Construction Market Update

Summer 2023

Based on more detailed underwriting, 2023 is expected to be a year of mixed markets. In areas with higher exposures, we are seeing capacity reductions coupled with increased pricing. In areas with less exposure, we are seeing increased capacity with moderate price increases. The market is also being driven by several larger issues, including:

- **Inflation and rising interest rates:** Traditionally, higher interest rates are good for insurers because they can invest premium dollars at a higher rate of return, but inflation is bad because losses and verdicts come in current dollars. As the prices of basic materials, such as lumber, concrete and steel have increased, so have the costs of replacing damaged property. These increased costs have translated into increased losses, particularly in areas exposed to catastrophic losses like coastal areas and areas prone to wildfires.
  - Inflation is also important with respect to continuing operations coverage. Most jurisdictions have a statute of repose that bars any claim after a certain date. As those periods approach, owners and condominium associations in particular start to look for potential claims. In a jurisdiction with a ten-year statute of repose, 2013 premiums are paying for 2023 claims at 2023 prices.
- **Regulatory Impacts:** Where premiums have not been allowed to reflect the risks, carriers have stopped writing new policies. This has become an acute problem in California.
- **Social Inflation:** Social inflation is the cost of higher jury verdicts punctuated with increasingly frequent "nuclear verdicts." Social inflation causes premiums to rise on both primary and excess policies. As excess carriers become concerned about their exposure, they issue excess policies in smaller tranches so that more carriers are required to provide desired excess coverage.

In this report, we will look at different insurance lines, examine current market conditions and provide suggestions on how to stretch your premium dollar.

I. Builders Risk and Property Insurance

Contractors are mostly concerned with Builders Risk insurance, which is just a form of property insurance designed to address the unique risks of property under construction. In the first half of 2022, the insurance industry sustained $35 billion in losses from natural catastrophes. This was 22% above average.[1] Then, in September 2022 Hurricane Ian struck South Florida, causing $60 billion of insured losses and total damages of about $100.[2]

Ian had a huge impact on the market, particularly in the re-insurance market. Most policyholders are familiar with retail insurance companies who write their policies, but many policyholders are completely unaware of the reinsurance market. Retail insurance companies enter into agreements with reinsurers to spread the risk they are taking in any given market. These re-insurers are often based outside the United States and take on global risks. When Ian struck Florida, much of the loss was passed onto reinsurers who reimbursed the retail insurance companies for losses paid to policyholders. The magnitude of the losses, however, was such that several reinsurers withdrew from the Florida market and the State of Florida was forced to provide reinsurance so that retail insurers could still issue policies.

Historically, large losses would lead to a temporary reduction in capacity, but as pricing rose, new players would enter the market and capacity would rebound fairly quickly. We are not seeing many new entrants entering the market today, meaning capacity is constrained. This is particularly true in markets with catastrophic exposure and with certain kinds of structures, like those framed with wood.

Because reinsurers take on global risks, reinsurance pricing and capacity can also be influenced by losses incurred on the other side of the world. The first quarter of 2023 experienced the highest global economic damage from natural disasters since 2011. Of the $77 billion in global losses, $45 billion came from earthquakes in Turkey and Syria.[3] Severe weather in the United States was a secondary, yet significant, driver of these losses with about $13 billion from March 2023 storms.[3] Compounding these losses, reinsurers are concerned with the emergence of El Niño, which can lead to more weather volatility.[3] These losses and concerns lead to limited coverage on unprofitable insurance lines, increased premiums and higher deductibles in the reinsurance market.[4] These have and will continue to flow down to the retail market, resulting in higher premiums.

Outside hurricanes and earthquakes, major losses have included claims from fires and water damage.[5] Aside from floods, plumbing failures cause about 50% of all Builders Risk claims,[6] wildfires have also been a particular concern.[7]

At the start of the year, we predicted that losses from Hurricane Ian and wildfires would lead to increased property insurance premiums and we were unfortunately correct. While commercial insurance lines increased across the board in the first quarter of 2023, the largest increase was in commercial property rates with double-digit rate increases.[8] Increases were most pronounced in areas with catastrophic exposure, where even properties with good risk qualities and minimal loss histories will see increases of 25%–150% in the second half of 2023. Overall rates increased by an average of 14%, in the first quarter of 2023, but for the riskiest quarter of properties, they increased by 36%.[9] We also note that Colorado and California are suffering challenges with high storm recovery costs and regulatory challenges.[10] Outside of such problem states, rates have otherwise stabilized, with rates rising in the 10%–15% range in 2023.[11]

Inflation is having a two-fold effect on the property market. First, insurers are demanding up-to-date valuations—especially in areas subject to catastrophic losses. This has a compound effect on pricing because policyholders are paying higher rates on higher valuations. Second, it is exacerbating the lack of capacity as each insured property takes up a greater share of the existing capacity at higher valuations.

Another trend is insurers leaving heavily regulated states with high risks, for which California is the poster child. In late May 2023, a major home insurer stopped selling new policies in California, citing wildfire losses, high construction costs and reinsurance challenges.[12] A week later, another large home insurer in California disclosed that it had stopped issuing new policies as part of its request for a 40% increase in home and business property insurance rates.[12] Auto insurers are following suit.[13]

[1] "Insurance Data Trends: How data and analytics continue to transform the insurance industry," Snowflake, accessed 06 July 2023. PDF file.

[2] Sims, Tom and Alexander Hübner. "Hurricanes and floods bring $120 billion in insurance losses in 2022," Reuters, 10 January, 2023.

[3] Meredith-Miller, Brittney. "Gallagher Re: 2023 begins with above-average global catastrophe losses," PropertyCasualty360, 25 April 2023.

[4] Meredith-Miller, Brittney. "Inflation, natural disasters will impact Asia-Pacific reinsurance in 2023," PropertyCasualty360, 07 February 2023.

[5] Wilkinson, Claire. "Construction market hammered by rising fire, water damage claims," Business Insurance, 04 June 2019.

[6] McFarland, Pam. "Water Tech Getting Smarter," Engineering News-Record, May 2023.

[7] "Gallagher Re 2023 US Wildfire State of the Market," Gallagher Re, 7 June 2023. PDF Download.

[8] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

[9] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

[10] Jefferson, Elana. "Forbes Advisor: Top states for billion-dollar disasters in 2023," PropertyCasualty360, 20 June 2023.

[11] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

[12] Kamisher, Eliyahu et al. "It's not just State Farm. Allstate no longer sells new home insurance policies in California," Los Angeles Times, 02 June, 2023.

[13] "Major car insurance companies getting out of California," CBS Los Angeles, 20 January 2023.

Some options for reducing property insurance costs include:

- Looking abroad. Some insureds have found lower rates for earthquake coverage and wind damage for high-risk states in the London market.[14]
- Utilize design features intended to reduce losses. For example,
  - Smart water systems can catch leaks quickly, reducing the loss. Indeed, one user reported a 10% reduction in Builders Risk insurance premiums from using such systems.[15]
  - Employ defensible perimeters and noncombustible building envelopes (e.g., cementitious siding instead of wood) to avoid wildfire damage.
- Locate facilities in areas less prone to disaster. Gallagher Forecast, which was developed as part of Gallagher's benchmarking tools, can provide our clients with a wildfire hazard score that identifies the wildfire risk for particular locations, which can help underwriters make informed decisions on your property instead of just resorting to less individualized tools.
- Implement loss mitigation measures during construction, such as security cameras and more secure fencing.

II. Casualty and Excess Liability

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

Social inflation continues to drive premium increases. The median personal injury jury verdict has increased by over 370% between 2010 and 2020.[1] This was exacerbated by nuclear or "jackpot" jury verdicts, such as the April 2023 award of $860 million to the family of a woman who was killed when a tower crane working on a nearby structure collapsed into her Dallas apartment while she was sitting on her couch.[16]

These trends are having a dual impact on liability insurance. First, higher awards translate into higher rates. Second, a number of carriers have left the excess and surplus lines business, leading to a loss of capacity. For example, at the end of June 2023, a major insurer announced it is exiting its excess commercial auto business.[17] This came on the heels of an insurer shutting down its excess and surplus lines just a few weeks earlier.[18]

Casualty rates diverge significantly between plaintiff-friendly and defendant-friendly jurisdictions. In jurisdictions prone to nuclear verdicts, it also can be difficult and expensive to build a tower of excess insurance to cover high-dollar verdicts.

Despite the issues with social inflation, we are seeing generally stable rates with slight increases in the 5%–7% range and sufficient capacity in both the primary and excess markets.[19] However, the riskiest 25% of insureds have seen higher rate increases averaging 13.5%.[20] Umbrella and excess rates are increasing at a slightly higher rate of about 7.9% on average and 23% in the riskiest quartile of policyholders.

One area that is really booming involves Controlled Insurance Programs (CIPs). These can be in the form of Owner Controlled Insurance Program (OCIP) purchased by an owner to take on most of the on-site casualty insurance needs for the project or a Contractor Controlled Insurance Program (CCIP), generally purchased on a rolling basis to cover all of the contractor's projects. Most such programs require specific health and safety protocols designed to reduce losses. These programs can also provide significant insurance savings, which translate into construction savings for owners. CCIPs can also be a profit center for prime contractors.

[14] "Stock Throughput Offers Relief in Hard Property Market," CRC Group, accessed 07 July 2023.

[15] McFarland, Pam. "Water Tech Getting Smarter," Engineering News-Record, May 2023.

[16] Beausoleil, Sophia. "Jury Awards More Than $860 Million to Family of Woman Killed in 2019 Dallas Crane Collapse," NBC 5 Dallas Fort-Worth, 26 April 2023.

[17] "Nationwide exiting $300mn+primary E&S commercial auto business," E&S Insurer, 28 June 2023.

[18] "GuideOne shuts down ~$125mn E&S casualty operation in latest reversal," E&S Insurer, 15 June 2023.

[19] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

[20] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

Insureds can employ a number of strategies to reduce premium costs, but some of these costs come with trade-offs. These strategies include:

- **Relentless Focus on Safety:** Although injured workers cannot sue their employers due to the worker's compensation bar, they can sue other contractors, including the prime who is almost always an additional insured on a subcontractor employer's CGL policy. Fewer injuries lead to fewer claims and smaller premiums.
  - **Written Health and Safety Policies:** These have many benefits, including helping underwriters understand your commitment and approach to safety.
  - **Hot Washes:** Establishing a "hot wash" procedure to evaluate what went wrong and how you can avoid future claims can lead to better results through continuous improvement.
- **Loss Mitigation:** On larger projects, this can include having on-site medical, but it also includes things like early-return-to-work policies, which have been shown to speed employee recovery and with the use of nurses to monitor patient compliance.
- **Quality Control:** Continuing operations (and Builders Risk claims) can often stem from faulty workmanship and the use of defective or substandard materials. Quality control accordingly not only reduces rework and punch list, but also reduces loss runs leading to lower premiums. Documenting quality control and safety procedures can also help with renewals.
- **Proper Planning for New Markets:** Whether you are expanding geographically or entering new kinds of construction, new markets expose you to the risk of your own ignorance. How are you to get the best workers out of the union hall? Who are the good subs? If you had never built a hospital, how is that different from the projects you have built? These all pose quality control risks that can result in later claims.
- **Increased Deductibles/Self-Insured Retentions (SIR):** These can lower your rates but require the contractor to establish greater reserves as you will be self-insured for losses below the deductible/SIR.
- **Bundling Primary and Excess Policies:** This can often lead to lower rates on the excess coverage as part of a "volume discount."
- **Looking to Multiple Markets:** London, Bermuda and domestic carriers are all competing for premium dollars and your broker should be looking at all available markets.

III. Automobile Liability Insurance

Most drivers have noted that the pandemic affected driver behavior. When the roads were wide open and the police were hesitant to pull drivers over for fear of catching COVID-19, drivers started going faster.[21] In 2020, the likelihood that a driver was driving more than 10 mph above the speed limit increased by more than 50% over the prior year, and drivers have not slowed down.[1] Additionally, distracted driving is on the rise, with 58% of road trips involving some form of phone use or screen interaction.[22] These have combined to increase accident severity. By 2022, bodily injury and property damage severity had increased by 35% over 2019 and collision severity had increased by about 40%.[23] In 2016, about 17% of accidents resulted in a car being "totaled," but that number increased to 23% in 2022—confirming the increasing collision severity statistics.[23]

As of June 2023, car insurance rates in the individual market have increased an average of 17% from the prior year, with actual rates going up as much as 40% in some states.[24] In the commercial market, rates often depend on the loss history. Fleets with a good loss history are seeing moderate premium increases of about 7.5%, but those with a poor loss history are experiencing higher rates, averaging about 19%.[25]

As with non-automobile coverage, a relentless focus on safety can be used to reduce rates. One significant driver is the use of "telematics," which involves the use of vehicle tracking devices that can monitor driver behavior and the vehicle's onboard diagnostic systems.[26] These systems can be used to look for unsafe driving behavior (e.g., speeding and sudden turns), to ensure that vehicles are being properly maintained (e.g., by monitoring the number of miles on the tires) and to make sure that vehicles are not being misused. A robust safety program that employs driver training, monitoring through technology and appropriate employee discipline can reduce accident rates and premiums.

IV. 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 contractors should obtain professional liability coverage as well.

Over the last several years, premiums have increased significantly, and we are in a challenging claims environment. One of the bigger issues now involves claims by contractors against their design consultants/partners on design-build projects.[27]

We strongly recommend that owners and contractors on design-build projects consider protective policies that can protect them if the designer's policy does not respond to such claims. For contractors and design professionals procuring professional liability policies, we recommend:

» Emphasizing steps you have taken to control risks when renewing policies;

» When switching carriers, perform a deep dive to make sure all potential claims are disclosed to the new carrier; and

» Inserting contractual liability limitation in engagement letters.

V. Worker's Compensation

Overall, worker's compensation rates continue to remain flat.[11] This is the continuation of a pleasant longer-term trend that we hope to see continue.

As always, contractors benefitting from lower rates are generally those with lower experience modification rates (EMR) resulting from a better safety record.

Two things you can do to decrease your worker's compensation rates are:

1. Focus on safety, safety and safety. Training, use of wearables, appropriate discipline for failure to adhere to safe practices, and use of robots and other technology to reduce injuries from lifting and repetitive motion injuries can all lead to lower premiums.
2. Look to bundle worker's compensation and other insurance with carriers, who will often provide a discount for bundled coverage where available. Bundling cannot be done in monopolistic states like Ohio, but it is something to look for when purchasing your overall insurance package.

[21]Tingwall, Eric. "Some Police Are Stopping Fewer Speeders as Coronavirus Spreads," Car and Driver, 19 Mar 2020.

[22]"Cambridge Mobile Telematics and The Kiefer Foundation Unite Forces Again to Combat Distracted Driving," Cambridge Mobile Telematics, 18 May 2023.

[23]"Auto Insurance Trends Report," LexisNexis Risk Solutions, accessed 07 July 2023.

[24]Englesham, Jean. "Car Insurance Rates Are Soaring With Little Relief in Sight," The Wall Street Journal, 24 June 2023.

[25]Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

2[6]"What is Telematics? Everything You Need to Know," Verizon Connect, 26 June 2023.

[27]Korman, Richard. "Will Claims By Contractors on Big Design-Build Projects Ever End?," Engineering News-Record, 8 February 2023.

VI. Cyber Liability

Virtually every expert will tell you that the question of a cyber-attack is "when not if." Accordingly, no business should be without cyber coverage, including both first- and third-party coverages. First-party cyber coverage protects the insured from losses like lost business income and data recovery costs. Third-party cyber insurance covers your legal liability to third parties in the event of a cyber breach, such as losses from failure to protect your client's sensitive data or allowing malware to infect a third party's network.

Because there is no standard cyber insurance policy form, you must consult with your broker to ensure that you have needed coverages. Such policies are unique in that first-party coverages are generally written on an "occurrence basis," meaning that they will provide coverage if the breach occurs during the policy period; but third-party coverages are generally written on a "claims made" basis providing coverage if the claim is made in the policy period. This means that an insured must be very careful to disclose any known or suspected breaches when procuring third-party coverages.

The Federal Cybersecurity and Infrastructure Security Agency (CISA) provides a wealth of information regarding cyber risk mitigation at its website www.cisa.gov. For example, its "Shields Up: Guidance for Organizations" recommends that all organizations reduce the likelihood of a cyber intrusion by taking steps to:

- Validate that all remote access to the organization's network, and privileged or administrative access requires multifactor authentication.
- Ensure that software is up to date, prioritizing updates that address known exploited vulnerabilities identified by CISA.
- Confirm that the organization's IT personnel have disabled all ports and protocols that are not essential for business purposes.
- If the organization is using cloud services, ensure that IT personnel have reviewed and implemented the strong controls outlined in CISA's guidance.
- Sign up for CISA's free cyber hygiene services, including vulnerability scanning, to help reduce exposure to threats.[28]

Even the best cyber hygiene, however, cannot protect against "zero-day" vulnerability. A zero-day vulnerability is one that is unknown to those interested in protecting systems and is referred to as a zero-day vulnerability because we have "zero days" to fix the problem once it becomes known — i.e., after one has become aware that it has been exploited.[29]

Like everything in construction, however, the 6P's — "Proper Prior Planning Prevents Poor Performance" — apply to the zero-day threat. Such planning should include:

GOOD INTELLIGENCE
Work with vendors and CISA to understand emerging threats. If another company using the same software is attacked, you too could have been infiltrated and should investigate that possibility immediately.

AN INCIDENT RESPONSE PLAN
This needs to include the identification of key personnel with current contact information and the identification of necessary steps to respond to an attack. Please be sure to have hard copies available. It will do you no good if the plan is in a system that you are locked out of.

FOSTERING STRONG VENDOR RELATIONSHIPS
When a zero-day or other cyber attack occurs, you will need to call on the expertise of the software providers and your cybersecurity vendors. Your house is unlikely to be the only one on fire, and you want the priority service that comes from stronger relationships.

CONTINUAL IMPROVEMENT
Consistently update software to have the latest security patches and implement the most recent best practices.

USER TRAINING
Many systems become infected because an employee clicks in response to a phishing scheme or does something else they should know not to do. All new hires with network access should be trained in cybersecurity measures, and retraining should occur on a regular basis.

The good news is that we are seeing a stable market. 2022 was marked by large cyber liability rate increases, but the market has stabilized. In the first half of 2023, we were seeing flat rates for optimal risk and about 15% increases for risks in the upper quartile.[30]

[28] "Shields Up: Guidance for Organizations," CISA, accessed 07 July 2023.

[29] Wells, Jeffrey and Jeff Esper. "Zero-day vulnerabilities: The hidden threat to the insurance industry," PropertyCasulty360, 29 June, 2023.

[30] Puckett, Linton B. and Mark Stachura. "Insurance Market Report," Gallagher, June 2023. Gated PDF.

The flattening rate increases have been most pronounced in the excess market and driven somewhat by increased capacity. However, the biggest driver has been the fact that insureds are paying much more attention to the issue and instituting better policies and training to address cyber risks. Reduced losses may also be an indirect result of Russia's attack on Ukraine. Prior to the war, many cyber attacks originated in Russia. Since the war started, Russian state actors have focused their attacks on Ukraine, and it appears that other groups have been disrupted through split political grievances and the loss of "prominent operators."[31] We should note, however, that carriers are now excluding coverage for cyber warfare, but the courts have not addressed those exclusions.

VII. Surety Market and Subcontractor Default Insurance (SDI)

The surety and SDI market is experiencing the same turbulence as other markets, but for different reasons. Unprecedented supply chain disruptions and price escalation caused severe damage to subcontractors with fixed-price contracts. The financial impact on prime contractors was also significant, especially in cases where the subcontractors were not bonded or covered by SDI. Indeed, there has been an increase in bond claims reported.[32] As a compliment to increased surety bond claims, we are seeing a tightening in the SDI market.

There are also concerns that some work will taper off so that contractors cannot make up those losses on future work. Rising interest rates, the collapse of Silicon Valley Bank and continuing concerns about regional banks with large commercial real estate (CRE) portfolios have led to the cancellation and/or suspension of projects in the pipeline. Other projects are being reduced in size. All of these currents adversely affect contractor balance sheets and increase the risk of default.

The construction market, however, is very bifurcated. Contractors engaged in hot markets, like new residential construction, infrastructure and manufacturing are going strong. Contractors dependent on office workers, including those performing tenant fit-out work or working in downtowns as diverse as San Francisco and Washington, DC are finding much less work. Overall, we see bond premiums as holding flat, but actual premiums depend on the credit profile of individual contractors.

With the flood of federal funding through the Infrastructure Investment and Jobs Act (IIJA) and other stimulus, contractors also need to be prepared to explain how they will avoid "catastrophic success." For example, the IIJA requires contractors to meet certain diversity, equity and inclusion (DEI) requirements and to fill some roles through union apprentices, but there may not be enough candidates to meet those requirements. Contractors must also consider how they will address material escalation costs as a low bidder. Many IIJA projects are still on the drawing board or going through the permitting phase. If the construction spend all hits at the same time, it could cause material prices to spike, causing costs to exceed bid prices.

The surety market itself does not currently lack capacity, but rising costs will require contractors to increase their bonding capacity to handle larger contracts driven by those higher costs. Because sureties are really extending credit, it is vitally important that they understand your business and do not run into any surprises. Concerns can include:

- Sudden changes to the financial condition without a warning;
- Changes in ownership or key personnel;
- Expanded or changed scopes of work;
- New geographic markets;
- An unclear or poorly thought out business plan; and
- Lack of established risk management plans (e.g., plans to address a cyber event).

[31]Huntley, Shane. "Fog of war: how the Ukraine conflict transformed the cyber threat landscape," Google, 16 February 2023.

[32]Collum, Jamie. "Surety Corner: Some pessimistic souls are predicting doomsday scenarios," ConstructConnect, 3 May 2023.

Contractors should also be able to explain how they will address the much-anticipated recession. There are many signs of an impending recession, from an inverted yield curve to a reduced money supply. But those signs have been in place for a long time while employment stays strong and the economy appears to be expanding. When renewing bonding capacity, it is increasingly important to be able to explain how you weathered previous recessions and your plans in case the market dries up.

Bottom Line

While property insurance remains stressed, particularly in areas subject to catastrophic losses, the market is generally stable. All parties, owners, architects, engineers and contractors have the opportunity to reduce their insurance costs by focusing on loss reduction and mitigation efforts, looking more broadly for coverage options, and bundling different kinds of coverage. They should also be looking for additional coverages through protective policies for design liability and the use of controlled insurance programs where appropriate.

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