McLarens

Inflation Report 2022: Rising Costs of Property Claims

Background

The supply chain, inflationary and workforce pressures affecting the global economy are well known.

The construction sector has been acutely affected by these developments and the knock-on effect for insurers are costly. There is a myriad of factors which have all contributed to this for the UK and Ireland including: COVID-19 pandemic; Brexit; Russia – Ukraine conflict; climate related changes; transportation problems.

Manufacturers faced difficulties with a decline in productivity and problems with transportation, including delays at ports caused backlogs and disruption of the entire supply chain, exacerbated by the Suez Canal incident.

The overall result has been material prices soaring, material and labour shortages, and delays to projects. Any hopes of things settling down have been dampened by the conflict in Ukraine and consequent restrictions on Russian gas and oil sales within Europe, as well as the implementation of sanctions affecting the availability of raw materials from Russia.

Attempts to address global inflation through quantitative tightening, by raising interest rates, is now affecting all tiers of the construction and property development chain including the financing of projects.

At McLarens, we anticipated some cost and time risk would be seen, along with uncertainty over building reinstatement and repair costs, from the outset of the COVID-19 pandemic. Our Major Loss qualified surveyors produced guidance notes for day one reserves which build in extra contingency of between 5% - 20% dependent on location and type of building structure. Regular reviews take place with this group to ensure the contingency % rates being used are reflective of the current market position.

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Research on Contractor Price Increases

By researching various construction elements during Q1 2022, we have sought to explain the higher prices being quoted by building contractors for the reinstatement projects:

Increased Cost of Building Material

- +81% universal steel sections
- +60% single skin metal sheets
- +30% insulated metal sheets
- +20% metal purlins
- +10% timber
- +5% cement

The above figures from contractors and builders merchants information relate to elements that form a significant portion of the overall reinstatement cost for industrial buildings. This increased cost of materials can be directly linked to supply chain issues, as the manufacture of building components has been disrupted by the lockdowns and a reduced labour pool following the UK's departure from the EU.

Shortage of Raw Materials

Builders merchants are missing out on supplies and so limiting what they offer to contractors, due to demand from significant contracts awarded in recent years, such as HS2, Cork Biopharmaceutical Manufacturing Facility expansion and Hinkley point, and the buying power of China and US to bulk buy timber. One contractor told us they had been limited to buying 15 sheets of plasterboard at a time.

A limited supply with high demand, increases the cost. Increased costs of raw materials mean the finished product has an overall higher cost.

> Some buyers paying $45 per sheet in USA vs $5 wholesale price[1]

Labour Shortages

The shortage of skilled trades (circa 10% fall) is mainly due to the end of freedom of movement for the UK within the EU, COVID-19 and early retirement post pandemic. Contractors need to pay more to secure their workforce, and therefore their tender bids increase to cover their overheads.

Contractors, and external surveyors, have a backlog of work, and are receiving a high level of enquiries. They do not need to price competitively because work is not in short supply.

2019	Bricklayer £35/h	Labourer £27/h
2021	Bricklayer £58/h	Labourer £43/h

> Two storey, one bed extension: £50k anticipated costs from architect; £180k quoted by contractors.

Additional Demand

It's a fundamental economic principle that when demand exceeds supply, prices rise. We have seen the following examples of surges in demand, therefore reducing availability and increasing price:

- Replacement cladding and associated scaffolding/plant hire because of the flammable cladding crisis
- Containers to store and ship PPE globally
- Portacabins required as COVID-19 testing stations, usually required as site offices on construction sites or temporary classroom space.

> 500% increase on container spot price (up from $2.5k to $15k)

Import Costs

Any imported materials are vulnerable to trade difficulties and haulier issues.

The reduction in domestic production for many materials, such as steel components, led to a requirement for these to be imported from abroad. Higher import tariffs following Brexit pushed up material costs.

The congestion experienced in UK ports last year resulted in a sluggish supply chain, contributing to shortages of materials, and further pushing up their cost.

> 60% of UK imported building material comes from the EU

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Weather Events

2021 saw weather related events, which caused widespread damage to property placing a further strain on contractors, the need for building materials and the availability of construction equipment.

Increased Energy Costs

Increased cost for electricity and gas visible in recent months will likely worsen due to the situation with Russia and our reliance on imported gas coming from there. This will impact all aspects of building materials production and transportation.

Resilience and Sustainability (R&S) Costs

Accepting the Corporate Socially Responsible (CSR) and longer-term benefits, the ongoing focus to apply R&S measures is impacting on cost in the short term. R&S materials can be more expensive and can have a longer delivery lead time. Employing alternative waste and salvaging measures to limit landfill use similarly impacts on cost.

Impact on Resourcing for Reinstatement Works

Ultimately, contractors pass on the cost increases to customers, via higher tender bids.

At tender stage, before a contract is agreed, we've seen contractors ask for reassurances, due to the volatile market conditions impacting material costs. For one claim, the insured was required to pay the contractor upfront to secure an order for insulated metal roof sheets and steel rafters. When the material arrived, this created a further complication, as the restricted site became cluttered, and space had to be found within the building to accommodate the material.

Contractors are also concerned with sub-standard materials being sold by builders merchants. Some contractors claim that timber, when delivered to their sites, is found only to be fit for firewood. Sub-quality products are sometimes accepted as there is no alternative available. This may result in future defects liability claims or public liability claims.

All contractors that we have spoken to have complained about longer lead in times for materials, which results in some projects not starting when originally anticipated.

We analysed lead times over Q1 2022 and found:

- 12 weeks insulated metal cladding
- 11 weeks purlins
- 6-8 weeks single skin cladding
- 2-3 weeks general timber
- 2 weeks structural steel
- 1 week cement

Some of these might not seem excessive however many of these could be bought 'off the shelf' previously.

The extended lead times increase business interruption and alternative accommodation costs and therefore directly impact on higher overall claim cost.

Preliminaries (prelim) costs on construction contracts involve weekly costs for site accommodation, fencing, welfare, and equipment hire. Prolonged lead times extend contract durations and higher prelim costs.

> Prelim costs are typically 15% of the project value

Where the policyholder is not VAT registered, the same will be true of VAT, with the corresponding increase in the VAT element.

The cumulative cost of these increases is considerable.

Contractors will undoubtably build in a 'buffer' to their tender bids as they will factor in the price risk to themselves. Most contractors will make an allowance to safeguard them against increased material and labour costs. If their tender bid is accepted though, this 'buffer' won't be reduced when the job is invoiced.

Costs have been seen to increase during a contract and if variations are necessary because additional work is required, we have been finding that the costs are higher than the rates included in the original tender.

In addition to the increased costs of the actual repairs, there is the associated surveying cost too. If there's a surveyor

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involved, they will usually charge a percentage of the agreed final contract sum so it follows that an increased contract value will also push up the surveying fee too.

Future-proofing Reserve Setting: Cost Analysis

The BCIS (Building Cost Information Service), which is published by the RICS (Royal Institution of Chartered Surveyors) provides rebuild rates for various types of property and building cost rates where they also publish indices that track building costs, such as the Tender Price Index.

This is an average of returned tender costs, for specific building types, and can be altered for each region of the UK. Scotland, for example, is 0.92% of the UK average price. We previously used these rates to help insurers calculate reserves and value at risks. When lockdown first eased and building work re-commenced, there were not up to date rates and later forecasts suggested an increase in single figures, circa 6.5% to 8%. This did not reflect actual costs that we were receiving back from contractors. Claims have been costing more and often taking longer, dramatically so in some cases.

In July 2022, The Society of Chartered Surveyors Ireland (SCSI) reported that tender prices for commercial construction projects rose by 7.5% in the first six months of the year to an inflation rate of 14%.[2] This data will not take into account the full effect of the aforementioned increase in energy prices.

We undertook an analysis to obtain a more accurate forecast for insurers, and to assist with our reserve setting. McLarens internal surveyors undertook an analysis during 2021 of tenders we had received, across various regions in the UK, the costs obtained were almost all in competitive tender situations, so any erratic cost could be easily identified when compared with the other contractors pricing the work. We knew that we were seeing an increase in building repair costs more than predicted by the BCIS.

We spoke to contractors and builders' merchants, to obtain first-hand data on the problems they were facing and the actual increased cost of materials. We then were able to formulate an extra uplift for the various types of properties, in the various regions of the UK.

Whilst there were some variances for location and building type, we did find the uplift for each region in the UK was the same in several specific areas:

- 20% for repairs to industrial buildings
- 15% for recladding
- 10% for internal repairs

Our analysis of market factors and the claims data available to us was suggesting an across the board increase of between 5 and 20% on building repair costs. Since this analysis, we have been able to predict repair costs more accurately when setting day one reserves. The tenders we have received since have largely been in line with these findings. However, there are numerous factors influencing price increases, so we are regularly reviewing the position to ensure that they remain reflective of market conditions.

Future-proofing Reserve Setting: Practical Steps

It has been taking longer to procure and repair and this needs to be anticipated for reserving purposes and managed using experienced technical resource. Steps that we have seen taken include ordering of materials in advance on large projects.

> 3000m^2 of plasterboard and all structural steel ordered in advance and stored on site to avoid delays

The above example of a large fire with 100 residents displaced, required a significant financial advance and more frequent interim payments to the contractor, these being relatively insignificant issues in comparison to the ongoing alternative accommodation and loss of rent costs.

Lengthier repair or machinery replacement periods impact on the business interruption loss and the longer a business is unable to trade the greater the potential impact on the longer-term viability of that business. We still witness the continued issue of inadequate insurance cover for the maximum indemnity period. Higher costs and longer repair periods mean a greater risk of a breach and this is best illustrated when material damage total losses arise.

We've seen cases where Building Sums Insured and Declared Values were adequate at inception, renewal, or at the time of damage, but inadequate to cover the full cost of reinstatement by the time the rebuilding scheme was tendered primarily due to recent cost inflation factors.

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Should the insured suffer the consequences of the cost inflation? In the case of a total loss, some protection is provided by Declared Value policies under the inflation uplift, provided that the Declared Value was adequate at Day One. Under a Sum Insured policy the Sum Insured is the limit of insurer's liability, so in the case of a total loss that is the limit of cover available.

Partial building repairs present different issues for consideration. Knowing that rebuilding costs have increased significantly, should that be factored into a Value At Risk (VAR) calculation? If it is, what if the VAR calculation reveals inadequacy; should average or any other underinsurance penalty apply? For most cases, and until market data such as BCIS rates confirm appropriate rates, the consensus appears to be 'no'.

Unless the full cost of reinstatement is tendered, nobody can say what the true value at risk is with any certainty. Yes, the market has seen a big increase in costs, but we are on occasion still seeing prices come in at something like 'normal'. Factor in the inflation protection provided by Declared Value policies, the 85% reinstatement condition that applies to most Sum Insured policies and the buffer that that they provide, and it would be unreasonable in most cases to assert inadequacy in the case of a partial repair.

> The sum insured for a basic steel framed, steel-clad building became inadequate due to steel price rocketing 60-81%

Although there have been cases where underinsurance is evident at the time of loss. Applying material price increase to the overall cost of reconstruction made the Sum Insured very much inadequate in this example; each case needs to be reviewed based on its own particular facts.

What Next?

The huge increases that we witnessed in 2021 do appear to be flattening off but will prices drop back down again? Not from what current data tells us. The latest BCIS briefing forecasts an annual rise in tender prices of 7.5% from Q1 2022 to Q1 2023.

How supply chain issues will develop though is less clear. We will continue to monitor the market and rates and factor our findings into our Day One reserves for potential exposures. As we then work through the validation exercise on each claim, we have more certainty on the position and the likely financial exposure will then be reported upon in a more factually accurate manner.

Underwriters and brokers should have in mind:

- Cost inflation when setting and reviewing sums insured
- 12-month maximum indemnity period for Business Interruption policies, is this ever enough cover, pandemic, or no pandemic?

Whilst we, as an industry, understand cost inflation and are getting to grips with it as much as possible, except when they need to claim, how many policyholders are alive to the risk associated with potential inadequacy of cover largely due to cost inflation effects in the past year and into the immediate future?

Update: As of 15th August British Steel announced that structural steel sections are £100 per tonne

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