Risk in Context Podcast

Episode 35

Risk management priorities as inflation impacts construction projects

Richard Gurney:

Hello, I'm Richard Gurney, the Global Head of Construction within Marsh Specialty.

Welcome to *Risk in Context*, which features conversations with Marsh colleagues, risk professionals, and others, intended to help you better understand your key risks, build more effective insurance programs, and think creatively about risk.

Persistently high inflation is affecting economies around the world, and businesses are feeling the effects of increased prices. In the construction industry, companies have seen costs rising for both essential materials and for skilled labor, with supply chain pressures and shortages evident in virtually all regions.

At the same time, the insurance market is also adjusting to this inflationary environment, leading to rating increases and increased sums insured.

In this episode of *Risk in Context*, I'm joined by Kelly Outram, head of global contractor development at Marsh, and Gaurav Kapoor, the strategy and operations leader for global construction. We will discuss the effect of inflation on the construction industry and the actions that companies should take to adapt their insurance requirements whilst they navigate through this turbulent economic cycle.

=====

Richard Gurney:

Kelly and Gaurav, thank you for joining us today.

First, let me set the scene. Rates of inflation are currently at the highest levels we've seen in over 30 years in many of the developed economies. Whilst it was initially hoped that this was a short-term consequence of production, demand, and supply chain issues resulting from the COVID-19 pandemic, there are signs that the disruption may be longer lasting than expected as focus has shifted to the conflict between Ukraine and Russia and the contagion in economic disruption that is resulting.

We also have an environment where contributing factors are and will be impacting the construction industry, such as increasing demand for infrastructure as a stimulus to COVID-impacted economies, increased construction activity driven by measures to alleviate the impacts of climate change, and a shrinking and changing labor market driven by pandemic-related retirement and local restrictions, like the impact of worker mobility as a consequence of Brexit.

So, high demand at a time of high prices and scarcity of materials and labor.

The question is: How long term will this high inflation impact last? And how can our clients manage the associated risks?

If we start with you, Kelly, can you talk us through the practical impacts we're seeing high inflation have on our clients operating in the construction sector?

Kelly Outram:

Thanks, Richard.

Well, I think we're seeing the effects of inflation show up and affect our clients in various ways, but most notably through two key ways, the first being increased cost of materials and the second, increased cost of labor.

So, if we take the cost element of materials first, we are seeing dramatically increased costs in terms of materials. And this is affecting both existing work and bids.

As we know, for many contractors and developers, the contracting environment is under a lot of pressure at the moment. Construction clients are busy with both existing projects and also new tenders, given some of the post-pandemic recovery. Yet, the increasing cost of materials is rapidly driving up bid prices. And this is presenting a real, real challenge for our clients.

So, to give an example, in the UK, bid prices have, in some cases, increased up to 8.5%. To put this into context, this has doubled from what it was in 2021.

And I guess a point to make here is that this is for new bids. So, for those contracts that contractors and developers are already locked into, in most cases, they're having to absorb these costs that they can't pass on.

Richard Gurney:

Can you give us some examples?

Kelly Outram:

Sure. So, if we look at some specific material costs and increases — some of which have reached a 40-year high based on historic rate indices — we are seeing dramatic increases, especially for timber and steel. Fabricated steel is now 66% more expensive than it was in November 2020. Softwood lumber received a lot of attention last year as prices quadrupled in 2021. This has eased a bit this year, although the latest US stats indicate that increases are still tracking at about 18%.

In terms of timber, there are other increase anomalies as well, such as OSB [oriented strand board]. Now, OSB is a wood product that is integral to the integrity of a building structure. And this material, believe it or not, has increased 510% since January 2020.

So, it's a totally crazy time for our clients, which I'm sure will resonate with some of our listeners today.

And to give just a few more examples, in the US, the non-residential construction input price has increased by almost 24% in a year. And we're seeing double digit increases [in] the US for plastic construction products.

And lastly, the UK inflation rate using the consumer price index has gone from 2.5% to 7% in the last 18 months.

And I guess just one last point on this topic is the increased cost of fuel, which we are all very aware of today. This is affecting almost everyone and every industry. The cost of getting materials to site is dramatically increasing. And this is really having an impact on our construction clients. Contractors pay a huge amount for fuel to run their trucks, to run equipment. In the US, diesel fuel has reached an eight-year high, which is up at least 41% from a year earlier.

Richard Gurney:

And on top of that, what about the impact on labor costs?

Kelly Outram:

As you know, Richard, labor shortages and increasing wage costs have been a big, big challenge for the industry for a number of years now. And I think this is set to continue, given the broader economic pressures that exist. Globally, the cost of living is rapidly increasing, and as we've already said, more recently exacerbated by increased fuel prices that have a direct impact on our clients.

Construction costs, as all of us I'm sure are aware, are affected by wage input. And in some cases, wage costs can account for over 50% of the overall construction costs.

And on this basis, you can see how sustained pressure on labor costs is affecting clients and their ability to control project costs. And given the shortages of skilled labor in many markets, this pressure on wage cost is likely to continue.

In the UK, wages have increased by as much as 15% in the last year.

So, turning to our clients, what does this mean for the construction industry?

Well, I guess, firstly, it means the continuation of higher costs to compete and bid for projects. If we take the UK as an example, these challenges have been mounting for a few years, especially coming off the back of Brexit, which you mentioned earlier, Richard.

And finally, I guess the point I wanted to share was that most contractors typically operate on small margins. And to have to go through a bidding process — all of which makes predicting accurately what future costs are going to be when we think about materials and labor — it all makes for a really, really tough environment.

Richard Gurney:

Presumably, there are significant issues impacting all construction-industry stakeholders, aren't there?

Kelly Outram:

Indeed. In most cases, we're seeing contractors bear the brunt of these risks of increased costs. As I have already mentioned, contractors work on small margins. And many are struggling to operate with increased cost of materials, particularly for those that operate via fixed price contracts.

In most countries, the risk of inflation is borne by contractors under their contracts. In some countries, we've seen contractors struggle to survive and in some cases collapse, particularly in the small to medium space, but also in the larger contractor arena too, as the material cost increase is really the tip of the iceberg for them.

And then, if we think about funding, what does increasing inflation do for the funding of projects?

I think some regions are already seeing challenges around securing funding for projects in a market that is already very, very uncertain. And if we think about the bankability of projects, some funders will be viewing certain projects in a different light, especially those that are high in value or complex, and particularly those that have long build times.

Then, if we turn to the availability of materials and the challenging supply chain and linking this back to inflation, which is of course what we're discussing today. Where supply chain pressures and bottlenecks continue to drive up inflation costs. What we're seeing is the added challenge of not actually knowing when materials will turn up to site, given the global supply chain challenges, again, having an impact [on] clients through potential project delays.

And I think since the start of the pandemic over two years ago, we've all seen how supply chains globally have been a major cause of headache for almost all clients. And I think this is a continuing trend.

In the past, when we think about risk and project delays, we would typically think of project delays due to material shortages coming from large power projects or tunneling projects, where there's often a reliance on a single piece of big kit that if it's damaged or is delayed in terms of getting to site, would severely impact the project schedule.

Yet now, what we're seeing is an increased risk associated with smaller materials across all projects, and relating to most materials where projects are, frankly, much more exposed to delays in all angles.

In the US, some contractors are even struggling to source concrete and get it to site.

Richard Gurney:

Gaurav, turning now to the construction insurance market. How do the steps insurers take to manage inflationary effects impact on our clients?

Gaurav Kapoor:

Yeah, I think it has a huge effect. Maybe just to set the context for our listeners: When we look at a construction insurance lens, there's two real main type of policies or programs that you look at that come into effect. So, the builders' risk or construction "all risks" policy and your third party liability policy. When we look at these types of coverages, they're priced on an exposure basis and are directly linked to inflation. When you look at builders' risk or construction "all risks" policies, you're linking that to estimated contract value.

When you look at third-party liability policies on a project-specific basis, you also link it to contract value. And you can also link it as well to payroll.

So, those are all things that are impacted by inflation. So, the obvious effect to our clients is that the premium is going to increase alongside inflation.

But there are some things that might not be apparent to clients that need to be considered. So, when we look at the property side of things with the builders' risk or construction “all risk” policy, the sum insured on that coverage is most of the times linking with your contract value.

So, when you think about something like inflation, you might have a situation where in a total loss, you are underinsured as a client if you have not kept up with that inflation trend.

Now, there are things on the coverages and the policies to mitigate that to some extent, when we think about escalation clauses or inflation protection. But they are limited as they are capped from a percentage standpoint. And they also apply or come into application in the event of a loss.

Other things we can look at are limit of losses. So, on these types of coverages, sometimes you procure a limit of loss on the policy, which would be significantly lower or lower than the contract value. But that can be done for a myriad of reasons, either because there's no capacity in the market, or the economics behind procuring those limits are not there.

So, as contract values increase with inflation, your scientific approach to how you came up with that limit of loss to procure might not be valid. You might need to reconsider what that looks like.

And then, when we look at the liability side of things, again, with inflation, costs involving judgments and different variables that come into a liability payout or judgment are going to increase as well. So, the consideration with clients' tower of liability limits will come into question.

Richard Gurney:

Taking that on further, what do we see this inflationary environment do so far as the insurers’ appetite where risk is concerned?

Gaurav Kapoor:

Yeah. I think it does impact the insurer's viewpoint or appetite on the various risks with construction. I think when we look at how they deploy their capacity, there's a lot of variables that come into play there. One of them is the estimated contract value over the life of the project.

So, if you take inflation and that contract value or the cost of construction is changing, that could affect how an insurer looks to deploy their capacity on a certain project. If we look at things like how they structure their deductible or how they structure attachment points on access layers when we think of liability towers, or even if we think about how an insurer structures their reinsurance treaty. Those things will all change with the change in contract value over the life of project.

When you sum it up, $1 today doesn't necessarily mean $1 tomorrow anymore. So, that really impacts how they approach the situation.

The other thing to look at is how the insurers view the risk. Kelly mentioned it earlier, that we're already in a contracted margin industry. When you take inflation, and those costs are increasing, and the pressures are on for our clients, the insurers potentially have a viewpoint that the risk exposure has increased because you might be more inclined to cut corners or accelerate a project when you might not be in a position to do so. And although we don't expect that from our clients, that's something that the insurers will potentially have a perception of that we need to manage.

Richard Gurney:

Kelly, turning back to you. You must spend a lot of time discussing what this environment means for clients as they consider how they manage their associated risks.

Kelly Outram:

We certainly do. But firstly, I just wanted to pick up one of the point that Gaurav made, which I think is really, really interesting, and that is on the topic of deductibles and how in fact inflation may impact the retentions that our clients take on. And when we think about how premiums are set and how clients adjust their premium expiry in line with final project values, in many ways, insurers are getting an additional premium if costs have increased, albeit further down the line.

But when we think about deductibles, which are set at the start of a project, they're usually static throughout the lifecycle of a construction project. And perhaps, this will be an area that our clients may need to consider more going forward and having constructive discussions with insurers on what is reasonable and acceptable for them.

In terms of your question, in terms of the associated risk, we continue to have regular discussions with clients on the impact that this challenging environment is having on their business.

And I emphasize the word “their” because, as we all know, each client is unique and has unique challenges or nuances that need to be understood and considered. And really, for us, it's all about getting under the skin of their business to really understand these challenges and find ways to support them alongside insurers and some of the points that Gaurav just quite correctly made. There's a lot of dialogue and partnership with insurers. Certainly, our major clients understand the importance of their insurance partnerships and working together, especially in challenging environments such as we're in now to revisit limits or understand exposures.

Gaurav mentioned the possible area of insurers' concerns. I think, if insurers have a particular area of focus, and we mentioned earlier the potential issue of labor quality in an environment where margins are already very stretched, then increasingly, I think what we are seeing is our clients dedicating more and more time to explain how they are managing these perceived risk as a business. And I think that's a really important area to focus on.

And I guess lastly, just to touch upon the surety market. If we think about the surety market, particularly in regions such as North America, there are some considerations to think about. Project execution is at risk due to the cost, labor, availability of materials — challenges that we've already discussed. And I think markets may be more cautious, given the larger value of contracts due to inflated costs. And also, central banks are raising rates to control inflation, resulting in a higher cost of credit.

And I think what this all does is make insurers have a much closer focus at some of these areas.

Richard Gurney:

Gaurav, of course, inflation cannot be considered just in the context of underwriting alone. How does inflation impact the claims environment that insurers are working in with our clients?

Gaurav Kapoor:

Yeah. Thanks, Richard.

I think it definitely impacts that environment. I mean, when we think about claims in general in relation to construction and insurance policies, I think insurers always have had a general understanding that there's going to be some extent of additional costs with adjusting a claim. Especially when you look at construction projects, it's very different to go from rebuilding with a blank slate to then rebuilding a construction project that's midway through.

And I think insurers have probably always considered inflation in the event of claims as well. But when we're talking about inflation going from maybe 1% or 2% a year to 8% to 10% and for certain materials, as Kelly mentioned, that are multiples of that, it definitely makes things trickier.

And also, add on top of that, projects that are getting longer and construction periods. So, when we look at it from an insurer's standpoint, I think it's fairly simple if you have a total loss on a project because the policy is very clear in terms of limits that you pay out and obviously, what we talked about with some of those clauses that account for inflation.

But what becomes tricky for insurers from an inflationary perspective is when you have those partial losses, because then you really dive into some of the nuances around materials and increases in costs over the years of construction.

And when we think about supply chain issues, like Kelly mentioned earlier, insurers then started to, during the underwriting process, pay more attention to higher value items that had longer lead times and start to underwrite those in more of a specific matter.

So, I wouldn't be surprised if we continue to see inflation go down this path of increases and uncertainty, more questions from insurers during the underwriting phase to articulate the different risks associated with that.

Richard Gurney:

So, a picture of a clients’ myriad of trading risks needing to be carefully translated into their insurance programs.

Kelly and Gaurav, what is your advice to clients in helping them navigate through this challenging period working with their insurers?

Perhaps I'll start with you, Kelly.

Kelly Outram:

I think some of the key areas that clients are looking at are the need to be more open to sharing risk of inflation under their contract conditions. So, our contractor, owner, and developer clients are looking at greater sharing of cost risk under a contract. And perhaps, we will see more alliance type contracts going forward. I mean, I certainly think that owners are being more flexible in their approach and certainly over the last couple of years, as we've been in a global pandemic.

So, whilst no one wants to have higher bills, the alternative of having a contractor go out of business because of, frankly, impossible cost increases, is likely to be far worse for many owners who will have had their projects delayed.

I think what is interesting is that in some regions that have experienced long periods of high inflation, if we take Latin America being one of those examples, inflation risks are often shared between the contractor and the owner, rather than just fully being taken on by the contractor.

So, perhaps some regions will take lessons from other territories that have been experiencing these challenges already. Owners and contractors may also start to consider price adjustment clauses that would protect all parties from unanticipated swings in costs, especially material costs, which we've talked about.

And lastly, we're seeing many clients look at stockpiling materials, especially items such as steel and timber. Discussing with all stakeholders when is the best time to order materials is key.

But as we know, buying items and at what time, there's no right or wrong answer here. You can buy them early, and you have the benefit, and it protects you from future cost fluctuations. But I guess the downside is then it does expose some of our clients to other risks and costs, such as increased storage and security costs, as well as the risk of fire, flood, and theft. And this could be a whole topic in itself as we think about storage conditions, how to manage temperatures, moisture risk, et cetera.

So, perhaps this is actually a good segue back to Gaurav and insurance as well.

Gaurav Kapoor:

Yeah, I think that's a huge thing to consider. I mean, when I look at it, collaboration is key. We need the insurers to support our clients in ways they're looking to mitigate. I mean, if we take that example of stockpiling, that could be a potential positive thing that clients can do to mitigate the risk of inflation on certain construction materials. So, insurers need to be there to support our clients in those decisions, where as you know, they might take another viewpoint as just isolating that risk. But we need to look at the bigger picture here that we need to collaborate to help mitigate that issue.

The other thing I think clients need to maybe look at continuing to do is staying up to date on construction values for each project. As we are seeing these prices of materials increase, as we are seeing maybe prices of the contracts as they're being awarded increase, those need to be in parallel with notifications to the insurers on those project policies to make sure that those limits insured are adequate and are in line as we go along the project. That's in comparison probably to prior years where we would do that adjustment at the end of the project because the inflation rates weren't as high. I think now, that changes with what we're seeing in terms of the amount of the increases.

The other thing I think we can suggest for clients to continue to do is reevaluate the analysis. When we think about things like our liability tower limits that are procured or limited loss limits that are procured on a builders' risk or construction “all risk” policy. As I mentioned earlier, those are usually done on a scientific approach or some other methodology. Those need to be understood how they were calculated in the beginning and then rerun. And those analyses are conducted again on a more frequent basis to ensure that whatever methodology you used prior is continuing to be valid as we see these price increases.

Kelly Outram:

And I guess, just to add some other areas my side. In some cases, we are seeing clients include contingencies of up to 10% into their bids and tenders to cater for future price uncertainties and increased costs associated with any rebuilding as they are thinking and planning ahead.

And I guess the other key question we are seeing and hearing is: Will clients continue to bid on large mega projects, especially those that are longer than five years, high in value, and are really complex? Is the risk of cost uncertainty too much for many contractors and developers? And will we see a change in appetite for those projects? Or conversely, will others view this as an opportunity? And if so, then perhaps there's even more need for support from their insurance partners, who will have an important role to play in terms of helping clients manage risk.

Gaurav Kapoor:

And, Kelly, just maybe just to add on to that, I think that was a great point of clients are building in buffers for that inflation within their pricing. I think it's really important that we communicate that to that insurance market to make sure that everyone's involved and it's a transparent process along the way, because that will only do positive things for helping with this risk.

Richard Gurney:

It is certainly a complex picture facing our construction clients and their insurers alike. And the messages today around the need for clear communication and collaboration between all those involved in the construction sector in this challenging economic environment really do come through loud and clear.

Kelly and Gaurav, thank you for your time today.

=====

Richard Gurney:

That's all for this edition of *Risk in Context*. We hope you enjoyed our discussion, and thank you for listening.

You can rate, review, or subscribe to *Risk in Context* on Apple Podcasts or any other app you're using. You can also follow Marsh on LinkedIn, Twitter, Facebook, and YouTube.

In addition to your podcast feed, you can find more episodes of *Risk in Context* and more insights from Marsh on our website, marsh.com.

Until next time, thanks again for listening.