consistent with all national program requirements. The individual quality system of the trade contractor is then fully implemented within the trade contractor's company. When a minimum of 90 days of quality system operation and documentation is available the trade contractor is eligible to request an on-site audit by an independent third party, in preparation for annual certification as a National Housing Quality Certified Trade Contractor.

Description of the NHQ Certified Builder Program

The builder program is also based on national program requirements that apply to all builders' quality assurance systems in all areas of the United States. Training is consultative in nature and is one-on-one with each builder. Training consists of an initial "gap analysis" to identify the gaps between the builder's current quality assurance practice and the national program requirements. Each home builder is guided through a modular process of developing a unique and company-specific quality assurance system that encompasses all aspects of their building operation. The heart of the system is a quality manual that each home builder develops from a standard template provided by the NAHB Research Center. At the end of the training each home builder has developed a quality manual that includes company specific procedures and documentation that is approved as consistent with all national program requirements. The individual quality system of the home builder is then fully implemented within the company. As this program is still in a pilot phase, details are still being developed. It is expected that when a minimum of the builder's trade contractors are quality certified, and the builder's quality system is fully operational the builder will be eligible to request an on-site audit by an independent third party like the NAHB Research Center in preparation for annual certification as a National Housing Quality Certified Home Builder.

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