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As Construction Costs Skyrocket — What Is the Impact on Insurance Coverage?

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Eastern Insurance Group LLC

The coronavirus pandemic has impacted businesses across a variety of industries, forcing them to rethink their daily operations to ensure the safety of their employees and the public. This is no different for construction firms, where the pandemic has led to project delays, significant job loss and unprecedented uncertainty. 2021 industry predictions anticipated that the insurance market for the construction industry would be difficult. This anticipation was largely due to catastrophic loss activity associated with natural disasters, the increased cost of litigation and so-called mega claims — claims in excess of $3 million. These claims were particularly prevalent in the construction industry, which accounted for 37% of claims between $3 million and $5 million, 42% of claims between $5 million and $10 million, and 46% of claims above $10 million.[1]

Among other things, the pandemic has led to widespread business shutdowns, introduced short- and long-term uncertainty, impacted project schedules, and disrupted supply chains. According to Nasdaq, the cost of lumber as of May 2021 was a record-breaking 374% jump from May 2020. For building owners, it is more important than ever to manage construction cost escalation around issues like these shared by the International Risk Management Institute, Inc. (IRMI).

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Nasdaq

So, how does this affect construction insurance coverages? In this white paper, Eastern Insurance Group walks through cost and policy definitions and potential impacts in order to help you understand how your coverage may change due to recent economic factors.

Replacement Cost vs. Actual Cash Value

Replacement or reconstruction cost policies cover the cost to replace or repair a building with materials of the same or comparable quality. Replacement cost policies do not include the value of any land, and limits are determined based on the amount of funds needed to hire contractors and purchase materials to repair a building or construct a replacement.

Actual cash value policies function in a similar way to replacement cost policies in that they cover the cost to replace or repair a property. However, under an actual cash value policy, there is a deduction in reimbursement to account for the depreciated value of the original property.

Theoretically, the replacement cost of a commercial property should be lower than its market value, as the replacement cost must only take building materials and labor into consideration when determining compensation. However, when the costs of materials and labor rise, along with numerous other factors that contribute to market value, it is possible for the replacement cost of a property to be higher than its

[1] Zywave Construction Risk Insights — 2021 Construction Industry Trends

market value. Typically a more expensive policy, replacement cost coverage offers a large amount of financial protection in the case of a loss, as it does not take depreciation into account when determining compensation.

Coinsurance Requirements and Margin Clauses

Perhaps the most concerning effect resulting from inflation is its effect on coinsurance for the insured property. A **coinsurance clause** penalizes the insured for failing to purchase a limit of insurance equal to some specified percentage of its full value.

The coinsurance formula is as follows:

$$\left(\text{Amount of Loss} \times \frac{\text{Limit of Insurance}}{\text{Limits of Insurance Required}} \right) - \text{Deductible} = \text{Loss Recovery}$$

When the property is underinsured and suffers a partial loss, the claim payment would be reduced by the percentage by which the property was underinsured before the deductible is applied. In the case of a total loss, the claim payment would still be subject to the limit of insurance since the loss payment calculated by the formula would exceed the limit of insurance.

There are two ways to avoid such a coinsurance penalty. The first is to insure the property for at least the required percentage of its full value. The second is to have an agreed-value provision added to the policy or to activate an agreed-value provision that is included in the policy form.

A **margin clause** is an endorsement on a commercial policy stating that the most the insured can collect for a loss at a given location is a specified percentage of the values reported for that location on the insured's statement of values. In the event of a claim, the amount paid by the insurer is limited to the value of the building multiplied by the margin clause percentage. It is critical that building and property owners update their statements of value in order to avoid coinsurance penalties. Inaccurate property values can change how much funding carriers have after a loss, putting them at financial risk. Essentially, the penalties from coinsurance transfer some of this risk back onto the policyholders.

Here is an example:

Buildings #1 through #3 are covered under a Blanket Limit of Insurance of $4,500,000. The combined value of these three buildings at the time of loss is $5,000,000. There is a coinsurance requirement of 90% (.90 x $5,000,000 = $4,500,000); therefore, no coinsurance penalty would be levied.

The value stated for Building #1 is $1,000,000. The Margin Clause percentage is 120%. The maximum loss payable for Building #1 is $1,200,000 ($1,000,000 x 1.20).

Building #1 sustains a loss of $1,200,000.

The deductible is $10,000.

Step 1: Calculate the amount of loss minus the deductible.

($1,200,000 - $10,000 = $1,190,000)

Step 2: Since $1,190,000 is not more than the maximum loss payable, the insurance company will pay $1,190,000.

In this example, the insured's payment is reduced only by the deductible ($1,200,000 - $10,000 = $1,190,000 paid). This amount is less than the maximum loss payable (scheduled value x margin clause = $1,200,000), so in this loss, the margin clause did not result in any penalty for the insured. However, had the margin clause been 105%, the maximum loss payable would have been $1,050,000.[2]

Inflation Guard — Is It Enough?

Under the **inflation guard** provision, coverage limits are automatically increased on a regular basis by the annual percentage shown in the Declarations section of the policy to account for increased replacement costs due to inflation occurring throughout the policy period.

Here is an example:

If: The applicable limit of insurance is $100,000.
The annual percentage increase is 8%.
The number of days since the beginning of the policy year (or last policy change) is 146.

The amount of increase is $100,000 x .08 x 146 ÷ 365 = $3,200.[3]

[2]Independent Insurance Agents and Brokers of America Inc. | E&O Claims Advisor, Jan. 2014
[3]Insurance Services Office Inc., 2011

In normal times, inflation guard coverage is intended to assist the insured in maintaining adequate property insurance limits without the need for constant monitoring or to account for industries characterized by rapid property value increases. But these aren't normal times; and with material costs hovering at over 300% from a year ago, inflation guard provisions may not provide adequate protection. One last item of note: It is imperative that the insured review the inflation guard provision percentage and verify building limits prior to renewal of the policy for the provision to have the intended effect since the provision is not meant to automatically increase the limit of insurance on a year-to-year basis.

Builder's Risk

Once a project price is determined, costs should be fixed as soon as possible (binding subcontractors, pre-ordering materials and storage, etc.). In addition, it is important to review the language of subcontractor proposals and supplier purchase orders regarding issues such as price increases, acceptance deadlines and ordering of materials.

Important aspects to consider:

Price Escalation Clause: How is it addressed in contractor bids, purchase orders and other subcontract documents?

Escalation Clause on Builder's Risk Policies: This covers unanticipated increases in the cost of labor and materials, or changes in construction specs. Insurance coverage is not automatically included on all forms; it may need to be added.

Inflation: Builders typically use historical data to predict upcoming trends. The pandemic and its aftermath present a unique market. Lumber, copper, steel and resins have seen significant price fluctuations. And demand is currently greater than capacity.

Review of 2020 and Looking Ahead

In 2020, construction managers and subcontractors held prices level to build a project backlog while subcontractor margins were decreased to offset increases in materials, labor and construction efficiency. Generally, escalation in 2020 was flat.

With a 6% annual escalation rate to procurement for 2021 and 2022, markets are returning to growth that is commodity- and material-driven. Once the backlogs have been rebuilt, labor and markup will drive escalation even higher.[4] There is still a long and uncertain road to recovery, with questions still looming around how the potential Federal Infrastructure Bill will affect pricing, supply chains and the availability of skilled labor.

Now more than ever, it's essential for businesses to take a proactive approach when it comes to their risk management efforts and their insurance policies. In an insurance and risk environment with many unknowns, businesses should focus on addressing the factors they can influence.

Good Advises. Good Insures. Good Protects.

In addition to helping you navigate the insurance market, Eastern Insurance Group LLC has resources to assist in your risk management efforts. Business owners who proactively address risk, control losses and manage exposures will be adequately prepared for changes in the market and will get the most out of each insurance dollar spent. You need an insurance professional who fully understands your industry, the dynamic insurance landscape and how to provide targeted loss control solutions. Overall, businesses need to focus on prevention, working with their trusted insurance consultants and leveraging data and analytics to anticipate exposures and make educated decisions regarding how to address them.

Eastern Insurance Group's knowledgeable professionals have strong relationships with leading insurance companies offering the most robust commercial property coverage. We partner with our clients as they evaluate their ongoing and ever-changing needs. Contact us today to learn more.

Eastern Insurance Group LLC is the largest independently owned insurance broker headquartered in Massachusetts, and a wholly owned subsidiary of Eastern Bank.

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