

# Construction Insurance Property & Casualty Market Update

# Willis

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## Midyear Update

For the US Property and Casualty insurance marketplace, the beat goes on. The record setting pace for profitability continued through the second quarter of 2007. The industry's underwriting performance<sup>1</sup>, as measured by the combined ratio<sup>2</sup>, was 92.4 for 2006, which would represent the best performance since the 1949<sup>3</sup>. This is due in large part to lower than expected catastrophe claims in 2006, which allowed the industry a record profit of more than \$60 billion. (Profits increased by \$19.5 billion in 2006 compared to 2005. Cat losses in 2005 totaled \$61.9 billion vs. \$9.2 billion last year.<sup>4</sup>) As it did in 2006, good insurer results bode well for buyers in 2007. Average premium reductions for all lines were 14 percent in Q2, following an average 13 percent reduction in the prior quarter.

Strong underwriting performance is expected to continue due to a number of factors, including adequate pricing across all market sectors, stable loss-cost factors and relatively low interest rates. Another significant deterrent to a near term repeat of the last truly soft market cycle appears to be continued redundancy in loss reserves. This factor is contingent on a "normal" to light hurricane season. Other catastrophic events in the second half of this year could also impact current reserves.

While the numbers above include all industry segments, construction underwriters – those who dedicate resources, marketing and capital to the construction industry – confirm that their books are performing well, with results equaling or bettering industry averages for their combined ratios. All claim strong performance and all express an interest in growing their current market share, which indicates a continuation of a competitive atmosphere for this class of business.

While premium growth is slowing and rates are becoming more competitive in most lines, buyers should be mindful of certain trends and potential problems facing the construction insurance marketplace. We see the following items to remain cautious of for the remainder of 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. We continue to discuss coverage trends with carriers on behalf of Construction risks. Underwriters are more willing to address lower deductibles and more aggressive treatment of collateral requirements than to negotiate more favorable coverage terms.

- Year-over-year rates for Primary General Liability coverage are flat or down 10-20 percent over expiring from key markets. Underwriters are more willing to aggressively price new



For more information,  
please contact:

Mary Ann Krautheim  
Senior Vice President  
Willis North America  
Construction Practice  
763 302 7141  
maryann.krautheim@willis.com

Paul Becker  
Practice Leader  
Willis North America  
Construction Practice  
615 872 3464  
paul.becker@willis.com

business to demonstrate growth and are reluctant to reduce premium on renewal business to the same degree. Construction insurers insist that they will continue underwriting discipline relative to coverage while aggressively pricing risk.

- Rates and other terms and conditions for this line of coverage are dependent on program structure, retention level, specific coverage grants, type of work performed, geography/litigiousness and loss experience of the insured. While there has been some willingness to address certain coverage gaps, the underwriting community still remains cautious relative to perceived longer tail exposures such as residential, excess wrap-up and joint venture treatment. Enhanced coverage terms are becoming easier to negotiate for artisan trade contractors at a faster pace than on behalf for general builders.
- Overall, the markets will continue to wrestle with issues of coverage interpretation for losses involving general liability property damage claims. Carriers routinely send reservation of rights letters on the majority of General Liability property damage claims, causing a delay in the investigation and resolution of these claims. Willis has negotiated claim escalation agreements with our main trading partners in an attempt to mitigate this phenomenon on behalf of our Construction clients. Early intervention and claim management strategy are key elements to 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 becoming more versant regarding this issue, as more court cases seemingly negate coverage for third-party property damage claims caused by faulty work-

manship, 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. 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; in certain states<sup>5</sup>, new case law is emerging that generally finds no coverage for faulty workmanship type claims that historically have been covered. Willis has attempted to provide a voice of advocacy on this issue, as it may serve as a continued source of friction between carriers and insureds. Greater awareness will prompt more discussions prior to the possible claim event.

- The slowdown in the housing market will cause a shift in underwriters' approach to this industry segment. Homebuilders are looking at methods to secure backlog and remain financially viable. Condominium developers are now hedging their bets by constructing apartment buildings with the option of converting them to condominiums should the market turn. This can cause a break in coverage during the completed operations phase, since strict exclusions for condo conversions are included in most policies. While there are new markets emerging to address habitational exposures, coverage must still be reviewed closely as inconsistency in language remains. Overall, the residential segment is in significant decline relative to the last three years.

## Workers' Compensation

The outlook for construction Workers' Compensation during the remainder of 2007 depends largely on what happens in the already tough construction labor market. A marked decline in work, and hence construction-related exposure, would likely place some downward pressure on average frequency and severity because of the relatively hazardous nature of this sector.<sup>6</sup>

This line is exhibiting positive loss trends which have created an attractive rate environment and appears to be sustainable for a number of key markets.



- The downward pressure on Workers' Compensation rates continues to impact wrap-up programs. While wrap-ups pose a distinct structure 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 are

less common – a trend 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 – competing for any given project. Carriers appear to be more amenable to supporting Contractor Controlled Programs over Owner Controlled Programs.

We are beginning to see interest from mono-line comp carriers in devising a method to address a companion Workers’ Compensation wrap-up with General Liability-only wraps from E&S (Excess & Surplus) carriers. It will be interesting to see if this idea catches on, given the competitiveness of this market.

## Excess Liability

Perhaps the greatest variability in construction insurance pricing and coverage terms can be found in Excess Liability. Managing the changing landscape of General Liability language into excess layers will be a challenge well into 2008.



- New carriers continue to enter the market for construction risks and the increased capacity continues to drive competitive pricing for this business segment. It is not unusual to see decreases in excess of 30 percent.
- Attachment and cost are not as much of an issue as is appropriate coverage. There continues to be a disconnect between primary and excess underwriters over appropriate language for construction risks. Difficulty persists in aligning terms of the lead carriers to address per-project general aggregate protection, excess wrap-up cover, blanket additional insured cover, etc. Occurrence definitions may also cause

concern if not in line with changes to the primary General Liability language. Careful scrutiny of excess language is critical to appropriate risk transfer. Particular attention should be paid to assure “follow form” language throughout all layers of coverage.

## Professional Liability

Professional Liability underwriters are attempting to attach “absolute” means and methods exclusions on contractors’ excess policies. Otherwise, Professional Liability coverage conditions are improving for buyers, including capacity, rates and appetite.



- Capacity has increased for architects/engineers and contractors and we anticipate ongoing product and capacity interest by current carriers in terms of contingent coverage for contractors.
- 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 trend occurs on both public and private projects.
- We expect up to 10% rate decreases on well managed risks.
- Underwriters are still wary of residential, stadium and infrastructure risks.

## 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 terms.
- 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 showing keener interest in scrutinizing areas of regulatory interest such as vapor intrusion of underground contamination into buildings.
- Insureds should be prepared 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 market choices, 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.

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.

- 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 that are 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. Large fleet exposures will drive umbrella options and pricing. Rate declines for automobile risks are similar to those of other lines, often in excess of 10% for better risks.

## Builders Risk and Property Coverage

Perhaps one of the most significant issues of concern 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. The second quarter of 2007 saw a marked loosening of this line of business. While some clients may have enjoyed a “correction” resulting in great rate reductions, we caution that these rates still are not reflective of pre-Katrina rate levels.

- A significant increase in property capacity may become advantageous to buyers for the remainder of 2007. While hurricane season is upon us, it appears that carriers have secured decent treaty terms and are looking for market share before year end.

Some clients have experienced additional capacity and improved terms in coastal markets, but this continues to be a difficult segment of the country to secure coverage.

Outside of coastal areas and California quake issues, Builders Risk coverage continues to be available and affordable with rates down 20 to 30 percent

- Second quarter contractors' equipment pricing is down 20 to 25 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. Significant competition is driving rates in this line, with additional capacity notable after the July 1 treaty placements.

## Looking Ahead

The Property and Casualty market for contractors is looking much more competitive for the second half of 2007. While pricing competition continues, we remain cautious about improving coverage terms. We expect continued competition well into 2008, with some flexibility in coverage terms returning in the General Liability and Excess lines as underwriters target growth. Carriers are very interested in wrapping up renewal terms early, but the same underwriting groups are becoming much more aggressive when pricing new business.

One of the biggest issues for 2007 is the potential for large-scale catastrophes. With the massive coastal housing and commercial construction boom of recent 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 in the not too distant future<sup>7</sup>. Other issues to watch include the financial health of carriers and overall trends in construction liability coverage restrictions.

While underwriting discipline remains, we do see some soft market behavior in the search for new business. Insurers are still flush with surplus and will deploy market capacity in reduced rates to generate additional growth in net written premium. Besides aggressively pricing new business, we also see increased geographic appetite from regional carriers, new appetite for construction risk and new product lines. This behavior is a tell-tale sign of a continued soft market cycle.



It is incumbent on buyers and their representatives to maintain the standards of coverage and traditional legal interpretation for contractors. This may be the biggest challenge the risk management community faces in 2007.

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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 NAIC Annual Statement Database.  
 4 Dr. Robert Hartwig, Insurance Information Institute, April, 18. 2007.  
 5 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.  
 6 NCCI Spring 2007.  
 7 Insurance Information Institute.