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Insurance | Risk Management | Consulting

2022 Winter/2023 Early Year

Construction Market Update

Many variables drive insurance pricing and availability, but the good news in 2023 for insureds in the Architectural, Engineering and Contracting (AEC) Community is that they can control a number of those variables. Proactive approaches in the renewal process can lead to superior outcomes — either in terms of pricing or coverage.

In this report, we will look at different insurance lines, examine current market conditions, share what we are hearing going into 2023 and then provide some guidance on variables within the insured's control and how to optimize your renewal experience.

We will look at

- Builder's Risk
- General and Excess Liability Insurance
- Professional Liability
- Workers' Compensation
- Cyber Liability

Before getting to specific markets, however, it is important to understand the insurance supply chain. In its simplest form, insurance works by spreading the risk among various policyholders. Insurance companies calculate the probability of a certain level of losses against any number of risks and charge premiums that reflect probable losses. In theory, the premiums will match anticipated losses; but because we are dealing with probabilities, actual losses in any given period may be higher or lower than expected.

As an insured, you purchase insurance from a primary carrier many of whom are household names. primary carriers are subject to state regulation and almost all receive a Financial Strength Rating (FSR) from A.M. Best. In addition, A.M. Best categorizes carriers with a Financial Size Category (FSC), expressed in Roman numerals, ranging from I (less than 1 million) to XV ($2 billion or more).

Even the largest and most financially strong carriers, however, are subject to exceptionally high losses in any given year. Accordingly, they purchase reinsurance from other insurance companies to further spread the risk of exceptional losses. While some reinsurers are not well known outside the industry, they provide a critical backstop for losses incurred by the primary carriers. In the Southeast, at least 12 primary insurers closed their doors between January 2020 and the arrival of Hurricane Ian.[1] Much of this was because the primary carriers were not able to procure reinsurance to cover risks from catastrophic risks like hurricanes. This prompted Governor Ron DeSantis to sign a law pouring $2 billion into a reinsurance relief program.[2]

I. Builder's Risk and Property Insurance

Builder's Risk is just a form of property insurance designed to address the unique risks of property under construction. Despite 2022 being expected to be an active hurricane season, the property insurance market stabilized and few storms occurred — until Hurricane Ian struck South Florida. Loss estimates range from $40 billion to $75 billion from Ian alone.[3]

This lone hurricane proved how fast and far the costs of a catastrophic event have risen. These costs have risen due to a number of factors. Increasing population densities in coastal areas where tropical storms make landfall have increased the number of structures subject to damage in any given storm. The costs of repairing or replacing these structures have also increased because modern houses are getting larger, stretched supply chains have caused the cost of materials to skyrocket, and severe labor shortages have made it increasingly difficult to find and retain workers to rebuild. Material and labor costs have always fluctuated, but downward fluctuations are now limited by overall inflationary pressures.

Commercial property lines were among the most affected by recent inflationary trends.[4] The extent of such increases depends on (i) whether the property is subject to a catastrophic loss and (ii) loss history. Through mid-2022, primary insurance premium increases on properties not subject to catastrophic losses and a good loss history have ranged from flat to 10%. Adding catastrophic loss exposure resulted in increased premiums of 10%–15%. Combining catastrophic loss exposure and a poor loss history resulted in primary carriers increasing premiums by a minimum of 20%[5] and in many cases much more, however, the biggest challenge is not just the cost, but the capacity as carriers are pulling out of CAT areas.

In the first three quarters of 2022, the market was stable outside the catastrophic category. The reinsurance market, however, was driving premiums up for properties subject to catastrophic loss. Even before Hurricane Ian hit, both primary and reinsurance carriers were reducing their exposures in coastal areas, resulting in a loss of capacity. The remaining reinsurance capacity became even more expensive, with rates increasing 15%–25%.[6] These reinsurance rate increases flowed down into primary insurance rates.

We're watching reinsurance costs in coastal areas in 2023 as many reinsurers have reduced capacity for more losses and need to adjust premiums to reflect the risks.

Here's what's ahead for the property insurance market, segment by segment:

Named Windstorm CAT Cover: We expect we'll see a bit of a pullback in the Florida market, with carriers continuing to trim their line size and watching accumulations in certain ZIP codes very closely. On average, we should expect Tier 1 exposed accounts to see rate increases in the 7.5%–15% range, and those numbers could be much higher for Florida customers who had claims from Hurricane Ian. In the aftermath of Harvey, Irma and Maria, clients with major CAT losses saw increases in the 25%–35% range, and we expect nothing less from those impacted by Ian.[7]

- **Wood Frame Builders Risk:** This market segment will remain a major challenge in 2023. Lead carriers and capacity can be counted on one hand, and most carriers will remain very selective on higher risk projects in urban areas. Rates for podium projects in urban areas are constantly hovering around the $0.50–$0.60 range and can then jump to north of $1.0 per $100 annually when you have a high crime score with limited market capacity available to you.[7]
- **California Wildfire/Brush Zone Business:** We will need several more years of less activity to move the market and hopefully have more capacity return to this space. As it stands, capacity is still tough to come by on single location risks and rates are well north of $2.0 per $100 for most clients. We expect to see increases in 2023 in the 5%–15% range.[7]
- **California Earthquake/Difference in Conditions:** California Earthquake (EQ) capacity remains as one of the most stable and most competitive segments within the property insurance marketplace. There's a lot of competition in the Difference in Conditions (DIC) world and as a result, clients will see some decreases and flat renewals with a bit more regularity (especially those in the middle market space).[7]
- **Multifamily Wood Frame Garden Style Apartments:** Clients with a 5-year track record of profitably and substantial replacement cost values will most likely see increases in the mid- to high-single digit range. Clients who have valuation and/or loss issues will likely see increases well north of 15% and that will be on top of restrictions to T&Cs. Several clients are slated to be coming out of the shared limit risk purchase groups that fell apart in early 2022, which means they are likely to have their first renewal in the open market in a number of years. For these clients, expect increases to be substantial and have major adjustments to deductibles. In some cases, market adjustments could mean as much as 50%–75% increases YOY.[7]
- **Hospitality:** Over the past five years, many owners and operators in this space have seen total increases north of 50% due to past hurricane activity and market conditions. As we move forward, we expect those with good losses and limited CAT wind footprints to see very stable renewals, but those with losses and/or a heavy CAT wind footprint to see increases starting at 10%–15% and going up from there, depending on how much they were impacted by Hurricane Ian.[7]

- While this discussion has focused on losses in coastal areas from named storms, such storms are not the only source of catastrophic losses. Such losses can also come from other events like wildfires, earthquakes and mud slides. Owners hoping to insure their properties and to limit their premiums should consider such catastrophic risks when establishing design criteria or updating their properties. For example, it may be advisable to replace a roof before it becomes strictly necessary because some carriers are limiting replacement value on roof damage to newer roofs built to higher standards.

Carriers are already employing tighter underwriting standards and imposing greater risk mitigation protocols. There is anecdotal evidence of carriers in coastal regions approaching their insureds months after the placement to request additional measures to limit losses, such as removing trees and tree branches to reduce possible wind damage. Increased water damage claims are causing insurers to require burst-proof piping to appliances, installation of battery backups for sump pumps and installation of water sensors that will turn off the water supply when a leak is detected. As owners move from construction to occupancy, these requirements may result in change order work.

Another consideration relates to the use of known materials and construction methods. For example, Cross Laminate Timber (CLT) is a relatively new technology where low-grade wood is bound together to create structural members. Because carriers do not have extensive claims experience with this technology, they are limiting their exposure so that multiple carriers are sometimes needed to complete an insurance placement.[8]

Specific to the Builder's Risk policies is the risk of delay. Supply chain and labor shortages are causing project delays. In some cases, this is making it necessary to extend the Builder's Risk coverage past the policy expiration date. This can be complicated because insurers may have lost their appetite for continued coverage — especially if the coverage extends into seasonal risk periods, like hurricane season.

We are also seeing increasing emphasis on loss mitigation during construction. Mitigation measures can range from increased security cameras and more secure fencing to reduce losses from theft to measures addressing more project-specific risks. When procuring and renewing insurance, the carriers will want to see that you have considered those risks and have a plan to mitigate them.

If the project is located in an area subject to wildfires, have you provided for a sufficient defensible space around the project? If the project involves complicated lifts, have you considered a peer review of the lift plan?

II. General and Excess Liability

Commercial General Liability (CGL) policies protect against claims for property damage (other than the work during construction, which is covered by Builder's Risk) and bodily injury to persons other than your employees (who are covered by workers' compensation).

General liability premiums continued to rise steadily in 2021 and 2022, on average, up to 10%. While new carriers have entered the marketplace, it has not prevented premiums from continuing their upward march. These rate increases have been concentrated in high-exposure sectors, of which construction is certainly one.

Primary drivers of increased premiums include social inflation (i.e., the costs associated with social trends that increase the frequency and costs of litigation, such as plaintiff-friendly legal decisions and large jury awards, reportedly resulting in a 300% increase in the median value of jury awards).[9] Insurers are primarily concerned with nuclear verdicts in the tens of millions of dollars or more.[10] As a result, it is becoming increasingly difficult and expensive to build a tower of excess insurance to cover high-dollar verdicts.

Fortunately, contractors can greatly reduce their premiums through a relentless focus on safety and quality control.

As to safety, the most common claims arise from injuries to workers. A subcontractor employee who is injured on the site cannot sue his or her employer due to the workers' compensation bar, but they will often sue the prime contractor and other subcontractors, claiming damages from their negligence.

Two keys to reducing these claims are to (1) prevent injuries in the first place, and (2) to provide immediate treatment. Strict safety protocols, including the use of wearables to track employee movement and activities, can greatly reduce injuries. On many large projects, an EMT will be on site to provide first aid and immediate treatment.

Quality control is important because CGL policies will often cover damage caused by defective work, even though they do not cover the costs of repairing the defect. For example, CGL policies will not pay to fix a defective roof, but they may pay to repair water damage resulting from the defect. Strict quality controls can reduce claims by preventing the loss in the first place. Additionally, thorough documentation of the QA/QC efforts can often reduce or eliminate liability.

Accordingly, when working on renewals it is helpful to be able to show written policies and procedures applied across the board to maintain and document compliance with safety and quality control procedures. If there have been losses, it is also helpful to show steps you have taken to prevent a re-occurrence.

III. Professional Liability/Errors & Omissions

Professional liability insurance — as the name implies — protects you from claims for professional negligence. This is most commonly associated with architects and engineers, but contractor's should obtain professional liability coverage as well.

Unfortunately, insurance premiums for architects and engineers have also surged in the last two years, up 10% year-over-year at the end of 2021 and up 10%–20% by mid-year 2022. The range of these increases reflects the range of risk profiles within the industry. Higher premium increases were associated with (1) significant growth, either through M&A activity or rapid organic growth, or (2) adverse claims activity.

On the contractor professional liability side, premiums have been rising at a much slower pace 2%–5% in 2022, but carriers are not expanding their capacity so it is increasingly difficult for contractors to obtain coverage if they do not already have that coverage.[11] The lack of capacity is particularly pronounced in residential work, such as condominiums, which tend to experience more claims than commercial projects.

In renewing these policies, it is important to emphasize the steps you have taken to control risks. This includes quality control measures through independent reviews within the organization, strict monitoring and adherence to licensure requirements, and contractual liability limitations. It is not sufficient for consulting engineers brought in on a limited scope of work to disclaim liability in their reports (although that is necessary), but they must also include contractual limitations stating they are not liable for errors and omissions if they are not retained to review final designs or to provide input if new information becomes available. Engineers and architects expanding into new disciplines or project types need to demonstrate the actual capacity to perform that kind of work, such as by recruiting experienced designers in those new (to them) markets.

Significant concerns to keep in your radar (Beside Design):

- Mold
- Curtain wall issues
- Installation issues
- CM at risk and agency-related issues
- Failure of oversight

Your PL policy may only be as good as your contracts. Close attention to detail is necessary on each project.

- Limitations of liability
  - To a fixes amount
  - To insurance proceeds
  - Minimum insurance requirement are not limitation of liability
- Extended reporting periods and coverage through the status of repose
- Mutual waiver of consequential damages
- GMP not to exceed fixed costs with incomplete drawings
  - This is a nightmare scenario from an underwriting standpoint especially on large projects for CMs and design/build

IV. Workers' Compensation

The first half of 2022 marked the 19th consecutive quarter of rising premiums across many lines of insurance, but workers' compensation premiums were a bright spot, with premiums decreasing at an average of -1.2%.[12] This is part of a longer terms trend that we hope to see continue.

This is just an overall average and actual workers' compensation rates depend largely on your safety record and the type of program. In some cases, premiums have gone down as much as 10% or up as much as 10% in 2022.[13] Contractors benefitting from lower rates are generally those with lower Experience Modification Rates (EMR) resulting from a better safety record. As they say, "safety is no accident" and stronger safety programs generally result in fewer and less severe losses, leading to lower rates.

EMR Updates: Item Filing E-1409 (The specific state rating effective dates span from November 1, 2023, to August 1, 2024, with the most common effective date being January 1, 2024.) — What's changing and Why? NCCI recently completed a comprehensive multiyear evaluation of the Experience Rating Plan Methodology and performance. Here are the underlying plan components proposed for updates as part of the filing. (Source: https://www.ncci.com/Articles/Documents)

What's Changing?	Why?
Split Point Will differ by jurisdiction to better reflect state cost differences.	Most values NCCI calculates already differ by state (such as loss costs and expected loss rates). Having the split point reflect state cost differences not only makes it more consistent with other rating values but also improves the accuracy.
State Per Claim Accident Limitation (SAL) Will equal the 95th percentile of lost-time claims by state and generally decrease in magnitude.	The new SALs make experience-rating modifications less sensitive to large claims without sacrificing accuracy. This change also promotes year-to-year stability.
Credibility Parameters Recalibrated with more recently available data.	NCCI uses credibility parameters in the calculation of the weighting values and ballast values in the experience modification calculation. NCCI updated the parameters to improve equity within the Experience Rating Plan.
Other Changes **G Value** — NCCI will adjust this measure of average severity to reflect the application of the SAL and reduction to medical-only loss dollars, where applicable. Updated G values will increase consistency with other plan parameters. **Discount Ratio (D-ratio)** — Used in the calculation of expected excess losses, the D-ratio will no longer differ for class codes in the same hazard group. This simplification eliminates unnecessary complexity in the calculation and promotes year-to-year stability in D-ratios.	

V. Cyber Liability

Unlike CGL policies, cyber insurance is not sold with a standard policy form, so it is vitally important to consult with a broker to ensure that you have the correct coverages. As a general rule, however, cyber liability insurance covers two broad forms of risk.

First, there is "first party" coverage that protects the insured from losses due to a cyber incident. These policies can cover lost business income and extra expenses caused by the breach, including data recovery. This can also cover cyber extortion, when your data is locked up or threatened to be exposed in a ransomware attack. These policies are generally on an "occurrence basis" meaning that they will provide coverage if the breach occurs during the policy period.

There are also "third-party" coverages available to cover your legal liability to other persons arising from the cyber breach. This include claims against you for failing to protect sensitive data on your systems or claims because you allowed malware to infect a third-party's network. It can also cover legal liability if you have to pay a fine for failing to protect data. These policies are generally written on a "claims made" basis providing coverage if the claim is made in the policy period.

Cyber insurance premiums increased 30%–50% over the second and third quarters of 2022. Ransomware attacks continue to impact pricing. Thirty percent of carriers report that cyber risk is their number one concern, followed by environmental and climate change issues at 21%.[14] That cyber risk is more concerning than environmental claims in the wake of Hurricane Ian goes to show how significant cyber risk is to the insurance market.

These concerns are causing carriers to reduce their exposure in a number of ways. Policies are generally being written with a typical limit of $5 million instead of $10 million in years past.[15] They are also increasing focus on security controls in underwriting, insisting on the use of multifactor authentication (MFA), employee training, 24/7 network monitoring, use of encryption, and the insured's Incident Response Plan (IRP).[16] In the near future, we expect carriers to insist on Zero Trust Architecture (ZTA), pursuant to which every device, user and application, together with certain amounts of network traffic must be verified.[17] ZTA essentially operates on the assumption that your network has already been breached.

One of the more concerning aspects is that Lloyds is considering excluding coverage which includes "retaliatory cyber operations" between states and those having a major detrimental impact on a state, which raises the prospect of coverage being denied for hacks out of Russia, China and other foreign countries that may be attributable to state actors.[18]

Bottom Line

While certain markets, notably cyber liability and catastrophic property damage are highly stressed, other insurance lines such as general liability and workers' compensation are holding up well. When submitting applications for insurance it is important to think about the risks that will most concern the underwriters and to work with your broker to address those concerns in your applications.

Sources

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