TOP 9

EARLY 2023
CONSTRUCTION INDUSTRY TRENDS

Gallagher
Insurance | Risk Management | Consulting

Starting off 2023 contractors are still dealing with concerning trends from 2022. This document will outline those trends and identify new areas to keep your eyes on. We strive to keep contractors abreast of current conditions and trends and provide our suggestions on how you can alleviate that pain or better prepare. The following nine trends are areas we see impacting insurance and risk management in the construction industry:

1 CONTINUED LABOR SHORTAGES

Despite rising interest rates, construction firms are experiencing increasing backlogs, with ABC news media reporting a 9.2 month backlog, the highest since the second quarter of 2019.[1] Ironically, despite record infrastructure funding from the Federal Government, infrastructure had the shortest backlog of 6.7 months compared to backlogs of about 9.5 months for commercial and heavy industrial work. We believe this reflects the combined effect of the CHIPS Act, which encourages development of microchip manufacturing in the US and continuing concerns about over-reliance on Chinese supply chains.

The existing labor shortages are reflected in the current labor market. By December 2022, the construction industry overall added 328,000 jobs on a Year-Over-Year (YOY) basis from December 2021, with 28,000 added in December alone. The largest increase YOY and monthly was in specialty trade contractors, which added 193,400 jobs in 2022 and 16,600 in December.[2] Even with this hiring, there were 388,000 construction industry job openings in November 2022.[3] Indeed, the AGC reported that 91% of firms surveyed reported having difficulty filling open positions.[4] This lack of workers is hindering Government efforts to encourage construction of semi-conductor plants in the CHIPS act, together with other infrastructure needs.[4]

[1] Commercial, Institutional and Health Care Construction Drive ABC's Backlog Indicator to Highest Level Since Q2 2019 | News Releases.

[2] Table B-1. Employees on nonfarm payrolls by industry sector and selected industry detail—2022 M13 Results (bls.gov), Table B.1.

[3] ABC: Construction Job Openings Flat in November | News Releases.

[4] Lack of construction workers threatens infrastructure efforts: AGC | Construction Dive.

2 EASING SUPPLY CHAIN DISRUPTION AND PRICE VOLATILITY

The last two years have been marked with supply chain disruptions and surging prices, but those issues seem to be easing. The ENR Materials Cost Index for January 2023 was flat despite a 16% YOY increase.[5] Steel and cement continued to march higher, but lumber and PVC pipe prices fell, perhaps reflecting increased infrastructure spending that relies on steel and concrete and continued weakness in single family residential construction, which relies on lumber for framing and PVC pipe for plumbing.

This price data indicates fewer supply problems, which is supported by anecdotal evidence of normalized supply chains. However, we are seeing that builders who were burned by prior supply chain disruptions are insisting on contract terms to address this risk. As a result, we are seeing increased use of contingencies to compensate for escalation and other costs to source materials. We are also seeing increased use of contractual mechanisms to share the risk of rising prices—for example, through use of the ConsensusDocs 200.1, which provides several templates for sharing such risks. Finally, we are seeing that contractors are requesting later price locks—taking deposits prior to permitting but not guaranteeing prices until permits are issued or work begins.

Another method to consider is "use of supply bonds to protect supply chain risks." A supply bond is a surety bond that guarantees the principal (supplier will provide material, supplies or equipment as specified in a contract or purchase order). These bonds will guarantee all the terms and conditions of the supplier obligations. This includes price, quantity etc. Supply bonds typically do not include any installation, only delivery of such products. For more information on supply bonds contact your local Gallagher representative.

[5] 0109_CE_WK2_combined.pdf (enr.com)

3 MODULAR AND PREFABRICATED CONSTRUCTION

Modular construction is the process of assembling components offsite in a shop or factory so that they can be shipped to the site and assembled. Modular construction works best for repeat elements and often involve entire rooms, like matching bathrooms in a condominium. In contrast to stick-built construction modular can offer multiple benefits. One study estimated cost savings of 20%, decreased overall project durations of up to 50%, and unspecified reductions in waste from using modular methods.[6] In one example, modular construction allowed delivery of a 320 bed long-term care facility in Canada in just 13 months—even with 35 extreme weather days.[7]

These benefits are attracting greater use of modular methods. Indeed, 52% of attendees at a webinar on modular construction reported using modular methods.[8]

We are also seeing increased use of prefabrication for building components. For example, some companies can assemble wall panels incorporating Mechanical, Electrical and Plumbing (MEP) components. In residential and commercial building, these elements are often designed by specialized MEP engineering firms. These are then assembled in the field using cranes, with workers responsible for making certain connections and completing finish work. Use of prefabrication, results in drastic labor cost reductions, avoidance of defects in pre-assembled components, and schedule savings.

[6] IFS_WP_Global_Construction_moving_to_off_site_manufacturing_05_2022.pdf

[7] Best Project Health Care: Lakeridge Gardens | Engineering News-Record (enr.com).

[8] Disrupting The Status Quo | Engineering News-Record (enr.com)

4 3D PRINTING

3D Printed Building Construction is defined as "a process for fabricating buildings, structures and building elements from 3D model data using automated equipment that deposits construction material in a layer-upon-layer fashion."[9]

Many prescriptive requirements in common building codes do not apply to 3D printed construction. As explained by UL Solutions, "code requirements for concrete construction are not directly applicable for cementitious-based 3D printed construction since mortar and cement-based fabrication, printed in a layer-upon-layer fashion without forming members, are not specifically covered by the concrete standards referenced in the model codes."[10] Accordingly, the November 2021 publication of Appendix AW by the ICC (International Code Council) is an exciting development. While the code needs to be adopted by states and localities, it finally provides builders a mechanism to use 3D printing in the field.

Finally, because 3D printing is a relatively new technique, we can expect increased scrutiny of these projects with respect to underwriting builder's risk, property insurance, and general liability policies.

[9] 2021 INTERNATIONAL RESIDENTIAL CODE (IRC) | ICC DIGITAL CODES (iccsafe.org), § AW102.
[10] H.D. Hopper, FPE, Build Trust in 3D Manufactured Buildings with UL 3401 | UL Solutions.

5 RISING PROPERTY AND CASUALTY RATES

The third quarter of 2022 saw moderating rate increases through most lines of insurance, with certain exception, including an 11.2% average rise in commercial property, compared to 8.3% in Q2.[11]

Increased construction and replacement costs was one of the main reasons for increased property insurance rates. This caused underwriters to require higher property valuations when writing or renewing coverage. Another driver was the increased number and severity of natural catastrophes, like Hurricane Ian, flooding in Kentucky, and wild fires in the drought-stricken west. Recent atmospheric rivers hitting California are now relieving the risk of wildfire and replacing it with risk of flood and mudslides.

There has been a well-documented impact on catastrophic lines of reinsurance used by primary carriers to lay off some of this risk.[11] Hurricane Ian alone cost reinsurers about $120 billion, and reinsurance renewals have increased by about 37% on a risk-adjusted basis, with stricter terms on when policies are triggered and losses covered.[12]

In the primary insurance market, we expect rates to continue climbing, especially in coastal areas and other areas subject to natural disaster. We also expect to see stricter coverage terms, including more "cessation of work" clauses, allowing carriers to cancel coverage when work is suspended. If the project is delayed, we expect more difficulty extending Builder's Risk coverage, and carriers to seek higher rates for coverage extensions. As a result, we recommend trying to negotiate extension terms when placing coverage. Finally, coverage for Builder's Risk is traditionally based on the contract value. On longer projects, the replacement value may increase over the course of the project, so it may be advisable to negotiate escalation costs in the coverage.

Underwriters are also going to be paying increased attention over use of new construction materials and techniques, such as 3D printing and modular construction. Accordingly, when placing coverage, we think it will be increasingly important to identify unique insurable risks for each project. These will often be tied to location, such as the risk of hurricanes and wild fire, but are by no means limited to such risks. It is also important to identify possible schedule risks and the impact of price escalation.

With respect to insurance limits, consideration should be given to whether policies should be placed on an annual basis under existing policies or whether project specific policies should be obtained. Also, when addressing professional liability, owners need to be concerned about eroding limits and consider whether to obtain an OPPI to stand over the designer's policy. As always, the parties should consider who is the best person to procure the policies at issue—for example, if going with a controlled insurance program, should it be the owner, the contractor, or a joint effort.

[11] Q3 2022 P/C Market Survey—The Council of Insurance Agents & Brokers (ciab.com)

[12] Reinsurers Getting Some Shelter From the Storms—WSJ

6 SUBCONTRACTOR INSTABILITY AND BOND AND SDI CLAIMS

Since the start of the COVID-19 pandemic, we have discussed the impact of rising prices on the contractor community. This has caused significant financial distress to subcontractors who often found themselves having to cover variable material costs under fixed price contracts. With prices jumping unpredictably, many subcontractors lost money or saw their margins shrink. Many subcontractors were able to keep going, but the losses eventually caught up with them, and we are seeing increasing defaults, leading to increasing payment and performance bond claims and SDI claims.

Contractors making claims under SDI policies or on subcontractor Payment and Performance Bond must follow the claims requirements strictly. We recently saw one bond claim denied because the condition of the bond required the claimant to agree to pay over the contract balance. The claimant explained in the default letter that there was no contract balance because back charges exceeded the unpaid balance, but the surety demanded an offer to pay over the non-existent balance. Failure to give timely notice is often fatal to claims against the surety and SDI carrier.

It is also critically important on performance bond claims not to give into the temptation to help the subcontractor by making payments outside the contract terms. The contract balance is the surety and SDI carrier's security for its obligations. Payment outside the subcontract terms impairs that security. In some states that relieves the surety entirely of its obligations, and in others it reduces it by the amount of the payment.

Another important point is to make sure you track all costs associated with the default. Some accounting systems allow for establishment of a separate job number. In others, you can use change orders to track the costs. A significant part of the SDI claims process involves accumulating costs and proving amounts paid out as a result of the default. Tracking these in real time is not only important from an accounting and management perspective, but also can save tremendous consulting fees.

Finally, the old saying "document, document, document" applies with respect to these claims. Every conversation and event needs to be documented in daily reports, emails, and correspondence. If you sense that a significant default will occur, you should engage Gallagher and experienced construction law counsel early on. These documents will become important evidence when presenting the claim and a compelling presentation at the claim stage can often prevent you from having to litigate the claim.

Finally, Gallagher has several specialist that can assist with Subcontractor Distress and Default considerations.

7 CYBER RISKS

Cyber Risk is a constant evolving area and you should no longer think "If" we get hit, but rather "When" will we get hit. The biggest current risk involves ransomware through which cyber-criminals take your data hostage and refuse to release it until you pay a ransom. An evolving trend is the opposite, where they threaten to release your data to the world unless you pay ransom. This comes on top of traditional schemes to misdirect payments or hack into your bank accounts.

Cyber risks will continue to be a disturbing trend, which is reflected in increased insurance rates, which jumped an average of 20.3% in the third quarter of 2022. While the rate of this increase was down from 26.8% in the second quarter and the highest increase of 34.3% at the end of 2021, the 20.3% increase was on a higher base. Additionally, carriers are demanding increased risk controls, higher deductibles, and sublimits to some coverages.[13]

When purchasing Cyber insurance, it is important to understand that there are no standard policy forms. Each carrier has their own form with varying coverages, so you must work with an experienced broker to understand what coverages you are getting for your premium dollar. One thing these policies have in common, however, is that they are issued on a claims made basis. Accordingly, when you have an indication of a problem, you need to make the claim as soon as possible and disclose it on renewals and when switching carriers.

To limit your risks and premium expense, it is important to implement good cyber hygiene practices.

EXAMPLES INCLUDE:

a. Multifactor authentication requirements
b. Implementation of a Zero Trust Environment
c. Development of a written Incident Response Plan
d. Addition of cyber security requirements to vendor contracts
e. Employee training, which can be provided by outside consultants and insurers
f. Use of encrypted backups
g. Network segregation
h. Subscriptions to outside threat intelligence services
i. Consulting with the Cybersecurity and Infrastructure Security Agency (Cisa.gov)

Federal Contractors handling certain kinds of confidential or classified information must also apply for Cybersecurity Maturity Model Certification (CMMC) 2.0, which provides a model for non-government contractors.[14]

[13] Q3 2022 P/C Market Survey—The Council of Insurance Agents & Brokers (ciab.com)
[14] CMMC Model (defense.gov)

8 CONCERNS AROUND PROPERTY AND PROFESSIONAL LIABILITY CAPACITY

Property Rising insurance costs for under construction and ongoing operations of commercial properties especially in climate impacted states are seeing costs rise upwards of 50%. Insurers are taking a much harder look at upcoming developments as weather related payouts have left some insurers insolvent and many insurers are avoiding high-risk states all together. Many property insurers use reinsurance companies to move portions of this type of risk off their balance sheets. We are seeing many reinsurers are now vacating high risk states which is even further affecting capacity. In addition to costs rising, insurers are covering less wind limit on replacement costs with larger deductibles and new exclusions for damages such as mold or flood endorsement and even limits on payouts.[15]

Catastrophic weather events add to the myriad other challenges facing the commercial property insurance market, including:

- Inflationary pressures stemming from the pandemic, which have resulted in increased costs for labor and materials. Supply chain disruptions are extending the time it takes to build, repair or rebuild commercial properties. As a result, many construction projects are running behind schedule, and it's increasingly common for a builders risk policy to expire before a project is completed.
- Late reporting of claims, which often occurs when there's property damage the insured did not initially discover (e.g., roof damage from hail) or did not realize was covered by their commercial property insurance. This is an issue when a claim is filed after a policy has been renewed, as the new rates won't truly reflect the insured's loss history.
- Underreporting of property values by insureds continues to be a significant challenge to insurer profitability. With inflation running at its highest levels in 40 years, the gap between what a property was insured for and what it would cost to rebuild it could grow significantly in 2022. This is a common issue in the habitational real estate sector where older buildings that need to be rebuilt to higher code standards often create claims that exceed the policy's replacement cost coverage.
- Limited capacity and treaty rate hikes from commercial property reinsurers.[16]

Contractors Professional Liability

In the past few years, the contractor's market has begun seeing a shift in the way capacity is utilized in the market. Although overall capacity may be (arguably) stable, the amount of primary capacity we are seeing has begun to shrink recently. Catastrophic losses resulting from bad contracts, cost overruns, insufficient design, and mold issues to name a few, have driven carriers to limit the amount of primary capacity they are willing to utilize. We have seen several markets get burned by offering in the $20 million range on hard to insure accounts. As a result, the new norm seems to be wanting to limit the maximum primary limit outlay to half that size. With the increase in job specific requests and multiple towers of PL and CPL insurance, reinsurance is playing a factor on TOTAL limit outlay for several large contractors. New carriers entering the market (like Vantage, ANV and Sirius) have added capacity in the market overall but are hesitant to add significant limits in specific industry segments or clients due to the fear of mass losses. The recent decline in the availability of project specific A&E has also driven he need for higher limit requests for contractors from owners — depending upon the project delivery method. (Source for intro: Jack O'Donnell, Brown & Riding)

- **Coverage Changes:** One coverage impact worth noting is rectification or mitigation coverage. Because of increase in claims activity especially larger civil design build projects, insurers have seen an increase in pretty common engineering errors. Many cases show first party rectification/mitigation coverage is the first coverage to be used. As a result similar coverage offered under other coverages such as project specific professional liability or commercial general liability are not being tapped into.
- **Capacity**: Project placements are getting tougher and more expensive to deliver. We are seeing habitational projects nearly impossible to secure. Many insureds will not offer capacity unless firms are purchasing primary or excess with them as well.

[15]Matrix Research Bulletin-Property Insurance-February 2023.pdf

[16]https://www.rpsins.com/learn/2022/feb/us-property-insurance-market-insights/

- **Project Specific Placements:** There doesn't seem to be consistency in the industry with insurance requirements centered around which entity should hold the "primary named insured position" (especially in the area of P3 and IPD or the more common design build delivery methods). We have seen larger projects requiring the prime A&E to also be named on the policy as additional named insured with the design builder as the primary named insured. This can impact the design builder in the following ways: (Which is the entity that is obligated to the owner for both design and construction)
  - » It voids the design builders protective indemnity (PI) coverage under their CPrL because of the insured versus insured exclusion (IVI) typically found in many if not all of these policies. Remember, to trigger PI coverage, the design builder, in many policies, must make a claim against the A/E. If there is an IVI exclusion, they may be barred under the policy from doing so.
  - » It could limit the design builder's recovery under the liability coverage for the same reasons noted above and may force the design builder to pursue recovery from the A/E's practice program (which may or may not exclude claims under which they are a named insured under a project policy).
  - » Rectification/mitigation may become the insurance solution for design or engineering errors. As a result of providing such coverage to the A/E firm, costs can skyrocket.[17]

9 OCCUPATIONAL FRAUD IN CONSTRUCTION

Occupational fraud is formally defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. There are three categories of occupational fraud: financial statement fraud, corruption, and asset misappropriation.

Occupational Fraud Schemes in Construction—Heat Map

Industry	Cases	Billing	Cash larceny	Cash on hand	Check and payment tampering	Corruption	Expense reimbursements	Financial statement fraud	Noncash	Payroll	Register disbursements	Skimming
Construction	**78**	**24%**	**8%**	**10%**	**14%**	**56%**	**17%**	**18%**	**24%**	**24%**	**3%**	**9%**

Less Risk — More Risk

The Association of Certified Fraud Examiners (ACFE) identified that in nearly half of all cases the fraud occurred because of a lack of internal controls or overriding existing controls. However, the presence of anti-fraud controls in victim organizations was associated with quicker fraud detection and lower fraud losses.

Two anti-fraud controls were associated with both a 50% reduction in the median loss and median duration of a fraud incident: job rotation/mandatory vacation policies and surprise audits.[18]

[17] https://www.irmi.com/articles/expert-commentary/2022-contractors-professional-liability-market-trends-and-challenges

[18] Occupational Fraud in Construction | CLA (CliftonLarsonAllen) (claconnect.com)

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.

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WE HELP BUILD IT.**

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