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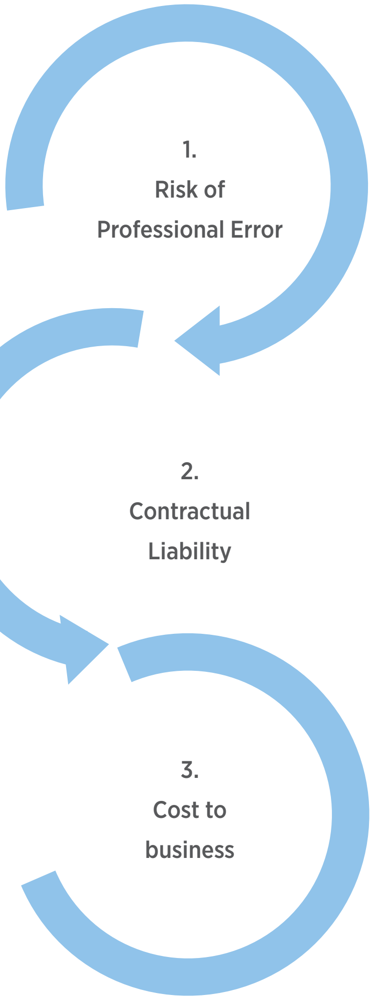
WHITEPAPER

Professional Indemnity Insurance Insight

The Value of Professional Risk Management for Design & Build Contractors



This diagram simply illustrates how the risk of professional error manifests itself as a cost to the business.

A certain level of risk is inherent with all professional activities, but the implementation of a proactive Risk Management (RM) strategy can minimise both the frequency and severity of professional errors, and better protect the contractor against resultant contractual liability.

While this will undoubtedly make their risk more appealing to PI insurers, discounting the cost of risk transfer, the benefits are far more wide-ranging. Not only can the business see a reduction in the cost of risk which they retain (e.g. losses within the policy excess); they will also help to guard against the intangible cost of reputational damage which results from professional error.

Introduction

In the construction insurance industry, there is one topic which has dominated above all others in recent months; the turbulent state of the Professional Indemnity (PI) insurance market.

It is an issue affecting all contractors to a greater or lesser extent. For many PI represents their largest insurance spend and, in addition to providing balance sheet protection, it also features as a standard requirement in most design and build contracts. PI insurance is therefore a prerequisite to trade.

However, all challenges present opportunity and this one is no different. There are a range of risk management measures which the contractor can take to mitigate their professional risks, the implementation of which will stand the company in good stead for the long term, irrespective of the state of the PI market (see the adjacent diagram). However, to have a tangible impact on PI renewal outcomes it is critical that the contractor works closely with a specialist insurance broker who has experience of articulating the benefits of a well-considered risk mitigation strategy to insurers.

Background

Hard Market Conditions

As with other industries, the insurance market goes through ‘cycles’. These cycles comprise periods when the market has a surplus of capacity, creating a benign environment for insurance buyers, and periods where capacity is restricted, with insurers’ diminished appetite making for a challenging marketplace. In the insurance world, a period restricted capacity is known as a Hard Market, which is characterised by increased premiums and excesses along with more restrictive policy terms and conditions.

Causation

The usual trigger for Hard Market conditions is a spell of low profitability for insurers driven by an adverse claims trend. In the case of the construction PI market, recent years have seen a spate of major claims activity arising from contractors’ acceptance of process risk in relation to Energy from Waste (EfW) projects and the consequential failure of the design supply chain. Insurers were quick to impose policy restrictions on those who continued to operate in this sector. This was followed by the Grenfell tragedy in June 2017 and the resulting government enquiry into building regulations and fire safety. In conjunction with this, building owners and contractors have undertaken project reviews and identification of affected buildings, drafted remedial solutions and engaged in the procurement of corrective works. This has led to a huge volume of claims notifications to the PI market by both designers and contractors who were caught up in specification of ACM cladding systems. All of this came on top of a general increase in claims sustained by the PI market, including a number related to PPP projects under which contractors assume greater risk than with conventional forms of contract.

Against the backdrop of a prolonged period of soft market conditions, it was inevitable that this claims activity would cause a seismic change in insurer appetite.

Current State of Market

These factors have culminated in a volatile marketplace, with at least six insurers having ceased to write construction PI over the past eighteen months. For their part, Lloyds have also recognised this dire performance; a 2018 report labelled PI (non-US) as the second worst-performing class of business and the Lloyds Performance Management Division (LPMD) has imposed remedial plans on insurers to address this underperformance.

What has this meant for Construction PI buyers?

When it comes to renewal, the two factors which are sure to attract greatest attention are the premium and level of retained risk (i.e. policy excess). On both measures 2018 and Q1 2019 have seen a dramatic shift for construction PI buyers. However, there is no 'rule of thumb' on the scale of increases; each contractor has their own unique risk profile and each underwriter their own specific business appetite.

In addition to the headline grabbing numbers, underwriters have also looked to restrict the cover afforded by the policy in a number of other ways, particularly where there are concerns around the contractors risk profile and/or historic claims experience.

The most widespread example of this is the application of restrictive clauses in relation to cladding, external wall systems, and fire protection of buildings which are now commonplace. In addition, contractors with a distressed claims experience may have faced a challenge to retain cover subject to unlimited 'round the clock' reinstatements of the aggregate limit, particularly where the overall programme limit is relatively modest. In certain cases unlimited reinstatements have only been offered on condition of the contractor purchasing a higher overall limit.

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Contractor Renewal Strategy

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What is clear is that the majority of design and build contractors do not have the luxury of deciding whether or not to purchase PI insurance. A failure to procure PI cover would not only act as a barrier to winning new work, but under existing contracts there will be an obligation to maintain the cover for a defined period of up to twelve years. The only contractual release from these obligations typically requires that PI insurance is unavailable to the contractors peer group at commercially reasonable terms and conditions. While there will be different interpretations of what constitutes commercially reasonable terms, employers would rightly point out that the vast majority of design and build contractors continue to maintain PI cover notwithstanding the current market dynamics.

Faced with the obligation to maintain cover, and a challenging insurance marketplace, what options are available to a contractor to protect against unsatisfactory renewal outcomes?

On a practical level, there are a handful of measures which a contractor and their broker should be taking;

- **Commence the renewal process as early as possible**
  Insureds should allow at least 30 additional days for marketing of their policy. This can protect against a situation where there is insufficient time to obtain alternatives following receipt of initial quotations.
- **Provide insurers with fully detailed underwriting information**
  In the current climate insurers can afford to be selective, and they are unlikely to even consider a risk on which underwriting information is scarce or poorly presented.
- **Meet with the insurance market**
  Underwriters welcome the opportunity to hear about their insured's business first-hand; allowing them a better understanding of their activities, strategy and risk management approach. This fosters a close relationship with insurers and may prove to be particularly valuable for those insured's with challenging claims experience.
- **Refine the claims experience**
  The insured must carefully consider the status of each of their notified claims, ensuring that all outstanding matters remain valid or are otherwise closed off. It is also critical to demonstrate to insurers that lessons have been learned as a consequence of any incurred loss (e.g. a change in appetite for similar projects or specific contractual safeguards).

Market Selection

In addition the contractor may adopt a number of different strategies, both in terms of Market Selection and Programme Structure, in order to navigate the market effectively:

- **Benchmarking**
  With a number of insurers exiting the market, and others reducing their capacity and/or declining to consider certain activities, straightforward renewals are few and far between. This reduction in average capacity being deployed means that a larger number of insurers are required to complete programmes. For many insureds it may therefore be necessary to undertake a full remarketing exercise to ensure a positive renewal outcome.

- **Cross Class Agreement**
  Where a PI insurer is able to write additional lines of business, it may be beneficial to market the PI as part of a cross class deal. Leveraging these relationships and reviewing total premium spend with each insurer on additional lines of business can help to secure preferential PI terms.

Programme Structure

- **Differential Self Insured Retention Structure**
  Where certain projects or operating units are perceived to present a greater risk than others, it may be necessary to voluntarily impose a higher excess in order to retain acceptable terms, conditions and excesses for the remainder of the business.

- **Increased Programme Limit**
  Over recent years certain contractors have seen cumulative high severity losses which have triggered reinstatement of the policy limit. To protect against this, insurers may impose a requirement to arrange a higher overall programme limit to protect against reinstatements.

- **Co-insurance**
  Co-insurance refers to the insured's retention of a proportion of each loss, as if they were a participating insurer e.g. the insured may elect to co-insure 20% of every loss applicable to the primary £5m layer, meaning a potential retained exposure of £1m for the initial policy limit and any subsequent reinstatements. In return for self-insuring this proportion of the risk, the insured should benefit from premium savings in line with the coinsurance percentage, in this case 20% of the total premium for the layer. This saving is likely to be more than that achieved through increasing the policy excess by £1m.

- **Combined Layers/ Re-layering**
  Consideration may be given to combining layers and/or re-layering in order to ensure that the structure appeals to insurers and produces the most cost efficient outcome. For example, it may be preferable to increase the limit applicable to the primary layer where there is a lack of appetite for the low limit / low premium first excess layer sitting above.

- **Captive Involvement**
  While captives are traditionally utilised by contractors to self-insure high frequency and low severity classes of insurance, it may also be feasible to incorporate a limited proportion of their PI risk. Captive involvement is particularly valuable on distressed risks which are subject to substantial rates and/ or excesses.

Professional Services Risk Management (PSRM)

While we advocate that PI buyers explore the aforementioned Renewal Strategies in conjunction with their broker, they do not fundamentally improve the risk which contractors are seeking to transfer to their insurers. Given the market conditions, underwriters are increasingly looking for contractors to demonstrate that they have put in place an effective contractual and behavioural risk management strategy.

In this section we explore some of the risk avoidance, mitigation and transfer measures which may form part of a contractor's PSRM strategy;

Contractual Risk Management

Perhaps the most valuable risk management tool at the contractors' disposal is their ability to be selective in the work which they undertake. It is therefore critical that senior management provide clear direction on their business appetite, management of the supply chain and contracting approach.

1. Business Appetite

While it is important to retain a degree of commercial licence, organisations should have established guidelines which convey their appetite for work and influence their decision making on whether or not to tender. Increased professional risk is a natural by-product where contractors accept work which is outside of their zone of appetite. Key questions which should be addressed as part of this governance include:

- **Expertise** - Does the business have experience in completing contracts of a similar nature, taking account of the market sector, scope of work, skills required and size of contract?
- **Geographic Location** - Does the business have experience and / or knowledge of legislation, customs, geotechnical and climatic conditions which are specific to this territory?
- **Employer Relationship** - Has the business worked with this employer before? Does the employer take a complimentary approach to dispute resolution?

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2. Supply Chain

The contractor’s ability to manage their professional risks is intrinsically linked to the performance of their supply chain. For this reason, it is critical that the contractor conducts appropriate due diligence in selecting supply chain partners, taking account of the following:

- **Expertise** - Does the supply chain partner’s business have experience in completing contracts of a similar nature, taking account of the market sector, scope of work, skills required and size of contract?
- **Financial Integrity** – Does the business have a balance sheet which is strong enough to withstand an appropriate level of uninsured losses? It is unfortunately too often the case that when a problem arises on a project and the contractor turns to the responsible member of the supply chain for recompense, he finds they have gone out of business.
- **Insurance Position** – Does the business maintain an appropriate level of PI insurance?

The contractor must not only apply supply chain controls, but also establish a system of assurance to certify that they adhere to these requirements. One key aspect of this is to check that professional indemnity insurance is maintained for the full limitation liability period required by contract/tort (typically 6 or 12 years post-completion).

3. Contract Terms and Conditions

It is common wisdom that the contract is king, and the contractor therefore lives by the terms and conditions which are agreed at signing. Determining which risks they are willing to accept, and which they will transfer to the supply chain is a key aspect of contractual negotiations.

However, professional appointments and design and build contracts are becoming increasingly lengthy and complex. They incorporate a myriad of terms, conditions, specifications, drawings and other documents produced by a number of different authors. Often insufficient care is taken to ensure that:

i. all contractual documents are consistent

ii. the contractual documents clearly articulate the design requirements and the nature of the duties owed

iii. each member of the design team properly understands their role and the extent to which they need to liaise and collaborate with the client and other members of the design team

iv. there is a clear focus on building safety

v. there are adequate gateways to sign-off at the various stages of the design process

vi. an effective system is put in place to manage the design process

vii. the culture and allocation of risk provisions encourages open and transparent engagement

Faced with these challenges, it is vital that the contractor's approach considers the following:

Head Contract

- Whether the contract includes an overall limitation of liability and the legal effect of such a clause
- The professional standard of care which applies. E.g. Fitness For Purpose, as per the NEC4 Engineering and Construction Clause 20.1, or the lesser obligation of Reasonable Skill and Care which can be achieved through application of optional clause X15 of the same form (note that great care needs to be taken that these standards are not varied by the contractual specifications, drawings and standards).
- Whether the contractor is liable for the employer's indirect and/or consequential losses, and what is meant by those terms.
- Whether the Liquidated Damages payable by the contractor represent a fair and reasonable estimate of damages which would have been recoverable at common law.
- Whether the contract promotes collaborative working. If so, what does that involve and how does that impact upon policy conditions? If the contract does not promote collaboration, what mechanisms are in place to ensure collaboration between the parties?
- Any requirement to provide collateral warranties to funders, freehold/leasehold owners or others.
- Where works commence under a letter of intent; do they properly record the work to be carried out, the standard(s) to which works need to be carried out, and any relevant allocation of risk provisions and any limitations of liability?

Subcontracts

- Whether the subcontract seeks to apply a limitation of liability (and the legal effect of such a clause) or allows the contractor to pursue full recourse
- Whether the professional standard of care mirrors the main contract
- Whether the sub-contract conditions have the effect of expanding a sub-contractor's obligations by providing the employer with an indemnity for breaches of the main contract conditions.
- The level of PI insurance which the supply chain shall be required to maintain, and on what basis, e.g. aggregated or each and every claim limit.
- The need to provide collateral warranties to funders, freehold/leasehold owners or others.

Programme

- **Whether sufficient time been allowed for the design to be produced**
  Contractors are facing great pressure to complete the design and construction of a project within increasingly short timescales, which do not allow a sufficient period for design development and sign-off.
- **Whether the design process involved all relevant designers**
  Contractual disputes frequently occur where there is insufficient ownership and management of the design process. Project managers, who are often not qualified architects or engineers, may adopt a light touch to the management of the design process. This can result in inadequate interrogation of the designs produced so as to ensure that they meet the design brief and are properly co-ordinated.

"Contractual disputes frequently occur where there is insufficient ownership and management of the design process".

Behavioural Risk Management

The contractor's opportunity to avoid and mitigate risk does not cease once terms are agreed and the contract has been signed. A clear behavioural risk management strategy can also assist the client in minimising error throughout the project lifecycle.

This is the principal aim of the Get It Right Initiative (GIRI), a campaign group with membership drawn from across the industry, including employers, contractors, consultants and major sub-contractors. Their 2015 research identified that the total direct cost of avoidable error across the UK construction sector stood at 5% of total project value, approximately £5bn per annum[1]. This figure rose to an astonishing 21% inclusive of indirect costs[2], unrecorded process waste and latent defects.

In light of our commentary around the PI market, it will come as no surprise that four of the top ten causes of error are rooted in deficiencies in design and it is in response to these findings that GIRI have published their *Guide to Improving Value by Reducing Design*[2].This report provides 12 principal recommendations to improve value by reducing error, including the development of collaborative working between partners, and establishing a culture which focusses on positive outcomes for the project as a whole.

1 https://getitright.uk.com/app/uploads/2017/03/GIRI-a-call-to-action.pdf

2 https://getitright.uk.com/app/uploads/2018/11/GIRI_Design_Guide-Improving_Value_by_Reducing_Design_Error_Nov_2018.pdf

Get It Right Initiative – 12 Recommendations

Culture: Every project needs a clearly defined intent, a consistent focus on outcomes and the project team to work seamlessly together and adopt the process of back-briefing.

Increased Investment: Increased investment in design reduces project error.

Robust Approach: A clearly defined and well managed design process should be established at the start of a project, and involve all key members of the project team.

Collaboration: Every project will benefit from collaboration, and effective collaboration will lead to more successful projects with fewer errors. It is up to clients and leaders across all disciplines to act to enable collaboration to take place. The adoption of a Partnering Charter should be a key goal at the start of any project.

Plan: Develop a comprehensive project specific plan of work.

Brief: The briefing process is fundamental in defining client needs and expectations, and requires sufficient time to be completed in collaboration with all relevant parties.

Information: Correct and well-communicated design information is integral to successful communication between designers, clients and contractors.

Stakeholder Management: Time invested in understanding stakeholder needs and the client's sign-off and approval process is never wasted.

Opening Up & Closing Down: Opening-Up' and 'Closing Down' a project allows for all creative thinking and key decision making to be carried out and completed in good time prior to preparation of subsequent production information. This reduces the necessity for change and hence the opportunity for errors.

Contractor Input: All projects, regardless of the form of contract or procurement, would benefit from contractor advice at the design stage. This should be encouraged and would lead to a reduction in design errors.

Handover: If a comprehensive set of information is produced at the handover stage and communicated and reviewed effectively, then the design is less likely to be misinterpreted, resulting in fewer errors.

Guiding the Design Team: Introduction of an Independent Principal Consultant as the 'controlling mind' for design development is critical to ensure that design-related communications are robust, co-ordinated, and well managed.

Given the vast costs associated with avoidable error, any contractor who is able to successfully apply these recommendations across their business will reap rewards which extend well beyond securing favourable PI renewal terms.

Gallagher would like to thank the following individuals who have provided valuable contributions to this paper:

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About Gallagher

Founded by Arthur Gallagher in Chicago in 1927, Gallagher (NYSE: AJG) has grown to become one of the largest insurance brokerage and risk management companies in the world. With significant reach internationally, the group employs over 30,000 people and its global network provides services in more than 150 countries.

Our Construction division arranges insurance for UK and international contractors and designs bespoke owner-controlled programmes across a wide spectrum of projects. Our clients range from contractors and engineers, to sponsors, financiers and government local authorities. With our help, project stakeholders can identify, mitigate and transfer risk more strategically.

We offer products and services to enable our construction clients to manage complex risks of all sizes:

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- Due Diligence.

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