Construction Insurance
Property & Casualty Market Update

Willis

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The US Property and Casualty insurance marketplace is emerging from a year of record-setting profitability. The industry's underwriting performance[1], as measured by the combined ratio[2], is projected at 93.2 and, if accurate, 2006 will represent the industry's best underwriting performance since 1936[3]. Total capacity of $481 billion is expected, due in large part to low catastrophic claims, with approximately $60 billion in profit for the P&C industry. This bodes well for buyers of insurance in 2007, as we saw a slowing of premium growth during the past 12 months. Premium growth, usually driven by rate increases, is expected to end 2006 at 3.3 percent and slow further in 2007 to 1.8 percent. Compared with 14.6 percent in 2002, the height of the last hard market, the drop is significant.

The industry numbers mentioned above for the US Property and Casualty market represent all segments, not just construction. Construction underwriters – those who dedicate resources, marketing and capital to the construction industry – confirm that their books are performing well, with at- or below-industry averages for their combined ratios.

While premium growth is slowing and rates are flat-to-lowering in most lines, buyers should be mindful of certain trends, especially in the construction insurance marketplace. To that end, you will find below a discussion of rates and trends by line of coverage along with expectations for 2007.

General Liability

General Liability, which provides protection for insureds against third-party property damage and bodily injury claims, continues to be a point of contention between buyers' coverage needs and underwriters' interpretation. In other words, within the construction insurance and risk management industry, senior-level discussion is lively concerning what is covered, what should be covered and how coverage will ultimately be interpreted when a claim occurs. The debate features General Liability and Professional Liability exposures, though also included is coverage restriction with a broad array of exclusionary type endorsements, with which buyers are somewhat familiar (e.g., mold, silica, etc.). Highlights of these issues and rate trends follow.

- Rates for Primary General Liability coverage are flat or down 5-10 percent over expiring. One might therefore expect that rates will continue to decline, but this remains to be seen. Construction insurers insist that they will continue to practice their new-found underwriting discipline and price their risks appropriately without getting caught up in what is usual in a softening market – significant downward pressure on rates and /or expansion of coverage.

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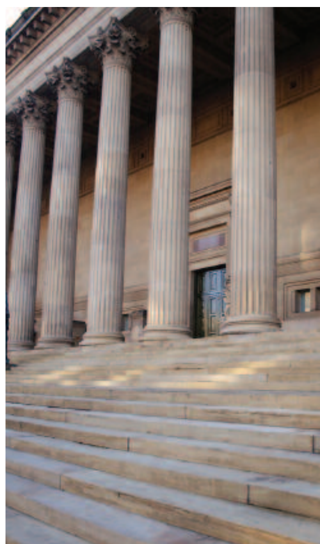
- Rates and other terms and conditions are dependent on program structure, retention level, specific coverage grants, type of work performed, geography/litigiousness and loss experience of the insured. Insurers will continue to refine their rating models to reflect these factors. For example, even though the market is softening, insurers will continue their push on retentions; for more definition in rate structures for western states relative to habitational work; and, for appropriate and disciplined product or capacity availability for certain types of work.

- Overall, the markets will continue to wrestle with issues of coverage interpretation for losses involving general liability property damage claims. Carriers are routinely sending reservation of rights letters on a number of General Liability property damage claims, causing delays in the investigation and resolution of these claims. As a result, the value and expense of those losses has exhibited an average increase rate of 30 to 40 percent per year for the past three years. Early intervention and claims management strategy are key in securing optimal resolution of these losses.



- Coverage interpretation and claim litigation surrounding the definition of "occurrence" relative to the business risk doctrine will remain volatile in our market segment. Trade associations, brokers, insureds and underwriting companies are just getting started on this issue as more court cases seemingly negate coverage for third-party property damage claims caused by faulty workmanship, stating they do not trigger the policy because they are not an "occurrence." This gets to the heart of what is a business risk and what should or should not be covered and defended by the General Liability policy. A more detailed examination of this issue is available from your Willis Client Advocate[SM]. As insurance buyers, however, contractors should be aware of the clear delineation as to what underwriters intend and how claim units will interpret coverage, with the latter taking positions that are contrary to years of ISO (Insurance Services Office) clarification and positive court interpretation providing coverage; today, in certain states[4], new case law is emerging that generally finds no coverage for faulty workmanship type claims that historically have been covered.

- Signs indicate that some construction underwriters and their reinsurers are focusing on the complexities and overlap of Professional and General Liability coverages. Underwriters are attempting, and succeeding in many cases, to remove endorsement CG 2280 from Contractors' General Liability policies upon renewal. This endorsement, which is actually an exclusionary endorsement relative to Professional Liability exposures in the General Liability policy, adds back or expands coverage for construction means and methods which can lead to professional liability losses. In some cases, contractors who have declined to purchase a true Contractors' Professional Liability coverage form, rely heavily on this endorsement in the General Liability policy to address bodily injury and property damage exposures arising from the design-build business.

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We will see General Liability underwriters increasingly carve out any potential coverage for Contractors' Professional Liability exposures and push them to a more appropriate Professional Liability coverage form. Reasons for this change include the underwriters' concerns over uncontrollable legal costs associated with the provision of defense outside the limit with the General Liability form (vs. a Professional Liability form which has defense inside the limit), and the fact that the General Liability policy is occurrence-based with relatively low retentions when compared with a claims-made Professional Liability form with higher retentions. Obviously, it is beneficial for buyers to retain the CG 2280 endorsement, but we will likely see continuing push-back by key construction underwriters. It is unrealistic to expect the Professional Liability marketplace to absorb the property damage and bodily injury high limit exposures along with the wrongful act exposures without an adjustment to their pricing and underwriting models, if at all. A separate discussion paper is available on this topic from your Willis Client Advocate.

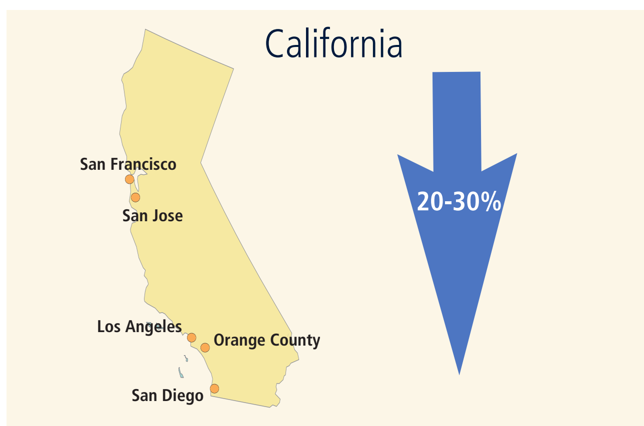
- Outside of the more common exclusions (e.g., EIFS, pollution, silica, mold, etc.), general liability underwriters address habitational risks differently and will continue doing so as underwriters ask for the split in a contractor's back log and work plan on habitational vs. non-habitational, high-rise/mixed use vs. frame attached product and geographic break downs by percent of work. They will then address the habitational exposure, either with an exclusion on the general liability policy

that provides no coverage; an exclusion that allows for scheduled projects; higher or bifurcated retentions for the habitational exposures; or separate general liability products. Although the condo and homebuilding markets have slowed, they continue to represent close to half of all put-in-place construction in the US annually, so program structures and General Liability products will reflect this in the foreseeable future.

Workers' Compensation

While Contractors' General Liability policies, changing products, endorsements and legal trends are in the spotlight and the subject of much discussion, Workers' Compensation is less dramatic and quite stable.

- With legislative changes and cost-containment strategies already in place, the loss cost numbers are now showing downward signs. In California alone, rates are down some 20-30 percent but should moderate in 2007. Issues in this area revolve around continued legislative bickering and adjustments to ensure injured workers are financially taken care of while managing the overall cost to business of this no-fault system.



- Perhaps the key issue facing contractors relative to Workers' Compensation is collateral requirements. With the maturity and longevity of loss-sensitive rating plans (e.g., large deductible plans) on this line of business spanning 8-10 years, many contractors have collateral being held by two or three insurers. Once a contractor moves its business to another carrier, it becomes more difficult to negotiate collateral requirements on past liabilities with former carriers, making moving business from carrier to carrier more challenging. As the market continues to soften in 2007, we expect that collateral may be less of an issue and more of a negotiating point with either the incumbent (reduction of collateral or more favorable terms) or the new carrier (flexibility in type and amount of collateral).

- The downward pressure on Workers' Compensation rates has an impact on wrap-up programs. While wrap-ups are a distinct topic and will be addressed in a separate project insurance market update, it is worth noting the impact Workers' Compensation rates are having on such program structures. While wrap-up or controlled insurance programs still exist, they do so in smaller numbers – a situation driven by the reduced costs of subcontractors' insurance (and therefore reduced deductions), LOC requirements by carriers of sponsors, increased aggregate and fixed cost rates, and generally fewer carriers due to the lack of historic profitability of these programs. Seven years ago, the insurance market included 12 standard market wrap-up carriers; in 2007, there are three – maybe four – standard market competitors for any given project. With rates down in this line of business, the size of a project required to achieve financial viability will continue to increase and be very sensitive to state level differences in rates for Workers' Compensation.

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Excess Liability

Perhaps the most variability can be found in Excess Liability. Gone are the days of assuming a pure follow-form excess placement, so whether the issue is pricing, attachment point, or specific exclusions, lead excess forms must be scrutinized carefully.

- For larger contractors who continue to grow, rate trends for this line show decreases of 20% or more, and although a general downward trend is noted, there will be high variability dependent on exposures, loss history and underlying limits.

- The key is the lead underwriter for the first excess layer and specifically the underwriter's underlying limits requirements. Some pressure to have higher underlying limits has been noted over the last several years, which has created the need in some cases to seek buffer layers over the primary General Liability and the primary Automobile Liability policy limits. Buffers can be an important tool in achieving both pricing balance between the General Liability and Umbrella/Excess policies and to attract more competition in the first excess layers. These also can be used to moderate Umbrella/Excess

underwriter concerns on specific coverage concerns, including habitational risks.

- As respects Professional Liability issues, underwriters are attempting to attach "absolute" means and methods exclusions on contractors' excess policies. This issue is similar to the CG 2280 endorsement on the primary General Liability coverage form mentioned above.

- One issue impacting the Umbrella/Excess area is the coordination of limits between project-specific placements (often in a wrap – up format) and contractors' master programs. Underwriters have been particularly sensitive to stacking limits on risks. This happens when they are offering coverage under a project policy as well as additional limits on the insured's master program. This can be mitigated by working with the underwriters to identify specific projects where they exist, but needs to be a focus for review to avoid issues on wrap – up programs.

Professional Liability

Professional Liability coverage including capacity, rates and appetite are all improving relative to a year ago and, while there are always exceptions, for the most part, this line is expanding.

- Capacity has increased for A/E's and contractor's coverage and we anticipate product and capacity interest by current carriers in terms of contingent coverage for contractors.

- Habitational construction issues faced by many buyers last year are loosening. Where underwriters previously declined issuing programs that have more than 10 or 15 percent habitational risk, that percentage is rising to 25 or 30 percent; in some cases, underwriters are not looking for a percentage any more but are underwriting on a case-by-case basis. We are also seeing project-specific professional coverage for condominium work for the A/E when the carrier writes the A/E's master program. Additionally, fairly significant limit is available, whether it is put in place or not, for high-rise concrete and steel condominium developments.

- Contractors' Professional Liability underwriters are showing a lack of interest in covering the construction management (CM) at risk exposures on Contractors' Professional Liability coverage forms. The underwriters continue to underwrite CM-agency but are more conservative on the CM-at risk model.

- Owners are showing increased interest in this coverage and are either requiring minimum threshold limits from their general contractors who do not carry professional coverage or are spiking already in-place minimum limits requirements and/or are pursuing their own contingent professional liability policy to treat the exposures. This issue arises on public projects, too.

- We expect slight rate decreases on good renewals.

Environmental Liability

Probably the most critical market question for Environmental insurance buyers is not limits or rates (which are only showing modest increases), but how to best manage increasingly restrictive terms and conditions driven by past carrier losses, new scientific advances and new regulatory initiatives.

- Insureds will feel pressure by underwriters to reduce policy periods.

- Upon renewal, insureds should expect requests for more location-specific information on their portfolio placements. In some cases, these requests are actually demands, and coverage is contingent upon more and better information by project and by location.

- Along with increasing their number of requests for information, underwriters are more keenly interested in scrutinizing areas of

regulatory interest such as vapor intrusion of underground contamination into buildings.

- Insureds should prepare for new coverage restrictions for key issues such as mold, specific building materials (with potential to cause mold), or emerging contaminants of concern such as perchlorate.

- Clean-up cost cap capacity continues to have unacceptably high loss rates for underwriters. With only a few markets in this arena, we see more restrictive terms and higher minimum premium thresholds. Up-front engineering or commitment fees are now common. Carriers are usually only offering this type of product to a pre-selected group of contractors.

- Professional Liability programs for large environmental service firms have been a source of significant losses for Environmental liability carriers. Expect a pull-back from accounts with a significant component of traditional design engineering (i.e., non-environmental) exposures.

- In contrast to the previous point, construction-related Environmental placements, such as the contractors pollution liability (CPL) product, represent a growth area targeted by the major carriers. Mold and completed operations exposures are two of the main coverage drivers.

- Insureds should expect challenging renewals with increasing restrictions on terms and conditions. Companies should take care and time with the design and marketing of their programs to avoid erosion of valuable coverage. For new placements, it will be important to carefully match coverage needs with the current appetites and offerings of the market. As Environmental insurers become more selective, purchasers able to combine innovative program design with high quality underwriting presentations will derive maximum benefit.

Automobile Coverage

Coverage issues are not usually noted in this line of coverage. More common is the uneasiness at the excess level as to what underlying limit will be needed on the auto policy before the excess will respond. We expect pricing to be competitive with the rest of the market trends.

Builders Risk and Property Coverage

One of the most significant concerns in 2006 regarding construction insurance was Builders Risk insurance. This was a critical issue in terms of capacity, deductibles and pricing for insureds in the southeastern part of the country. As we reported last year, the rest of the country fared much better with this line of coverage. 2007 will see much of the same.

- While predicted hurricanes did not form in 2006 and catastrophic losses did not occur, carriers for the Builders Risk coverage line have clear memories of the previous two years. Usually, we could expect capacity and rates to loosen in this short-tail line of coverage based on the year we had in 2006, but don't expect to see much movement for buyers doing business in the southeast. Carriers will continue to be stingy with capacity and cautious with allocation. Driven by new catastrophic models and rating agency scrutiny, carriers will retain strict underwriting discipline for certain areas of the country. Larger placements may require participation by several insurers to achieve adequate limits in these areas. This will require care in structuring these programs to avoid coverage dislocations.

- Outside of coastal areas and California quake issues, Builders Risk coverage continues to be available and affordable with rates down 20-30 percent. Interesting and perhaps short-sighted was the flood of insurers allocating their capacity to the middle- and upper-Midwest regions where the New Madrid fault line resides.

- On moderate to large projects, we see underwriters requesting more technical project information prior to quoting Builders Risk projects. More and more, underwriters are asking project managers technical underwriting questions, which means that longer lead-times are needed to obtain multiple quotes and optimal terms and conditions.

- Contractors' equipment pricing is down 5-10 percent over expiring. Loss experience, retentions and geographies must all be factored in, but for the most part, this line of coverage will enjoy stable to reduced rates.

- Permanent property rates, typically, are down with concerns for aggregation of risk in certain areas of the country.

Summary

The 2007 Property and Casualty market for contractors will be much the same as in 2006: stable in terms of rates, with modest decreases in most lines and tighter terms and conditions in the General Liability and Excess Liability lines of coverage. Expect continued erosion of coverage granted in the General Liability and Excess lines of coverage, either literally by endorsement or effectively by claim handling and litigation in certain states and regions of the country grappling with the business risk issues involving faulty workmanship and the definition of occurrence. Property lines, for the most part, are stable with rates down (the exception being coastal wind Builders Risk coverage and California quake coverage). Workers' Compensation is enjoying a great run, primarily due to legislative changes, while Professional and Environmental coverages require tailoring to fit specific defined exposures to assist underwriters in pricing of their risk.

Other issues to watch for include potential catastrophic losses, carriers and financial health, and overall trends in construction liability coverage restrictions. One of the biggest potential risks for 2007 is catastrophes. With the massive coastal housing and commercial build up during the past several years, most analysts expect $40 billion catastrophic losses to become more prevalent. Most in the industry also say that it is reasonable to expect a $100 billion catastrophic loss year soon.[5]

Along with this concern is the overall financial well-being of the P/C industry in the US. While 2006 was record-setting and the industry is flush with cash, the next step is generally the setting aside of underwriting discipline and the fight for market share. Without many new standard insurance market entrants into the construction segment, the few that exist need to decide and define how they will participate. While several have their paths outlined, others search for their niche; this can also be said of the construction-focused excess and surplus lines carriers that wrote significant premiums in habitational wrap-up coverage during the last couple of years. However, even with increased competition based on strong capital, coverage restrictions and interpretations may allow underwriters to stave off the dreadful loss trends they were saddled with after the last soft market in the late 1990s. It is incumbent on buyers and their representatives to maintain the standard of coverage and traditional legal interpretation for contractors. This may be the biggest challenge we face as a risk management community in 2007.

1 See Insurance Information Institute "Industry Financials and Outlook".

2 The combined ratio is the ratio of losses and expense to premiums where 1.00 is par. It reflects whether or not the industry or a given company makes money on its core business of pricing risk.

3 The combined ratio for the P/C US market in 1936 was 93.3.

4 South Carolina, Illinois, Pennsylvania, Virginia, New York, Iowa, Colorado, Oregon, West Virginia, Missouri, Indiana, Georgia. Other states have conflicting laws: Texas, Ohio, Florida, North Carolina, Arizona.

5 Insurance Information Institute.