SIX KEY TRENDS

Gallagher

Insurance | Risk Management | Consulting

IMPACTING INSURANCE AND RISK MANAGEMENT IN THE CONSTRUCTION INDUSTRY LATE-YEAR 2022

Gallagher is one of the largest insurance brokerage, risk management and consulting firms in the world. As an industry-specific insurance broker and trusted consultant, we make it our goal to help contractors and their businesses move forward with confidence. Gallagher's Construction team provides risk management solutions to contractors that extend beyond traditional exposures to protect your business. We strive to keep contractors abreast of current conditions and trends, while trying to anticipate future risks that you may want to address. The following six trends are areas of particular concern:

1 EUROPEAN SUPPLY CHAIN DISRUPTIONS

Supply chain issues and price volatility continue as the number one issue for the industry,[1] but we believe supply chain issues out of Europe will dominate the conversation on a forward basis. We previously reported our concerns about the European production of products using oil and gas inputs (e.g. chemicals, fertilizer and plastics) and logistical challenges as the European Union's (EU) sixth round of Russian sanctions prohibits the import of about two-thirds of Europe's current oil imports beginning in December 2022. Even if the war in Ukraine were suddenly to end, it is unlikely that gas imports to Europe could resume any time soon as two gas pipelines from Russia to Germany (Nord Stream 1 & 2) were sabotaged on September 26, 2022.[2] As such, it is even more imperative that contractors using European-sourced equipment and materials find alternative suppliers.

When purchasing European goods, firms should also be aware of increased financial risks from the war. Many European car makers and other manufacturers obtained parts from Ukraine. As a general rule, insurance policies providing business interruption coverage will not provide that coverage when the cause of the loss is not insured, and most policies contain exclusions for losses and disruptions caused by war.[3] As such, losses from war-caused supply chain business interruptions are not covered.

From an insurance perspective, there are several approaches one can take to address some of the financial impacts of these events. First, Political Risk Insurance (PRI) can provide coverage for losses covered by political actions and instability. While most insurance requires some form of property loss, PRI can cover losses to contract frustration arising from political events. For example, if a supplier cannot fulfill its contract because the EU barred Russian oil imports, that may be covered by such a policy. There are no standard PRI insurance forms and such policies are usually procured to cover a specific project or activity.

If the loss is caused by a cargo being lost or damaged due to supply chain disruptions from the war, it may be covered by Marine Cargo Insurance. A more direct way to address some of these issues is through Supply Chain Insurance under Marine Cargo. Traditionally, these policies only covered physical damage to the material, but some carriers are now issuing policies covering losses in the absence of any such damage. This includes many items that generally would be considered force majeure, such as public health emergencies, natural disasters, labor issues, and political unrest. However, coverage can be made available for supply chain disruptions where the supplier ordinarily would not be excused from performance through force majeure, such as production process problems or insolvency.[4] At this point, there are no standard policy forms, but policies are generally written on an "all risk" basis, with certain losses excluded.[5] Accordingly, these policies must be read specifically and consideration should be given to endorsements adding coverage for causes of concern.

Another method for consideration is the use of supply bonds to protect Supply Chain Risks. A supply bond is a surety bond that guarantees the principal (supplier) will provide materials, supplies or equipment as specified in a contract or purchase order. These bonds will guarantee all the terms and conditions of the supplier's obligations. This includes price, quantity, etc. Supply bonds typically do not include any installation only delivery of such products. A supply bond also provides leverage for your project to be prioritized vs. the supplier's un-bonded obligations.

2 DROUGHT INDUCED ISSUES

As of July 19, 2022, 73% of the western U.S. was in drought, with 30% in extreme to exceptional drought.[6] This drought has resulted in critically low reservoir levels with impacts on agriculture and power generation.[7] Indeed, between October 2021 and July 2022, federally administered hydropower projects in the west produced only 65.7% of their average power output.[8] The impact on crops varies, but California rice production is down by 50% due to current drought conditions.[9]

The drought had several impacts on the construction market. As we previously noted, drought impacts the supply chain for products with water-intensive manufacturing processes like microchips and paint.

On future projects, designers must consider ways to reduce water usage. One method is the incorporation of on-site water recapture technologies, which can recycle both black and gray wastewater for non-potable uses, like toilet flushing and cooling tower makeup, thus reducing water usage by up to 95%.[10] We can expect building officials to require the use of such technology and owners to demand it to reduce long terms costs.

Water shortages are also leading to increased water infrastructure spending. For example, in August, Governor Newsom announced a water strategy calling for California to invest $8 billion in a broad range of water infrastructure projects, including desalination plants, reservoirs and groundwater-recharge facilities.[11]

3 FINANCING ISSUES—RESULTING IN PROJECT CANCELLATIONS OR DELAYS

Borrowers are well aware that the Federal Reserve has been raising the Fed Funds Rate to help fight inflation. A lesser known aspect of the Fed's efforts has been to reduce the money supply (the total amount of cash, coins and bank account balances in circulation) by about $100 billion per month.[12] Over a three year span, the Fed's "Quantitative Tightening" is expected to withdraw about $3 trillion dollars from the Fed's Balance Sheet, thereby reducing the money supply.[13]

Fed studies indicate that such tightening will result in higher interest rates, lower loan volumes and increased collateral requirements.[14] However, this same study found no significant changes in the distribution of loans to smaller firms, loan duration, or the mix of term loans and credit lines.[15]

In early August, the St. Louis Fed reported that almost half of the banks surveyed had reported tightening loan standards for Commercial Real Estate (CRE).[16] Other data indicated this was accomplished lowering Loan-to-Value (LTV) and Loan-to-Cost (LTC) ratios.[17]

These factors are now filtering into the project financing market. Last June, 15% of multi-family developers surveyed reported concerns over lack of availability for construction financing. That number doubled to 31% by the end of September.[18] While banks have not reported significant increases in delinquencies, they are expecting a CRE "apocalypse" in some markets.[19] However, this apocalypse is expected to occur in a bifurcated market, where certain markets remain strong and modern "green" buildings outperform older properties.[20]

It is notable that 90% of the multi-family developers surveyed reported experiencing construction delays and 76% reported cost increases.[21] Anecdotally, we are seeing many projects where key subcontractors or even the prime contractors themselves are unable or unwilling to perform due to materials price increases. Banks are surely aware of these risks, and developers should include a solid plan to address delays and price shocks in their loan applications.

4 CYBER LIABILITY

Cyber attacks have unfortunately become a fact of life. Attacks against construction companies are rising,[22] and 75% of construction–related companies have experienced a cyber incident over the past 12 months.[23] Attacks include "social engineering" attacks designed to trick employees into letting criminals into your systems,[24] and the more well-known ransomware attacks where a company's data is held hostage. Construction companies are rich targets because of the information they have on their client's facilities as well as their interconnection to other companies through electronic payment systems and data sharing.[25]

While most engineering and contacting firms are worried about threats to their own systems and data, they also need to be concerned about damage to their clients. In 2013, Target suffered a major data breach, where hackers got access to Target's database through an employee of a mechanical contractor accessing Target's electronic billing system.[26]

Basic ways to avoid losses from a cyber attack are to ensure that all employees are trained to spot social engineering attacks, making sure that all software is updated with the latest security patches, and using cybersecurity software and services. We also cannot emphasize enough the need to develop a plan for responding to cyber incidents ahead of time. This plan should be maintained in hard copy as well as electronic versions in case you are locked out of your system. It should include a brief summary of your cyber-coverages, contact information for cybersecurity and forensic consultants and law enforcement, and plans for moving forward without access to your computerized systems.

With respect to cyber liability insurance, the exercise of putting a cyber-response plan into place with a summary of coverages will help you think through the possible losses and the kinds of coverage you will need. These policies are generally manuscripted—meaning they are not on the standard policy forms—so you will need to review the coverages and exclusions with your broker. Coverages should include not just first-party insurance to protect your systems but added on third-party coverage to provide coverage from claims arising from fraud, invoice manipulation, and electronic funds transfers.

5 SAFETY AND SECURITY TECHNOLOGY

With a median recovery time of ten days for a jobsite injury, jobsite safety is critical to keeping costs down and efficiency up.[27] As a result, we are seeing increasing use of technology for both safety and security. On the safety side, wearable devices can reduce injuries by warning workers of hazards, including low oxygen levels.[28]

Supply chain disruptions incentivize thieves by making materials more expensive, so contractors are installing increased security to prevent theft, including motion detectors, lighting, and cameras on site to discourage jobsite theft.[29]

Industry attitudes toward safety have evolved markedly over the last century and builders have come to realize that increased safety corresponds to increased profitability as accidents cause downtime and affect productivity of uninjured workers. Fewer accidents also result in fewer claims resulting in lower insurance premiums.

But in today's market, accidents may also serve as a warning sign of future construction defect claims. Labor shortages are well documented, and some estimates indicate that it needs to 650,000 new workers.[30] As new workers are brought in, they must be trained in all aspects of their work, including safety and quality. If these workers are not adequately trained, we can expect the lack of training to manifest itself first in increased accidents, and later in construction defect claims.[31]

6 WEATHER-RELATED STORMS RESULTING IN INSURANCE AND CONSTRUCTION MARKET CHANGES

Weather-related events are impacting the property insurance market. Drought conditions in the west increase the risk of wildfires, affecting insurance availability and cost.[32] Initial damage estimates from Hurricane Ian range from $42 billion to $70 billion, which will ripple through the insurance markets, and could affect the balance sheet of some insurers.[33] This cost is somewhat amplified by inflation in the construction industry, which has outpaced the consumer price index and makes the costs of replacing damaged properties higher than they otherwise would be.[34]

The cost of these events will certainly work its way into insurance premiums, but there is also a significant concern about availability. Most Property and Casualty Insurers have treaties or other arrangements with reinsurers to pay a portion of the claims. These will often involve specific risks like those arising from natural catastrophes. The reinsurance market was already grappling with how to support increased demand based on inflation and risk appetites before Hurricane Ian struck.[35]

Over the past five years, there has been an increase in catastrophic losses.[36] At the same time, reinsurer capital has shrunk due to the declining value of their investment portfolios.[37] Natural forces of supply and demand will almost certainly cause reinsurance rates to increase, which will be passed down to the insureds in the form of higher premiums.

These events have several other impacts on the industry. First, massive amounts of money will be spent on rebuilding efforts, which will place further stress on supply chains and labor shortages. Second, FEMA funding is subject to Buy America Act, requiring the purchase of domestic steel and other materials,[38] which will be a boon to U.S. manufacturers. Finally, the Biden administration has emphasized the implementation of more hazard-resistant building codes,[39] although it is unclear if this will have any immediate impact on local codes or if FEMA will require stricter codes for rebuilding.

One interesting study showed that the relative placement of buildings and structures can dramatically affect wind loads through tunneling effects.[40] Because tunneling increases wind loads, current models evaluating the benefits of wind damage mitigation may undervalue the savings from closer nail spacing or stronger connections.[41] These findings could affect building codes, insurance rates, and lending requirements.

CONCLUSION

While the industry continues to navigate current challenges like these, it is critical to work with a team of construction and specifically contractor experts to help you create a risk management program that closes gaps and supports the continuous running of your business. Gallagher Construction works closely with our clients to help them enhance their growth and development, while protecting their assets and reputation. We conduct in-depth assessments of our client's organization to better understand their unique culture and the specific risks their business faces.

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[5]"Update: Business Insurance Considerations Amid Conflict in Ukraine," Morgan Lewis, 4 August 2022.

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[23]"The Case for Cyber Coverage in the Construction Industry," *Risk and Insurance,* 6 June 2018.

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[27]"Construction Market Marketing and Industry Trends Shaping 2023," *LinchpinSEO*, 1 October 2022.

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Because of the highly nuanced nature of this market, it is imperative that you are working with an insurance broker who specializes in your particular industry or line of coverage. Due to the variability that we're seeing in this market and specific account characteristics, your individual situation may vary from others. Gallagher has a vast network of construction specialists who understand your industry and business, along with the best solutions in the marketplace for your specific challenges.

WE DO MORE THAN HELP PROTECT YOUR BUSINESS. WE HELP BUILD IT.

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