



MINISTRY OF BUSINESS,
INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

4

Discussion paper –
Building system legislative reform

Risk and liability

APRIL 2019



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Summary of Part 4: Risk and liability

Risk and liability affects people's behaviour in the building process

The way risks are identified and managed affects the way people behave during the building process. Risks are allocated by statutory and common law responsibilities and contractual arrangements – and when things go wrong, someone has to pay to put them right.

The proposals set out in this section aim to address several problems.

- ⊗ Homeowners often aren't aware of the risks of the building process, or the need to have something in place to manage them.
- ⊗ When something goes wrong, homeowners may face a long, expensive and stressful process to get compensation.

MBIE is also seeking feedback on whether changes are needed to address concerns that building consent authorities (BCAs) may face a disproportionate share of damages when other parties are absent.

MBIE wants stakeholders' feedback on two proposals

- 1 Require that a guarantee and insurance product is put in place for all residential new builds and significant alterations. Homeowners would be able to actively opt out of having a guarantee and insurance product.
- 2 Leave the liability settings for building consent authorities unchanged.

These changes will help deliver the programme's outcomes

The programme's three outcomes are safe and durable buildings, an efficient regulatory system and a high-performing building sector.

The proposals set out in this section would help deliver these outcomes by:

- providing protections for homeowners
- providing incentives for builders and designers to produce high-quality building work.

Guarantee and insurance products

Guarantee and insurance products offer protections to homeowners who are building or renovating their home. These can be a 'guarantee' or an 'insurance product'.

- A guarantee (or warranty) means that, should a problem arise, the responsible party will correct the problem.
- An insurance product is a policy that will pay out to compensate the policy holder for a loss, and often pays for the problem to be corrected.

Risk and liability

Changes to produce fairer outcomes when things go wrong and parties are absent

There are many different types of risks in the building process. This part of the discussion paper considers the risks that arise when there are defects in a building and some parties in the building process are absent. Changes to address these risks would require legislative change. Measures to address other types of risks (such as commercial contracting risks) can be addressed through mechanisms outside of the *Building Act 2004*.

Part 1 of the discussion paper sets out what all of the proposed changes in the legislative reform programme aim to do – that is to lift quality throughout the building sector by:

- making sure things go right in the building process
- delivering fairer outcomes when things do go wrong.

Part 2 (building products and methods) and Part 3 (occupational regulation) are focused on changes that would increase the quality of building work and make sure things go right. This part is focused on changes that would deliver fairer outcomes when things do go wrong and increase incentives to get things right.

Risk and liability is governed by statute and common law

Risks are allocated by statutory and common law responsibilities and contractual arrangements. Parties often shift risk to other parties using contracts, insurance and other arrangements.

Liability may arise when things go wrong. In New Zealand, like in many other common law jurisdictions, the principal liability rule is that of ‘joint and several liability’. This means that where two or more people have caused a particular loss, each party can be held liable for the full extent of that loss. The overriding concern is to correct harm and compensate injured parties, rather than determine the relative level of wrongdoing by each defendant.¹

MBIE’s objectives include fairer outcomes and changes in behaviour

MBIE has identified four objectives for risk and liability

The objectives for the risk and liability settings are that:

- each party understands their roles and responsibilities in the building process, the risks they face and their options for managing those risks
- each party faces risks that are in line with their role
- each party has access to cost-effective options for managing their risks
- homeowners have access to cost-effective ways to quickly resolve disputes about building work.

The changes aim to influence how people behave when they undertake building work

Any proposed changes should support the programme's wider objectives to drive behavioural changes throughout the building sector.

The table below sets out the behaviours the proposed changes aim to reinforce.



Homeowners

Have access to information and advice about the risks they face, and have a better understanding of these risks.

Make informed decisions when hiring someone to do their building work.

Are more likely to take up guarantee and insurance products.

Can get building defects fixed – without having to resort to costly litigation.



Builders and designers

Understand their responsibilities and have stronger incentives to fulfil their obligations.

Don't rely on BCAs alone to identify errors in building work.

Stand behind their work.

Improve the quality of building work, resulting in fewer defects.



BCAs

Take a proportionate, risk-based approach to building consents and inspections. This could contribute to more efficient consenting processes and lower costs for homeowners, builders and designers.



Providers of guarantee and insurance products

Provide products that meet or exceed the minimum standards placed on guarantee and insurance products.

How risk and liability in the building process works today

Risk and liability should reflect the responsibilities of participants in the building process

The table below sets out participants' current responsibilities in the building process.



Homeowner²

Obtains any necessary building consents and code compliance certificates.



Designer³

Makes sure that plans and specifications are sufficient to result in building work that complies with the building code, if the building work is completed as set out in those plans and specifications.



Builder⁴

Makes sure that building work complies with the building consent, the plans and the building code.

Makes sure they meet their obligations under the implied warranties and other consumer protection measures (eg written contracts, disclosure statements, repair of defects).



Product manufacturer and supplier

Makes sure that any information they provide about their building products is accurate.

Makes sure their products are fit for purpose (under consumer protection or commercial law).



BCA

Checks that an application for a building consent complies with the building code and that building work has been carried out in line with the building consent.

Issues building consents and code compliance certificates.

Makes sure they make these decisions on reasonable grounds.

² Includes body corporates and developers

³ A 'designer' is defined in section 14D of the *Building Act* as someone who prepares plans and specifications for building work or who gives advice on the compliance of the building work with the building code.

⁴ A 'builder' is defined in section 14E of the *Building Act* as someone who carries out building work, whether in trade or not.

The *Building Act* gives homeowners some protections

Under the *Building Act*, protections are available for homeowners before building work starts (pre-contract and contract protections) and after the building work is completed. These measures include a set of implied warranties for building work. These warranties apply for 10 years to all residential building work, and include that building work will:

- comply with the building code
- be carried out with reasonable care and skill
- be completed in a timely manner.

In 2015, the consumer protection measures for homeowners were extended to require that building contractors:

- provide pre-contract disclosure statements, and written contracts for work worth \$30,000 or more
- repair defects that are identified within 12 months of the work being completed.

The *Construction Contracts Act* helps resolve disputes

The *Construction Contracts Act 2002* aims to facilitate payments and provide efficient methods of dispute resolution for parties to construction contracts. It covers all construction contracts, including residential and commercial. This Act provides an adjudication process for construction contract disputes, including disputes about payments and rights and obligations.

In March 2017, changes to the *Construction Contracts Act* were brought in that aimed to strengthen the protections for subcontractors. MBIE is evaluating these changes in 2019.

Joint and several liability is used to allocate liability when there are multiple parties

The operation of the common law also plays an important role in how parties can seek a remedy. BCAs, designers and builders owe a duty of care to the owners of buildings, including to people who later purchase that building.

In New Zealand, claims for building defects are limited to 10 years from the date of the action that caused the defect.

More than one party may cause a building defect. For example, the BCA, the builder and the designer may all have contributed to the defect. The courts usually determine how much each party contributed to the defect. For example, the BCA may be found responsible for 20 per cent of the damages, and the builder responsible for the remaining 80 per cent.

New Zealand uses joint and several liability to allocate liability when multiple parties are found responsible for the same loss. Under joint and several liability, a claimant can recover damages from any or all of the parties that caused the loss. In a case where some of the parties are no longer in business (an absent party), the remaining parties would have to cover their share of the losses.

It's not uncommon for one or more party to be absent for claims relating to defects in buildings. The nature of building defects means that it can be a long time before defects are discovered. The parties responsible for that defect may no longer be in business. The churn rates of businesses in the construction sector are consistent with those of other New Zealand industries. But the expected lifespans of the sector's outputs is far longer than most other goods and services.⁵

If no parties are left, homeowners would be unable to recover their losses.

In 2014, the Law Commission recommended that BCA liability be capped to limit the exposure of BCAs in liability cases. The Law Commission also recommended developing a comprehensive guarantee or warranty scheme to cover building work for single and multi-unit residential dwellings.⁶

Guarantee and insurance products are available to protect homeowners

Guarantee and insurance products offer protections to homeowners who are building or renovating their home. These can be a 'guarantee' or an 'insurance policy'.

- A guarantee (or warranty) means that, should a problem arise, the responsible party will correct the problem.
- An insurance product is a policy that will pay out to compensate the policy holder for a loss, and often pays for the problem to be corrected.

Homeowners normally purchase a guarantee and insurance product through their builder. They might pay the premium for the guarantee and insurance product separately, or the premium might be incorporated into the total cost of the building work.

Three main guarantee and insurance products are available in New Zealand:

- Halo Residential Guarantee, provided for work done by members of the New Zealand Certified Builders Association.
- Master Build Guarantee, for work done by a member of the Registered Master Builders Association.
- Stamford Building Warranty Insurance, available from any builder approved by Stamford Insurance, or through BuiltIn Insurance.

Professional indemnity insurance is available to protect builders and designers

Professional indemnity insurance helps protect builders and designers who face a negligence claim. The insurance may contribute towards their legal fees and any damages awarded for economic losses or negligence. Some professionals, such as architects, are required to have professional indemnity insurance as part of their occupational regulation requirements.

5 Statistics New Zealand report 61,860 construction firms were in business as at February 2018. Between February 2017 and February 2018, 7,038 construction firms went out of business and 8,277 were established. In 2017/18, construction firm owners faced a 12% chance that within one year, their firm would have ceased trading. Of construction firms established in 2008, 22 per cent remained in trade 10 years later. (Source: Statistics New Zealand, *New Zealand Business Demography Statistics for February 2018*.)

6 Law Commission (2014) *Liability of Multiple Defendants: Report 132*.

Homeowners and BCAs may face a disproportionate share of the costs when things go wrong

Homeowners have a limited understanding of their risks and how to manage them

In 2018, MBIE commissioned Colmar Brunton to carry out qualitative research into how homeowners and builders perceive and manage risk in the building process. They carried out in-depth interviews with 18 homeowners who had been involved in the building process and with 16 builders.

The research found that homeowners have limited understanding of the risks they face when commissioning building work and low awareness of the tools they can use to manage their risk.⁷ While some homeowners may be aware that there are risks, they struggled to identify specific risks or the potential consequences – they didn't know what they should be protecting against.

Low understanding of the risks they face may mean that homeowners fail to take adequate steps to manage their risks. Homeowners can help to manage their risks by using the implied warranties in the *Building Act*, and guarantee and insurance products.

Enforcing the implied warranties in the *Building Act* can be difficult

Stakeholders have told MBIE that homeowners can find it difficult to enforce the implied warranties under the *Building Act*. Enforcing implied warranties relies on homeowners being aware of their rights and the builder still being in business when building defects come to light.

After the first year, the homeowner becomes responsible for showing that the defect was a result of the original building work. If a builder is unwilling to fix a defect, the homeowner may need to seek remedies through the court. This can be a long, expensive and stressful process.

Homeowners don't know about guarantee and insurance products

The research found that there is low awareness of guarantee and insurance products. Homeowners who took part in the research struggled to differentiate between general house insurance and insurance to cover building work. None of the interviewees had actively sought out a guarantee and insurance product of their own accord.⁸

7 Colmar Brunton (2018) *Risk, Responsibility and Liability in the Building Process: An exploration of the behaviours of homeowners and builders*. Report prepared for the Ministry of Business, Innovation and Employment.

8 Colmar Brunton (2018) *Risk, Responsibility and Liability in the Building Process: An exploration of the behaviours of homeowners and builders*. Report prepared for the Ministry of Business, Innovation and Employment.

Only 40 per cent of new homes and renovations are protected by guarantee and insurance products

Research estimates that only about 40 per cent of new homes and significant renovations have a guarantee and insurance product.⁹

In comparable jurisdictions like Canada and Australia, many provinces and states have made it compulsory to have some form of guarantee and insurance product.¹⁰ In the United Kingdom, mortgage lenders only approve mortgages on newly built homes covered by a guarantee and insurance product.

BCAs may face a disproportionate share of damages

Concern is often raised about BCAs being the only party left to compensate homeowners when building defects arise. This can mean that the total amount paid by BCAs is disproportionate to the role they played in contributing to that defect. Generally, BCAs are seen as having a relatively passive and supervisory role in the building process. To be liable to pay some of the costs, BCAs must have contributed in some way to the defect.

MBIE has heard mixed views about whether the financial risks that BCAs face in performing their role are significant. We commissioned an analysis of court cases involving building defect disputes between 2008 and 2018 to get an up-to-date picture of the financial risks faced by BCAs.¹¹

BCAs paid out \$1 billion to settle building disputes in the last ten years

The research found that BCAs paid out an estimated \$1 billion for the period 2008-2018. This includes court-ordered and out of court settlements.¹² About \$332 million of the total amount paid covered the costs of defects incurred by other parties who were unavailable to pay their share of the claims (eg insolvent). Rate payers ultimately carry these costs.

While these are substantial amounts, they need to be considered within the broader context. Over the same ten year period, BCAs issued consents for new residential and non-residential buildings valued at approximately \$75 billion.

The research estimated that around 2.5 per cent of residential building consents resulted in disputes settled by court cases or dispute resolution processes. Court cases relating to building disputes have been steadily decreasing since 2012 as cases related to leaky homes have worked their way through the courts.¹³

9 Covec (2018) *Guarantee and Insurance Products: Market and policy analysis*. Report prepared for the Ministry of Business, Innovation and Employment.

10 Five of 10 Canadian provinces and all Australian states, apart from Tasmania, require guarantee and insurance products.

11 Sapere (2018) *Liability outcomes in the building sector – glimpses from available data*. Report prepared for the Ministry of Business, Innovation and Employment.

12 Sapere (2018) *Liability outcomes in the building sector – glimpses from available data*. Report prepared for the Ministry of Business, Innovation and Employment.

13 Sapere (2018) *Liability outcomes in the building sector – glimpses from available data*. Report prepared for the Ministry of Business, Innovation and Employment.

BCAs have limited ways to manage their risks

Unlike other participants in the building process, BCAs can't decline to do certain work, enter risk-sharing arrangements in contracts, or be absent or insolvent at the time of a defect liability case.

Previously, some BCAs attempted to manage their risks by setting up 'risk pools' for territorial authorities that could be used to cover their liabilities. But this system didn't survive the leaky homes crisis.

Currently BCAs manage their risks by requiring detailed plans and specifications for building consent applications and carrying out multiple and detailed inspections.

MBIE proposes one change to the risk and liability settings

1

Require guarantee and insurance products for residential new builds and significant alterations, and allow homeowners to actively opt out.

2

Leave the risk and liability settings for BCAs unchanged.

The objectives of this change are to:

- provide protections for homeowners
- provide incentives for builders and designers to produce high-quality building work.

1. Require guarantee and insurance products

Proposal



Require a guarantee and insurance product to be in place for all residential new builds and significant alterations. Homeowners would have the choice to actively opt out of having a guarantee and insurance product.

Guarantee and insurance products can be an effective way for homeowners to manage their risks during and after the building process. They can provide a remedy for some of the most significant risks that a homeowner may face during the building process:

- the risk that their building work isn't completed due to the builder going out of business, being insolvent, or disappearing
- the risk that the finished house or renovations will have defects.

MBIE is seeking your feedback on a proposal to require all residential new builds and significant alterations to be covered by a guarantee and insurance product when the building work starts. Homeowners would be able to actively opt out of having a guarantee and insurance product.

How this proposal would work

Residential builders would need to be able to offer a guarantee and insurance product to homeowners. The builder could either join one of the two builders' associations or be approved by an insurer or broker to offer their product.

Homeowners would either pay the premium directly through their builder or the builder would incorporate the premium into the overall cost of the build.

The homeowner would be the 'policy holder' of the guarantee and insurance product allowing them to make a claim directly with the guarantee and insurance provider. Homeowners would still be able to take a claim for negligence through the courts whether or not they have a guarantee and insurance product.



If the house was sold, the guarantee and insurance product would transfer to the new owners.

MBIE proposes that the guarantee and insurance product would be in place for 10 years once the building work is completed, to align with the implied warranties in the Building Act.

Builders who don't offer a guarantee and insurance product would face financial penalties. Related obligations would be included in the licensed building practitioner scheme requirements.

Homeowners would be able to opt out of a guarantee and insurance product

MBIE proposes that homeowners should be allowed to actively opt out of having a guarantee and insurance product. This would provide choice to homeowners who are in a position to manage their own risks.

Information about the guarantee and insurance product would be included on the building's land information memorandum (LIM). This information could include whether the building had a guarantee and insurance product, the term and extent of cover and who the provider is.

Protections would need to be in place to ensure that homeowners make an informed decision to opt out. These protections could include several measures:

- A 'cooling off period'. The homeowner would be automatically offered a guarantee and insurance product, but be able to apply to opt out once they received confirmation that they're covered.
- A declaration that confirms the homeowner understands the risks of proceeding without a guarantee and insurance product.
- Owner builders could be exempted from having to have a guarantee and insurance product.

MBIE doesn't recommend making guarantee and insurance products compulsory

Some comparable overseas jurisdictions don't allow homeowners to opt out of a guarantee and insurance product.

MBIE considered making a guarantee and insurance product compulsory, with no way to opt out. But we have taken the view that:

- this would be a significant intervention that isn't in proportion with the size of the problem
- this would place greater pressure on the market to be able to meet demand
- this would be unusual for New Zealand as there are no other comparable compulsory private insurance schemes.

MBIE considers it is preferable that homeowners are the policy holder because:

- If the builder was the policy holder, it could be difficult for the homeowner to make a claim as they would have to go through their builder. Their builder may dispute that there is a problem or refuse to submit a claim to the provider.
- There would not be any difference in the costs to homeowners, as builders are likely to pass on the costs of the guarantee and insurance product on to homeowners as part of the cost of the building work. Guarantee and insurance products cost an estimated 1 per cent of the value of the building work.
- It would be challenging to establish and enforce clear rules about what happened to a guarantee and insurance product if the builder holding the product went out of business. Of the building firms established in 2008, only 22 per cent remained in trade 10 years later.
- Having the homeowner as the policy holder is consistent with the existing practice in the market.

MBIE wants stakeholder feedback on how best to make this proposal work

The proposal should apply to all residential buildings – including high-rise apartment buildings

MBIE considers that guarantee and insurance products should be required for all types of residential buildings. This includes simple detached houses, medium density housing (eg townhouses) and high density housing (eg apartments). This recognises the potential risks faced by all homeowners, irrespective of the type of building they live in.

MBIE has to test whether the existing market would be able to provide guarantee and insurance products for high-rise apartment buildings if they were all required to have a guarantee and insurance product. We will also undertake further work on how this option would apply to mixed-use buildings (eg where a residential building also has office or retail space). MBIE considers that this proposal should cover the residential parts of mixed-use buildings, but more work is needed on how to draw the boundary between residential and non-residential use.

Further work will be undertaken on the types of residential buildings covered by this proposal before MBIE finalises our advice to Ministers. We're interested in your views on what types of residential buildings should be covered.

There are three options for a threshold for guarantee and insurance products for 'significant alterations'

We consider that all new residential buildings should be required to have a guarantee and insurance product. However, not all alterations to existing residential buildings need to have a guarantee and insurance product.

Minor alterations are unlikely to create significant enough risks for homeowners to justify a requirement to have a guarantee and insurance product (eg they're more likely to choose to self-insure). Therefore, MBIE considers that this proposal should apply to 'significant alterations'.

Significant alterations could be defined using a threshold. We've identified three potential thresholds:




- alterations valued at \$30,000 or more
- alterations valued at \$100,000 or more
- alterations that would affect the structure or weathertightness of the building.

Setting the threshold at \$30,000 would be simpler to implement as it would align with the requirement to have a written building contract. However, it would capture lower-risk work. Homeowners may prefer to self-insure as the potential costs of getting defects fixed should be lower. A low threshold may limit the number of builders available to undertake alterations, if they were unable to meet the requirements to offer a guarantee and insurance product.

Setting the threshold at \$100,000 is more likely to capture high-risk work, and it is a level of risk that most homeowners would be less willing to self-insure. A higher threshold would have a smaller impact on builders who were unable to offer a guarantee and insurance product, as they would still be able to do work under the threshold. This threshold may make it harder to remember the different requirements, as it's a different threshold to the requirement for written building contracts.

Another option is to base the threshold on the type of work done. This would capture work that is more at risk of defects that could result in high repair costs (eg work that affects the structure or weathertightness of the building). This threshold may be harder to clearly define or implement

Options for a threshold for the requirement to have a guarantee and insurance product

	OPTION 1 At \$30,000	OPTION 2 At \$100,000	OPTION 3 Type of work done
	<ul style="list-style-type: none"> ✔ Simple to implement ✔ Mirrors threshold requirement for a written building contract 	<ul style="list-style-type: none"> ✘ Doesn't mirror threshold for written building contracts 	<ul style="list-style-type: none"> ✘ Harder to clearly define or implement
	<ul style="list-style-type: none"> ✘ Captures lower-risk work that homeowners may prefer to self-insure 	<ul style="list-style-type: none"> ✔ Captures a level of risk that most homeowners are less willing to self-insure 	<ul style="list-style-type: none"> ✔ Captures riskier work
	<ul style="list-style-type: none"> ✘ Fewer builders may be available to undertake alterations 	<ul style="list-style-type: none"> ✔ Lower impact on builders who can't offer a guarantee and insurance product 	<ul style="list-style-type: none"> ✔ Lower impact on builders who can't offer a guarantee and insurance product

Minimum standards should apply to guarantee and insurance products

MBIE proposes setting minimum standards or requirements for guarantee and insurance products. The minimum standards would be set in regulations. Public consultation on these standards would be undertaken before the regulations are put in place.

MBIE has identified the following areas that the minimum standards need to cover (at the least):

- the type of product (eg insurance, guarantee)
- the types of events that are covered (eg loss of deposit, non-completion of building work, defects etc)
- the minimum level of cover to be provided
- the period of cover for different types of events
- the nature of redress (eg if the provider will provide monetary compensation or arrange someone to fix a defect, and whether the homeowner has to try to get the builder to repair any defects in the first instance)
- the maximum claim value
- dispute resolution processes
- the ability to transfer the guarantee and insurance product to subsequent owners of the building.

Providers would have to certify that their product meets the minimum standards. It would be an offence to hold out that a product meets these requirements when it did not.

Financial and prudential requirements would need to be placed on providers of guarantee and insurance products

This proposal depends on enough guarantee and insurance products being available in the market. Currently, only three products are available. Based on current evidence, the existing providers have the capacity between them to cover the entire residential building market.¹⁴

Current evidence suggests that additional providers are unlikely to enter the New Zealand market. These providers may be, for example, insurers operating in New Zealand who don't currently offer guarantee and insurance products, or guarantee and insurance providers based overseas.

Providers have been reluctant to enter the New Zealand guarantee and insurance product market for a number of reasons. Guarantee and insurance products have not always performed well internationally. It is a unique form of 'long-tail' liability insurance. Homeowners pay a one-off premium in return for being covered for up to 10 years. This can be a significant liability for providers and they can find it hard to take steps to manage those risks (such as raising premiums or declining cover). Additionally, the total premium pool for guarantee and insurance products is relatively small. The average total cost of building a new residential building in 2017 was estimated to be \$642,296. Guarantee and insurance products are estimated to cost around 1 per cent of the cost of the build, giving a potential premium pool of around \$200 million.¹⁵ Residential consents are estimated to reach a peak of 43,000 a year in 2023.¹⁶

¹⁴ Covec (2018) *Guarantee and Insurance Products: Market and policy analysis*. Report prepared for the Ministry of Business, Innovation and Employment.

¹⁵ Covec (2018) *Guarantee and Insurance Products: Market and policy analysis*. Report prepared for the Ministry of Business, Innovation and Employment.

¹⁶ Ministry of Business, Innovation and Employment (2018) *National Construction Pipeline Report 2018: A Forecast of Building and Construction Activity* (6th ed.)

In Australia, most states have mandated the purchase of guarantee and insurance products. Many states have experienced a collapse of their private insurance market, leading to state government intervention in the market. The risk of similar events occurring in New Zealand must be considered.

Regulation of providers can help to ensure their financial stability and continuing viability. Insurers in New Zealand are currently regulated by the Reserve Bank under the *Insurance (Prudential Supervision) Act 2010*. This Act requires insurers to meet various standards, including solvency, auditing requirements, security and prudential requirements.

MBIE needs to consider whether:

- the existing requirements under the *Insurance (Prudential Supervision) Act* should apply to guarantee and insurance providers
- a different standard to the *Insurance (Prudential Supervision) Act* is more appropriate so as to ensure an adequate supply of guarantee and insurance products
- guarantee and insurance providers should be subject to further regulation, including what should happen if a provider is no longer in business.

Questions for stakeholders



4.1	Do you support the proposal to require guarantee and insurance products for residential new builds and significant alterations?
4.2	Do you think homeowners should be able to actively opt out of having a guarantee and insurance product?
4.3	Should there be conditions on when homeowners are able to opt out? What should these conditions be?
4.4	What types of buildings do you think should be required to have a guarantee and insurance product?
4.5	What threshold do you think the requirement for a guarantee and insurance product should be set at?
4.6	Do you have any views on the minimum standards that should be set for a guarantee and insurance product? For example: the type of product, the types of events that are covered, the minimum level of cover, the period of cover, the nature of redress, the maximum claim value, dispute resolution processes, the ability to transfer to new owners.
4.7	What financial and prudential requirements do you think should be placed on providers to ensure there is a continuing supply of guarantee and insurance products? For example: reinsurance or other insurance backing, solvency, auditing requirements, security and prudential requirements.

How the proposed change measures up to our five assessment criteria



Does the proposal meet the objectives for risk and liability?

The impact of this proposal depends on a well-functioning market for guarantee and insurance products.

The current number of providers in the market is small. Further work is needed to test whether the market can meet potential increased demand and the regulatory requirements on providers.

If a well-functioning market is operating, then this proposal should meet three of the four objectives for risk and liability.

Each party understands their roles and responsibilities in the building process, the risks they face and their options for managing those risks.

Homeowners would have to make an informed decision about their risks and options for managing these as part of the process of opting out of a guarantee and insurance product.

The proposal would introduce more system checks on the quality of builders, as providers would want assurance of the builder's competency and financial viability before they would allow the builder to offer guarantee and insurance products.

Each party has access to cost-effective options for managing their risks.

Homeowners would have effective options to manage their risks. With an active 'opt out' in place, people are more likely to remain with the default option so they would be more likely to be covered by a guarantee and insurance product.

Homeowners have access to cost-effective ways to quickly resolve disputes about building work.

It should be easier for homeowners to get their build completed or defects fixed if their builder is no longer in business.

Each party faces risks that are in line with their role.

It is unclear if the proposal would ensure that each party faces risks that are in line with their role. This depends on whether guarantee and insurance providers try to recover the costs of a claim from other parties who had contributed to the defect.



Does the proposal support the desired behavioural shifts in the building sector?

The proposal should support the desired behavioural shifts for homeowners and builders.

In making an informed decision on whether to opt out, homeowners would become more aware of their risks and take steps to manage them.

Builders would be further incentivised to undertake quality building work so they continue to meet providers' requirements for offering a guarantee and insurance product and they can continue to operate in the residential construction market.



Would the benefits of the proposal outweigh the risks and costs?

Further work is needed to quantify the costs and benefits of this proposal.

The use of guarantee and insurance products would increase upfront costs for some homeowners. Homeowners could opt out if a guarantee and insurance product did not suit their particular circumstances.

When something does go wrong, the overall costs for homeowners with a guarantee and insurance product should be lower. The cost and effort associated with making a claim should be lower than having to seek redress from other parties involved in the building work, particularly if those parties are unwilling to resolve the problem or are no longer in business.

Some builders who don't currently offer guarantee and insurance products may face increased compliance costs. They would incur costs to meet the requirements on them to be able to offer a guarantee and insurance product, and administrative costs (such as filing applications with providers).

Increased regulation and oversight of this market would likely add costs to the government and to guarantee and insurance providers.

The long-term benefits of reduced defects and improved quality in the system should outweigh the short-term compliance and regulatory transition costs.

One risk is that an external shock, such as in financial markets, may adversely affect the ability of providers to stay in the market. In some Australian states, the state government was forced to intervene after insurers withdrew from the market due to the poor performance of the home warranty sector. The government may face political pressure to intervene if an external shock was to occur.

MBIE is aware that some builders don't comply with the requirement to provide a written contract. This suggests some builders may not offer homeowners a guarantee and insurance product. MBIE considers that increased enforcement and advising homeowners on what to ask their builder would help to mitigate this risk.

Recording the guarantee and insurance product on the LIM would provide a way to check if a guarantee and insurance product was in place. This record may help to identify potential non-compliance for regulators to follow up.



Is the proposal consistent with other elements of the building regulatory system?

This proposal is consistent with other elements of the building regulatory system as it complements the existing consumer protection measures.

It is possible that this proposal could have a limiting effect on innovation. To manage their risk, guarantee and insurance providers might choose to limit their cover to tried and tested building methods and products, and could be more reluctant to cover new and innovative builds.



Is the proposal consistent with related government policy and regulations?

This proposal is consistent with other government policies, providing it doesn't significantly reduce the supply of builders to build new homes. MBIE doesn't know yet how many builders would meet the requirements to be able to offer a guarantee and insurance product.

A long transition period would help to mitigate the risk from a drop in the number of available builders as it would give them time to adjust. Alternatively, the risk could be mitigated by setting a high threshold for when guarantee and insurance products are required.

The price of housing might increase slightly if building owners or developers pass on the cost of a guarantee and insurance product to subsequent owners.

Potential impacts of the proposed change



Homeowners

Improved awareness and take up of guarantee and insurance products. This would offer them protection in the event of lost deposit, non-completion and post-completion defects.

May increase immediate costs of building. Premiums for a guarantee and insurance product are estimated to be about 1 per cent of the value of the building work. We consider that these costs are offset by greater protection if something goes wrong. Homeowners could opt out if they believe a guarantee and insurance product isn't right for them.

Given the current size of the market, homeowners would have limited choices of guarantee and insurance product providers. The provider is likely to be determined by their builder. However, the guarantee and insurance product is likely to be one of many factors that help inform their decision on which builder to use. Regulating minimum standards for guarantee and insurance products would help mitigate the limited choices for homeowners.



Builders

May have increased costs (eg membership/application fees, administration costs) if not already able to offer a guarantee and insurance product.

Stronger incentives to ensure work complies with the building code and run a sound business in order to be able to continue to offer guarantee and insurance product.

If not eligible to offer a guarantee and insurance product, would have to choose to only do residential work under the threshold or subcontract to another builder.



Designers

No direct impact.

**BCAs**

New role to register and monitor the presence of a guarantee and insurance product.
May require changes to their systems.

**Guarantee and insurance providers**

Increased demand for their products.

Would need to review their products and processes to ensure that they comply with new requirements.

Would need to approve builders who apply to them to be able to offer their products.

**Guarantee and insurance market**

May incentivise new providers to enter the market or a greater range of products on the markets, but this seems unlikely based on current evidence.

**Government**

Increased role in monitoring and enforcing guarantee and insurance products as well as existing consumer protection measures.

Questions for stakeholders**4.8**

If residential new builds and significant alterations are required to have a guarantee and insurance product, what do you think the impacts will be?

4.9**For builders:**

How difficult will it be for you to gain eligibility to offer a guarantee and insurance product?

A two-year transition period

The proposed change would require a change to the *Building Act*. Once the legislation has been changed, the following things need to happen:

- Regulations would need to be put in place that set out the minimum requirements for guarantee and insurance products.
- Guarantee and insurance providers would need enough time to prepare for the increased demand and to ensure their products meet the minimum standards.
- Builders would need time to meet the requirements set by providers to allow them to offer guarantee and insurance products.
- Builders and BCAs would also need to change some of their processes and systems.

MBIE considers that a two-year transition period is needed after the regulations are made for these things to happen. We're interested in your feedback on how long the transition period should be.

Implementing a guarantee and insurance product would take time. A possible interim measure is to introduce a requirement to record on the LIM whether a guarantee and insurance product is in place. This would help to signal the importance of a guarantee and insurance product to home buyers.

An information and education campaign would support any changes, to ensure people are aware of, and understand, them.

Questions for stakeholders



4.10

How long do you think the transition period for guarantee and insurance products needs to be to ensure providers, builders and BCAs are prepared for the changes?

4.11

Is anything else needed to support the implementation of guarantee and insurance products?

Two options MBIE considered but doesn't recommend

Below are two alternative options for guarantee and insurance products, but MBIE doesn't recommend either of them.

- Rely only on increased educational campaigns to try and increase the use of guarantee and insurance products: This option by itself is unlikely to be effective at increasing the uptake of guarantee and insurance products. As a result, many homeowners may still have no protection. Further, this option wouldn't be durable as many homeowners only build a new home once in their lifetime. They may not receive the information when they need it and have a significant ongoing cost to the Government of a continued awareness campaign.
- Have the government provide guarantee and insurance products: This option would incur significant costs to implement. While homeowners would be covered, it would crowd out the private market for guarantee and insurance products. The costs of introducing a government scheme wouldn't equate with the size of the risk being managed.

MBIE wants stakeholders' feedback on the liability of BCAs

There are concerns that BCA liability may be disproportionate – or create a risk-averse consenting process

A BCA can be liable for a building defect where the BCA's actions or inactions have contributed in some way to that defect.

Suggestions to limit the liability of BCAs have been driven by concerns that:

- BCAs' financial contributions towards fixing defective buildings are disproportionate to their largely supervisory role in the building process
- BCAs' potential liability exposure results in risk-averse consenting processes.

MBIE proposes to leave BCAs' liability as it is – but have considered how a cap might work

Based on the evidence currently available to us, MBIE proposes not to make any changes to the liability settings for BCAs. However, this position is based on assumptions that need to be tested further. For that reason, we are seeking your feedback on two options:

- leave the liability settings for BCAs unchanged (preferred)
- place a cap on BCA liability.

This section describes how a cap would work and sets out our initial assessment of both options.

2. Leave the liability settings for BCAs unchanged

Proposal

Leave the liability settings for BCAs unchanged.

How a percentage cap on BCA liability could work

MBIE has examined different ways to limit the liability of BCAs. Of the options looked at, we consider that placing a cap on the amount BCAs would have to pay is the option that best meets the objectives. But all of the options could have significant risks for the performance of the building sector.

BCA liability could be capped at 20 per cent

Under this option, BCAs that are found to have contributed to a defective building would pay no more than 20 per cent of the total losses.

Any cap would apply to all types of buildings

This option would apply to all types of buildings, including residential and commercial. The joint and several liability settings for other parties in the building process (such as product manufacturers and suppliers, designers, builders and developers) wouldn't change.

Setting a cap of 20 per cent would be broadly consistent with previous court decisions

MBIE proposes setting any cap on the liability of BCAs at 20 per cent. This figure would be more closely aligned with their supervisory role in the building process.

A cap of 20 per cent is broadly consistent with decisions made by New Zealand's courts. The courts make an assessment for liability based on the specific facts and circumstances of each case. Precedent suggests that a BCA's liability in each case is assessed by reference to the nature (and value) of its role and responsibility in that building's process. This has been determined to be in the region of 20 per cent.¹⁷

A percentage-based cap has advantages over a dollar-based cap

In 2014, the Law Commission recommended capping liability at \$300,000 for a single dwelling; \$150,000 per unit in a multi-unit development with a total cap of \$3 million per multi-unit development. MBIE considers that a dollar-based cap would be difficult to apply (as the thresholds would need to be regularly adjusted) and may result in unfair outcomes for owners of higher-value buildings. The thresholds are likely to be arbitrary amounts as data on where to set the thresholds is limited. The main advantage of a dollar-based cap is that it would provide greater certainty on the maximum amount that a BCA would have to pay.

¹⁷ Court decisions have broadly supported this approach since the late 1970s (see *Anns v Merton London Borough Council* [1978] AC 728, 755 (UK) and *Mount Albert Borough Council v Johnson* [1979] 2 NZLR 234). The approach taken is that a building consent authority's liability is limited by the nature of its more passive, regulatory role (compared with the more active role carried out by builders/architects). For example, in *Morton v Douglas Homes Ltd* [1984] 2 NZLR 548 the High Court fixed the council's liability at 15%, and referred to the council's inspector's role as "only supervisory". In *Body Corporate 188529 v North Shore City Council* [2008] 3 NZLR 479 Justice Heath's general conclusion was that the council ought not to be required to meet absolute standards when performing its regulatory functions and that its duty is to respond proportionately to the obligations cast on it. Based on the circumstances before him, he set the council's contribution at 15% as against the developer's 85% share.

MBIE considers that a percentage-based cap would be a better approach. It doesn't have to be adjusted to reflect inflation and wouldn't disadvantage owners of higher-value buildings.

Another option is to have a higher cap where the BCA's contribution to the losses is over 20 per cent

The liability of BCAs could be capped in all situations, irrespective of how much the BCA's actions (or inactions) contributed to the defect – that is, a blanket cap set at 20 per cent.

Alternatively, in situations where the BCA's contribution is found to be greater than 20 per cent, then its contribution to the losses could be the maximum it would have to pay.

For example, if a BCA was determined to have contributed to 15 per cent of the losses, the most it would have to pay is 20 per cent of the total (its contribution of 15 per cent plus 5 per cent towards any missing parties' contribution). Alternatively, if the BCA was found to have contributed to 30 per cent of the losses, the most it would have to pay is 30 per cent.

The table below illustrates how the two different options would work.

BCA level of contribution to losses	Blanket cap of 20 per cent	Higher cap when the BCA's contribution is over 20 per cent
15 per cent	pays up to 20 per cent of the total: 15 per cent (its share) + 5 per cent (towards losses incurred by any absent parties)	pays up to 20 per cent of the total: 15 per cent (its share) + 5 per cent (towards losses incurred by any absent parties)
30 per cent	pays 20 per cent	pays 30 per cent

A blanket cap is straightforward but could be unfair in some situations

A blanket cap of 20 per cent would be easier to understand. It may make it easier to resolve claims out of court, as the courts wouldn't be required to determine the extent of the BCA's contribution.

Allowing for BCAs to pay a higher share in some situations would send a stronger signal about the importance of BCAs undertaking appropriate levels of scrutiny in carrying out their role. It would reduce some unfairness to other parties who have to pick up some of the BCA's share. However, this potential variation would reduce certainty and may require more involvement from the court in settling any dispute.

MBIE are interested in your thoughts on whether BCAs should pay more than 20 per cent if their contribution to the losses is higher.

The liability settings should not be changed without a requirement to have a guarantee and insurance product

Any limitation to the liability of BCAs would have to be implemented at the same time as the proposal to require a guarantee and insurance product. If the only change was to limit the liability of BCAs, then homeowners would risk greater financial losses if the building turns out to have a defect.

How the two options measure up to the five assessment criteria

The assessment below considers two options:

- Leave the liability settings for BCAs unchanged. When assessing this option, MBIE has assumed that all the other changes in this discussion paper have been made. We've described this option as the 'enhanced status quo'.
- Place a 20 per cent cap on BCA liability.



Does the proposal meet the objectives for risk and liability?

Enhanced status quo

There would be no direct impact on the objectives for risk and liability.

The impact on BCAs' liability would depend on whether guarantee and insurance providers try to recover the costs of claims from BCAs. If they did not, guarantee and insurance products would help to reduce BCAs' contributions when some parties are absent.

Incentives for parties to change how they manage risks would not change directly. Homeowners are assumed to be more likely to have a guarantee and insurance product.

Changes to building products and methods and occupational regulation would increase awareness of parties' roles and responsibilities.

20 per cent cap

While it would meet the objective that the liability of BCAs is better aligned to their role, this wouldn't be the case for others in the building process.

It would increase the amount that other parties have to contribute. In some cases, the amount they have to contribute may be greater than their role.

Limiting BCAs' contribution would provide a strong signal to some participants that they cannot rely on BCAs alone to identify defects or to contribute towards any losses to a significant extent. This may encourage these participants to put in place other mechanisms to manage their risks.

It may strengthen incentives for builders and designers to take out professional indemnity insurance. However, this option may increase costs for insurance providers and, in turn, affect the cost or availability of professional indemnity insurance. This could potentially reduce the availability of cost-effective options to manage people's risks.

This option wouldn't affect the other objectives for risk and liability.



Does the proposal support the desired behavioural shifts in the building sector?

Enhanced status quo

The incentives for parties to change their behaviours would not directly change.

Proposed changes to building products, methods and occupational regulation (and offences and penalties) would incentivise behavioural changes that lead to higher-quality building work.

BCAs have identified a range of factors that influence how they approach consenting. The proposed changes to building products and methods and occupational regulation should give BCAs greater confidence in the overall quality of the building sector. This, in turn, should support them to introduce more efficient consenting processes.

20 per cent cap

Limiting BCA contributions may strengthen the incentive for homeowners to take out a guarantee and insurance product. However, it is unlikely that BCA liability is a significant factor in their decision making.

This option may incentivise builders and designers to improve their quality assurance processes, resulting in better building work. On the other hand, it may lead to more risk-averse behaviour that would lead to increased costs or delays in the building process. Examples are when technical experts don't want to be involved in more complex building work or need more assurance before they provide a producer statement.

Risk aversion may lead some participants to rely more on contracts so they can shift some of their risks on to others. Where these risks are outside the other parties' control, this may increase the risk of insolvency when something does go wrong.

The responses from builders and designers would depend to some extent on whether the other proposed changes reduce the number of building defect claims.

This option may provide BCAs with greater confidence to be less risk-averse about how they fulfil their roles and responsibilities. However, a number of factors drive the consenting approach of BCAs. The proposed changes to building products and methods and occupational regulation are likely to play a greater part in changing their behaviour.



Would the benefits of the proposal outweigh the risks and costs?

Enhanced status quo

Further work is needed to quantify the costs and benefits of this option.

BCAs should face no direct change to their costs. Indications are that the BCAs' liability risk may be decreasing. Research indicates that the number of defective building cases involving BCAs has decreased since 2012. It is assumed that the other proposed changes would increase the quality of building work, further decreasing the number of building defect cases.

20 per cent cap

Further work is needed to quantify the costs and benefits of this option.

This option would likely increase the share of costs that other participants in the building system, such as designers and builders, would have to contribute in liability cases. Homeowners would find it difficult to recover costs from builders and designers who don't have sufficient assets or insurance to cover the losses.

This option may not change the total costs that fall on homeowners and rate payers. It may only change the way costs are spread among them. The total costs may decrease if the quality of building work increases.

We intend to undertake further work to test how this option would affect the provision of guarantee and insurance products. One risk is that capping liability reduces the attractiveness of the market to providers, as it would limit their ability to recover costs. Alternatively, it may significantly increase the cost of guarantee and insurance products for homeowners. Both scenarios would reduce the uptake of guarantee and insurance products and potentially leave homeowners financially exposed.



Is the proposal consistent with other elements of the building system?

Enhanced status quo

If the liability settings are creating ineffective consenting processes, then the settings may be working against what the regulatory system is trying to achieve.

20 per cent cap

This option would be consistent with other elements of the building regulatory system if it incentivises more efficient consenting processes and quality building work. If it leads to more risk-averse behaviour by other parties, then it would work against what the regulatory system is trying to achieve. It may limit innovation and the use of new products or building methods. It may shift to other parties more risk than they're able to manage. This may reduce firm viability or increase insolvency.



Is the proposal consistent with related government policy and regulations?

Enhanced status quo

If the liability settings are creating ineffective consenting processes, then the impact on the building of new houses may be limited.

20 per cent cap

More work is needed to identify what impact this option might have on the building of new houses. It may reduce the viability of a development if a suitable guarantee and insurance product (or another type of risk management mechanism) isn't available or the costs of building increase.

Potential impacts of the option to cap BCA liability

The assessment below only considers the potential impacts of a cap on BCA liability.

Making no changes to the liability settings should have no direct impacts – the indirect impacts are identified in all other parts of the discussion paper.



Homeowners

Should be no direct impact if the homeowner has a guarantee and insurance product and they can make a claim.

Increased risk of financial losses if they don't have a guarantee and insurance product.

May create a barrier to taking claims related to BCA negligence (as the costs may outweigh the potential amount that could be paid).

Size of impact depends on what impact there is on the availability of guarantee and insurance products and the cover provided.



Owners of non-residential buildings

Greater risk of financial losses.

May increase use of mechanisms to control risks, such as insurance, contracts, performance bonds and retentions. Could have negative outcomes (eg increased risk of insolvency) if shift risks to other parties who are unable to control those risks.



Builders and designers

Potential to face greater share of losses, especially if other parties absent. The losses may be greater than their role.

May incentivise use of professional indemnity insurance. But may have negative impacts on availability of this type of insurance.

May be reluctant to take on riskier or more complex building work.

May lead to increase in insolvencies.



BCAs

Likely to face lower liabilities from defective buildings.

May make it easier to get insurance cover.

Unlikely to directly impact on consenting process.



Guarantee and insurance providers

May find it harder to recover costs of claims from other parties.

May reduce viability of providing guarantee and insurance products.

Questions for stakeholders



- | | |
|-------------|---|
| 4.12 | If the government decides to make all the other changes in this discussion paper, do you agree that that the liability settings for BCAs will not need to be changed? |
| | What area of work do you think will have the biggest impact on BCA consenting behaviour? |
| 4.13 | If the government decides to limit BCA liability, do you support the proposal to place a cap on BCA liability? |
| 4.14 | If there is a cap on BCA liability, do you agree that the cap should be set at 20 per cent? |
| 4.15 | If there is a cap on BCA liability, do you think BCAs should have to pay more than 20 per cent if they have contributed to more than 20 per cent of the losses? |
| 4.16 | What do you think would be the impacts of placing a cap on BCA liability? |
| 4.17 | Do you have any other comments on these proposals? |

Three options MBIE considered but doesn't recommend

Below are three further options for the liability of BCAs, but MBIE doesn't recommend them as they fail to meet the objectives for risk and liability.

- **Restrict liability to dangerous defects.** The liability of BCAs would be restricted to where they have been found to contribute to a defect that risks causing death or serious injury or illness. This option was based on the approach taken in British Columbia, Canada. However, it's hard to define 'dangerous defect'. The term may be interpreted broadly, which could result in little or no change. It would result in some uncertainty and increased costs from court cases (to test the definition of 'dangerous defect').
- **Restrict the liability to residential buildings.** BCAs currently have a common duty of care for all types of buildings. A differentiated duty of care would introduce more complexity because of the lack of a clear boundary between residential and non-residential buildings, especially in mixed-use buildings. Costs would increase as people tested the boundaries. This option wouldn't align well with the roles and responsibilities of BCAs.
- **Introduce proportionate liability.** Under proportionate liability, each defendant is only liable for the proportion of damage that they caused. Proportionate liability wouldn't protect homeowners from financial loss, and may deter guarantee and insurance providers from entering the market due to the lower likely recovery of damages from others in the system. Homeowners would find it hard to show how much each defendant contributed to their loss. Court costs are likely to increase as the parties dispute their proportion of contribution. The Law Commission has recommended against moving to proportionate liability for building-related claims.

Recap of questions

Part 4 – Risk and liability



4.1	Do you support the proposal to require guarantee and insurance products for residential new builds and significant alterations?
4.2	Do you think homeowners should be able to actively opt out of having a guarantee and insurance product?
4.3	Should there be conditions on when homeowners are able to opt out? What should these conditions be?
4.4	What types of buildings do you think should be required to have a guarantee and insurance product?
4.5	What threshold do you think the requirement for a guarantee and insurance product should be set at?
4.6	<p>Do you have any views on the minimum standards that should be set for a guarantee and insurance product?</p> <p>For example: the type of product, the types of events that are covered, the minimum level of cover, the period of cover, the nature of redress, the maximum claim value, dispute resolution processes, the ability to transfer to new owners.</p>
4.7	<p>What financial and prudential requirements do you think should be placed on providers to ensure there is a continuing supply of guarantee and insurance products?</p> <p>For example: reinsurance or other insurance backing, solvency, auditing requirements, security and prudential requirements.</p>
4.8	If residential new builds and significant alterations are required to have a guarantee and insurance product, what do you think the impacts will be?
4.9	<p>For builders:</p> <p>How difficult will it be for you to gain eligibility to offer a guarantee and insurance product?</p>
4.10	How long do you think the transition period for guarantee and insurance products needs to be to ensure providers, builders and BCAs are prepared for the changes?
4.11	Is anything else needed to support the implementation of guarantee and insurance products?

4.12	If the government decides to make all the other changes in this discussion paper, do you agree that that the liability settings for BCAs will not need to be changed?
	What area of work do you think will have the biggest impact on BCA consenting behaviour?
4.13	If the government decides to limit BCA liability, do you support the proposal to place a cap on BCA liability?
4.14	If there is a cap on BCA liability, do you agree that the cap should be set at 20 per cent?
4.15	If there is a cap on BCA liability, do you think BCAs should have to pay more than 20 per cent if they have contributed to more than 20 per cent of the losses?
4.16	What do you think would be the impacts of placing a cap on BCA liability?
4.17	Do you have any other comments on these proposals?



Have your say

See **page 4** of the introduction (Part 1) for details on how to submit your feedback.



**Submissions close
on 16 June 2019**

List of acronyms

BCA Building consent authority

LIM Land information memorandum

MBIE Ministry of Business, Innovation and Employment
