Willis

MARKETPLACE REALITIES 2016

ANALYSIS AND INSIGHTS: CONSTRUCTION

A RISK IN NEED OF MANAGEMENT

The role of risk management needs to evolve to face what may be the critical risk facing the construction industry: a talent shortage. The ongoing soft market and other long-term trends present opportunities for addressing this problem directly.

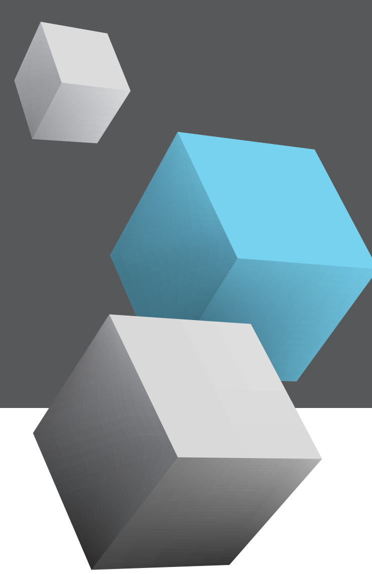
I spoke to three construction CEOs this week and each of them confided separately that their number one concern right now is finding qualified people to do the construction that's picked up as the Great Recession shrinks in the rearview mirror. At the same time, our team was finalizing a detailed report (which appears below) on insurance market conditions. This got me thinking about the changing role of risk management in the world today and some opportunities that might be presenting themselves to those of us in the business of enabling construction in the 21st century.

Of course my CEO colleagues aren't as worried about insurance at the moment: an ongoing soft market makes it a bright spot in a very complex environment. On the other hand, the talent shortage is creating big headaches:

- Difficulty staffing jobs with project management personnel
- Inability of subcontractors to hire enough labor, impacting schedules, quality and safety results
- Cost of attracting qualified people rising faster than margins, creating a daunting war for talent

'WHY CONTRACTORS FAIL'

This was the title of a recent presentation by Ryan Howsam of FMI at Willis's 21st Annual Construction Risk Conference. In an eye-opening look at Millennials and issues of business culture, he pointed out that the ability of contractors to connect with the current generation may be the most important challenge they face to success and profitability. **Click here** for more.



The talent shortage is not hitting us out of the blue and it's not just affecting the construction sector. For years, labor experts having been warning that the retirement of the Baby Boomers will leave a knowledge and experience gap that may not be readily filled by the Generation Xers and Millennials behind them. Harder to predict was the impact of the Great Recession on the construction workforce. Many workers left the sector for good, either finding other industries or leaving the workforce altogether. Meanwhile, construction as a field has not evolved sufficiently to capture the imaginations or match the work ambitions of a workforce eager to start careers.

As the problem has come into clear and alarming focus, solutions have taken shape. Our clients are each trying various strategies:

- Reinvigorating hiring and training of entry-level construction people
- Working closer with unions to encourage qualitative training and expand their ranks with the younger generations
- Rethinking construction career paths to address younger workers' workplace goals:
  - Advancement
  - Flexibility
  - A window, if not inclusion, into decision making
- Telling the story that construction is becoming steadily more tech-centered and an exciting, quickly evolving field with a wide range of career paths

One CEO in particular, a 35-year construction veteran, noted that the pace of innovation is increasing geometrically and new thinking and new technologies will be needed to pull it all together. He and his colleagues also agree that all of the strategies being put in place to address the talent shortage will take time to implement – and there is no guarantee that they will work.

So where in all this do I see opportunities? Three places. The first is in the industry itself. The pace of innovation and the drive toward new technologies that's already front and center for construction will in turn drive several of the changes in the works: training for the new technology, career arcs for people who master that technology, and a new sense of what construction is today – a thriving field in the digital age.

The second opportunity is for risk management professionals – and in that I include both risk managers and broker/advisers. For years, we've been saying that risk management is a lot more than buying insurance and the place that risk professionals need to be is in the C-Suite talking at the highest strategic level. Here we see that one of the biggest risks construction companies face relates to talent and that's where risk managers should be involved. They should be doing what they do best: assessing risk and figuring out options for addressing that risk and helping their organizations attain their most fundamental objectives. They may not necessarily be invited to make this move, so the first steps may need to be taken with some forethought – and with some boldness.

We're talking here about a change in mindset that breaks down the borders between the traditional Property and Casualty risks and human capital risks. We're talking about taking a more active and open minded approach that brings new ideas to recruiting, compensation and talent management. For broker/advisers like Willis, we're talking about a different kind of conversation with our clients. On all sides, we're talking about a challenge to risk management business as usual.

The third opportunity is in the marketplace. The ongoing soft market means a **predictable insurance spend for the foreseeable future**. That takes some of the pressure off of the risk professionals responsible for buying the right insurance at the right price, which in turn frees up time and resources to realize the second opportunity outlined above.

Of course, we can't take our eye off the ball in terms of the hammer-and-nails basics of the insurance transactions, which remain crucial to the success of every construction endeavor. To that end, here's a deeper dive into the construction insurance marketplace.

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THE CONSTRUCTION INSURANCE MARKETPLACE: Q4 AND BEYOND

Expectations for Construction Risks: Rates, Terms and Conditions

The U.S. Construction Property and Casualty (P/C) market remains competitive going into Q4 2015. Outside of a couple of issues and states (i.e., residential construction overall in the U.S. and any construction in New York), contractors are enjoying one of the longest running soft market cycles in recent history. Overall, newer entrants in both the Casualty and Property underwriting space are driving competition for new and renewal business. Regarding the Property lines of business such as Builders Risk, the market continues to be hyper competitive; without a natural catastrophe or global event before year-end, we expect continued downward pressure on pricing.

There continues to be movement of professionals and teams among carriers and brokers. This coupled with significant capacity will likely drive down pricing in both Property and Casualty lines and in product creation.

Contractors Casualty Insurance (General Liability, Workers' Compensation, Auto Coverage, Umbrella/ Excess Liability Coverage)

The overall marketplace for construction Casualty risks in the U.S. remains competitive. With increased capacity and competition, we are starting to see more downward pressure on rates for good risks with little to no loss experience. Several markets that historically were accessed via wholesale brokers are now allowing direct access by retail brokers. In addition, new capacity continues to grow and formalize with talent and products.

General Liability rates are stable to slightly down, particularly for accounts with good loss experience and desirable risk profiles (e.g., no residential construction). One trend we are seeing now is a drive by excess markets for higher primary limits. For example, excess or umbrella markets are seeking a 2/4/4 versus a 1/1/1 GL primary limit (per occurrence limit/general aggregate limit/products-completed operations limit). This is due to loss development and larger project size.

The Auto line of business in the U.S. continues to decline with carriers posting reserves. While Auto Liability, in particular, is historically a severity and not a frequency loss profile, there is a trend in the U.S. toward an increased 'frequency of severity.' Overall, rates are trending upwards but this does not necessarily account for the loss development. We likely will see rate pressure on contractors' fleets and scrutiny of contractors' loss control and safety for this line of coverage.

Workers' Compensation remains stable throughout the U.S. Of course, benefit levels and rates vary by state but with no real outliers notable. This stability is leading to more General Liability-only controlled insurance programs (CIPs) versus Workers' Compensation CIPs.

The excess and umbrella Liability marketplace is very competitive, particularly above the lead $25M layer. As in General Liability, there has begun a shift with these markets toward attaching at higher primary limits. Additionally, while the excess and umbrella carriers have capacity to offer, they are leaning more toward ventilating their capacity by participating in excess and umbrella towers at various layers (i.e., a carrier may put up a total of $25M but break this up into two or three chunks at various layers within an overall tower).

Contractors Professional Liability Insurance

Over the past year, new market entries have increased capacity in the Professional Liability marketplace. All of these markets have developed competitive forms and are offering coverage to contractors on a primary basis.

The new markets and capacity have offered an expansion of options in Professional Liability which has resulted in a higher number of renewals being marketed than usual. This has resulted in steady rates and some rate reductions for contractors with well performing programs. Buyers have also seen favorable terms and conditions on renewals in lowering retentions, enhancing coverages and increasing limits based on this competition.

Residential (i.e., condo) construction continues to be a challenge for Professional Liability insurers. Historically, Professional Liability losses have been most frequent and severe in residential projects. With the continued increase in residential construction and conversions, insurers are being very selective when offering coverage to contractors engaged in this work. The acquisition of Catlin by XL has also thrown the Professional Liability market into a state of flux as questions about future capacity of the merged company remain unaddressed.

Delivery methods such as Integrated Project Delivery (IPD) and Public-Private-Partnerships (P3) require expert broker involvement in contract review and structure when seeking project-specific professional liability coverage. Insurers have been willing to take on non-traditional approaches to these delivery methods when presented with the proper information.

The increasing size of construction values on projects of all scopes has required contractors to review their Professional Liability program structures and limits with more diligence than ever before. Many contractors are finding themselves under-insured. Contractors are also reviewing subcontractor agreements and are requiring increases in Professional Liability limits of subcontractors with professional exposures as part of their sub-packages.

Finally, owners and lenders are contractually requiring Professional Liability annual and project-specific policies at higher limits and are more educated on professional exposures than in the past. This has resulted in contractors with lower limit policies to struggle with contract compliance.

Contractors Pollution Liability Insurance

The application of environmental coverage to the construction industry remains at an all-time high as a result of contractual requirements, an increase in exposure due to regulation and enforcement, and broad coverages offered by more than 30 environmental carriers. Sustained domestic and international construction activity has fueled demand for Contractors Pollution Liability products, especially when placed in conjunction with Builders Risk or Wrap-up programs. Despite this demand, soft market conditions have resulted in flat to decreasing rates for preferred classes of monoline contractors pollution liability programs, except where buyers have seen significant claims activity or Professional Liability exposure.

The continued rise in the frequency of Environmental claims activity (20%–30% each year) – especially resulting from Indoor Air Quality (IAQ) issues including mold and Legionella – continues to be a challenge for both the construction industry as well as for their Environmental insurance providers. Accordingly, insureds are becoming more aware of the importance of establishing an Environmental claim protocol, including incident reporting and notice, before claims happen. Similarly, insureds are seeking to further reduce their exposure by broadening Environmental coverages wherever possible on their standard P&C lines (General Liability, Builders Risk, Property, Auto) to increase their potential for overlapping coverage with Environmental policies.

Potential threats to the favorable underwriting conditions in the Environmental marketplace include a decrease in appetite by some carriers for habitational exposures as well as redevelopment and M&A activities that may pose longer-term and potential moral hazard exposures associated with known conditions and voluntary testing. Additionally, recent market consolidation between some of the major environmental insurance carriers could signal an eventual hardening of the market if the trend continues.

Builders Risk & Construction Property Coverage

Barring significant natural or man-made catastrophic losses, terms and conditions are expected to remain ultra-competitive in 2016. Soft market conditions are being driven by an abundance of capacity, stemming from domestic carriers continuing to increase their net and treaty capacities and new, formidable, players entering the space.

For good construction types and depending on geography for any given project, U.S., domestic capacity is upwards of $1B. Capacity, in general, is upwards of $2B when coupled with London-based capacity. We expect to see continued pressure on rates through the end of the year. Important to note is that spot pricing for any given project may be significantly cheaper than a contractors master builders risk terms and conditions.

Controlled Insurance Programs

The controlled insurance program (CIP) marketplace continues to be competitive and grow for both residential and commercial construction. Pricing is stable and capacity is plenty.

Regarding residential construction, CIPs are primarily placed in the Excess and Surplus lines marketplace via wholesalers. Coverage terms and conditions can vary and there is greater awareness among buyers that specialist wholesalers are necessary. While this has been our view all along, the nuances of expertise and leverage among wholesale brokerage firms and even among specific brokers within the same firm, seem to be more relevant in today's marketplace. This shift in the marketplace is driven by competition.

While General Liability-only (GL-only) programs are commonplace for residential construction, in particular, for-sale construction, they are becoming more commonplace for commercial construction. Factors driving this continued shift include desire on the par to of a sponsor's (i.e., general contractor or owner) for coverage consistency and certainty through the statute of repose.

Standard markets continue to not want for-sale construction risk in their portfolios. Apartments, too, are becoming less tolerable risk profiles for the standard markets due to the possibility of conversions in future years to condominiums. There is a slight trend toward deed restrictions and other tools to help avoid future conversions but, while these are helpful, the E&S market remains competitive for this risk and we don't see a significant need for these tactics or tools at least for insurance purposes.

Two-line CIPs (i.e., Workers' Compensation and General Liability) are now as prevalent in today's marketplace due to the stability of Workers' Compensation rates. In other words, a two-line CIP doesn't make financial sense when including costs such as the administration of the CIP. Standard markets underwrite both two-line and GL-only CIPs typically with retentions starting at $250K but with upward pressure on retentions. Again, the standard markets won't underwrite for-sale product and are not as willing to take on apartment risks. Of course, E&S markets don't do two-line CIPs as they don't underwrite Workers' Compensation risk.

New York continues to be a challenge for any construction risks due to the labor laws in the state. For the most part, projects in the metro area and the five boroughs, in particular, are underwritten on a project-specific basis, non-CIP. These CIPs are typically two-line and afford little true risk transfer. In other words, the retentions are usually close or equal to the limit of liability provided on the General Liability line of coverage. Without legislative relief, we see little to no change in how construction insurance is underwritten in New York City.

Finally, overall excess pricing for CIPs remains very competitive, especially above the lead $25M layer. We do see the need in today's marketplace for arranging the lead $25M with more than one or two carriers. In many cases, carriers will provide ventilation options, meaning they will participate with a smaller limit (e.g., $10M) in the lead $25M and then provide additional capacity above the $25M lead layer. There is a trend, too, for attaching at a higher primary limit. While this is relatively new and can be negotiated, we believe that in the future, excess markets will want higher attaching primary limits.

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FMI Research
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