McLarens Inflation Report 2023: Rising to the Challenge of Stagflation

Economists are now forecasting falls in inflation rates over 2023, however, lower inflation is still inflation, and prices are not forecast to return to pre-2020 pricing. In dealing with claims, we continue to monitor and analyse market prices to help accurately set reserves. This report sets out our recent findings and forecasts for coming months. Are we seeing levelling off? Is a period of stagflation inevitable? If so, how will it impact the cost of reinstatement for insurers?

Background

The reports published in September 2022, McLarens Inflation Report 2022: Rising Costs of Property Claims and McLarens Inflation Report 2022: Rising Costs of Casualty Claims, highlighted the impact of a 'perfect storm' of issues such as supply chain, inflationary and workforce pressures as a result of COVID-19, Brexit, and the Russia-Ukraine conflict leading to material process soaring, labour shortages and delays. Claims costs increased because of this myriad of issues and the volatility of reserve setting was a challenge that we had to rise to.

> "The inflationary environment is unlike anything adjusters have experienced before, primarily due to the rapid onset of labour shortages and supply constraints, and the uncertainty as to the shape of the correction curve. Contract outcomes are determined by market competition, which is driving continued supply and pricing pressure. The consequent challenge around claim reserves is one which our adjusters are closely attuned to and well equipped to manage."
>
> *– Steven Wallace, Managing Director EMEA*

Towards the close of 2022 the huge price increases were flattening off but despite this, the Building Cost Information Service (BCIS) continued to forecast increases for the UK, with an annual rise in tender prices of 7.5%. The latest reports from 2023 on annual rises in tender prices show a minimal increase, with BCIS predicting 1.1% for this year.

We do not foresee the same minimal increases in the Republic of Ireland. The UK projections are based on the perfect storm of ongoing inflation and higher bank interest rates, these have not increased as much in the Republic of Ireland.

Currently inflation is running at about 10% (UK) and expected to fall in coming months.

Stagflation

The current prices situation can be described as 'stagflation'. This is a combination of two factors: high inflation and economic stagnation, including slow growth, increased unemployment, reduced GDP and wages. Essentially, inflation drives prices up, but purchasing power down, so as prices increase, consumers are receiving less for their money.

When does Stagflation Happen?

↓ Economic Growth Slows + ↑ Inflation Increases + ↑ Unemployment Increases

> "One of the key impacts of inflation is on Gross Profit Margin. The question arising is how a business protects its Gross Profit margin if input costs are going up significantly."
>
> *– Louise Butcher, Head of Forensic Accounting*

It has been well publicised that a shift to remote working left our high streets empty supporting the slowdown in economic growth. While there has been a shift to hybrid working, many businesses opted to move to fully remote working to reduce overheads. Some even ceased trading because of the earlier referenced perfect storm.

This has left many vacant properties, increasing the risk of vandalisation and other perils typically associated with unoccupied premises. In addition, soaring mortgage prices combined with unfavourable tax changes have been cited as reasons behind an exodus of landlords leaving the buy to let market.[1]

Immigration was at the centre of the Brexit campaign, and the post-Brexit system ends free movement, favouring skilled workers regardless of their country of origin. In the aftermath of the pandemic, big labour shortages in health and social care, transport and hospitality have emerged, as many foreign nationals left and fewer arrived. However, more recently, net immigration has been recovering, but when compared with estimates of numbers if we hadn't left the EU, we are still over 300,000 workers down.[2]

> "The issue of labour resourcing is a major factor affecting construction project costs and programme periods. Brexit resulted in a loss of EU workers. Recent announcements by the Government to tackle the current labour shortage in the construction industry by looking at ways to enable employers to bring back to the UK tradespeople from the EU along with increased training schemes in the UK should be welcomed"
>
> *– Mark Simmons, Head of Construction & Engineering*

Contractor Price Increases: Are They Justified?

The general cost-of-living crisis, where food and fuel prices have rocketed, has given a perception of continuing high inflation in the building industry. The word 'inflation' is still being used to seek increases to tenders and claiming for material cost increases during a project, which are not always justified. In these cases, we would always challenge or seek substantiation.

We are seeing requests of 10-20% uplifts, however most contractors fail to acknowledge the split between materials and labour. In the Republic of Ireland, the team are seeing a reduction in the cost of materials, but costs overall remain high as labour shortages are leading to increased salaries.

Typically, the weighting of labour far outweighs that of materials. Contractors have certainly not given their employees pay rises of this magnitude.

> One contractor requested an overall uplift of 30%.

These uplift requests are being received almost immediately following the expiry of the quotation/validation period, as it presents an opportunity for increasing costs.

At McLarens, as we do not operate a building repair network, we have the flexibility to seek competitive tenders which can help reduce the impact of inflated tenders as there is an element of competition to win the job. Some contractors and suppliers are concerned with future projects due to the suggestion of a recession, to the point where we are aware of some contractors ceasing trading or struggling to commit due to a shortage of labour. Contractors tell us they have fewer projects in the pipeline. Basic rules of economics indicate that we will see reduced tender prices as demand reduces.

The price rises we have seen will not reverse. Projects that were budgeted some time ago will need to be re-appraised and increased costs deemed justified. A well-known builder's merchant published price increases in January 2023 with bricks up 20%, aerated blocks up 18%, plaster up 18% and insulation up 10%.

Due to pressure to progress claims as quickly as possible, notional percentage increases are easily overlooked however this is always in the forefront of our adjusters and surveyors minds.

> One contractor claimed 10% extra on a project, but when the costs were analysed, the extra was only 2.5% over the project value.

Reserve Setting

Accurate reserving remains a challenge due to the volatility in supply, demand and pricing.

The supply chain situation is still difficult, although supply issues have eased since 2022. We continue to see that a contractor's buying power is defined by whether they have pre-existing arrangements with suppliers.

> "The repair or replacement cost of damaged items is much higher as a starting point for negotiating an indemnity settlement in third-party property damage cases and we are seeing an impact, particularly amongst claims pursued by direct claimants."
>
> *– Kim Alcock, Head of Casualty UK*

Teams have encountered consultants working on related claims who have not undertaken detailed quantum reviews in accordance with the contract administrator duties.

Where surveyors have not challenged contractors on their tender submissions, suggesting that this is "the current market" and should be taken as fact, this would be directly addressed by our adjusters. Everyone involved must do more to assist the process and ensure that claim costs are being presented fairly and reasonably.

Contractors are expected to submit copies of all suppliers' invoices and confirm their overheads and profits on each invoice, as a means of substantiating costs for variation orders and provisional sums, regardless of whether it had been tendered. This is an opportune moment as an industry to ensure accuracy in costs presented.

At McLarens, alongside our quarterly analysis of tenders received per region to ensure accurate reserve setting, we are also looking at the effective rates by pound per metre squared (£m^2), which is proving to be a useful mechanism to review and validate where costs are for varying types of reinstatement work.

> "Evidence points to some flattening of the inflationary factors, but we remain in an economically difficult space. Whilst costs are scrutinised on every claim, now feels like the appropriate time for robust challenges when tender returns still exhibit inflated costs and/or we are asked to consider uplifts between award and commencement on site."
>
> *– Gareth Bowers, Head of Major Loss*

What else is contributing to challenges in reserve setting, and what can we expect in the future?

Underinsurance

> 1 in 5 SMEs have reduced their cover.

Research from Allianz has found that one in five SMEs have reduced their insurance cover in the past 12 months, with a similar proportion planning to do likewise in the coming year as they struggle with rising cost pressures.[3] Chances are that they would now be underinsured if a covered peril resulted in loss. This can be devastating, and fatal for SMEs.

Even more worrying are the figures from research by Gallagher: 43% of commercial property owners who repaired or rebuilt their premise last year were underinsured.[4] Stephen Smout from McLarens Agriculture had a technical interpretation of policy cover referred to the Financial Ombudsman Service (FOS) due to underinsurance.

The policy interpretation was upheld:

- In 2020 a fire damaged building was viewed, with the sum insured at £138,267 but the value at risk of £162,750, resulting in 15% underinsurance.
- An external surveyor confirmed the building was a total loss, and accordingly insurer's liability was restricted to the sum insured.
- Shed construction comprised asbestos fibre cladding/ steel portal frame, resulting in debris removal costs of £94,360. A policy limit applied for asbestos contaminated debris removal of £50,000, used as a contribution towards the overall costs of removal. Accordingly, a shortfall of payment occurred to the insured of £44,360 which could not be absorbed by the inadequate building value at risk due to under-insurance and there were insufficient funds to replace the damaged building.

"With an accepted 30%+ underinsurance aspect now prevalent unless sum insureds have been uplifted recently, this case demonstrates issues we may all encounter going forward."

– Stephen Smout, Head of Agriculture

Whilst business can choose to effectively self-insure some parts of risks, it is vital that this is done consciously with full knowledge, and the appropriate financial planning in place. For example, for buildings cover, they must consider building reinstatement costs for a total loss, the business interruption period coverage related to an estimated time for total rebuild, and availability of supplies and labour.

"It's a problem which I have been talking about since the pandemic when material costs first started to soar. We are seeing reinstatement works that cost £60,000 pre-COVID, now costing circa £100,000. It is thankfully now being recognised more widely that policyholders may not have the right level of cover, as the valuation of their assets is not up to date."

– Phil Barmby, Managing Director, Brawdia, project and building consultancy.

"Policyholders will need careful guidance from their brokers more than ever to fully understand the implications of under insurance. It's tempting to reduce cover and/or sums insured, along with indemnity periods to try and control rising premiums. Without the right advice, policyholders have little understanding of the devastating impact this can have on the insurers legal liability to meet submitted claims costs."

– Rebecca Webster, Broker Development Lead

"In addition to claims fraud increases over the last few years; the decision to knowingly reduce cover raises issues of policy fraud that in some cases results in a substantial financial loss when compared to the premium difference of insuring correctly. Deliberately underinsuring to obtain a cheaper premium, has put many at risk of losing significantly more that they had thought of."

– Brendan Gillooly, Head of Investigation

Claims Lifecycle

Commercial property repairs are taking on average 33% longer to complete than one year ago, according to claims managers.[5] With the known material and labour shortages, this is not a surprise to most in the market. Inevitably, longer reinstatement periods mean other costs also escalate, such as alternative accommodation and loss of rent, and delays can lead to dissatisfied customers and an increase in complaints which require further resources to investigate and resolve.

McLarens proactively manage claims lifecycle and look for an economic balance between tendered sums, timescales and the impact on alternative accommodation costs - not helped in recent years by the increasingly low number of suitable accommodations in many areas. Creative solutions are becoming more common when requiring alternative accommodation.

A 10-day holiday saved up to £25,000 in extended AA tenancy.

An adjuster recently arranged for a couple to take a holiday in Tenerife during the latter stages of repair as their home remained uninhabitable. With extremely limited local alternative accommodation options, costs savings were £18,000 to £25,000 as a further six-month tenancy extension would have been required. The policyholder returned home after 10 days abroad to all repairs completed.

ESG (Environmental, Social and Governance) Considerations

When buildings are damaged following a loss they must be repaired, reinstated, or rebuilt in accordance with Building Regulations, which state minimum standards for design, construction and alterations. New building regulations are estimated to add 6% to building costs. These regulations are designed to deliver the UK government's net zero CO2 emissions target by 2050.

New-build Homes Regulations

- Must produce around 30% less carbon emissions, expected to be achieved via systems including electrical heating and solar PV (photovoltaics).
- Adhere to glazing limits to reduce unwanted solar gain in care homes, schools and student accommodation.
- Undergo preparatory work for the future installation of an electric vehicle charging point.

Non-domestic Buildings Regulations

- New buildings will need to produce at least 27% less carbon emissions.
- Existing buildings must improve the efficiency of heating and hot water boiler systems through the installation of new controls and thermostats.
- Trickle vents for air circulation are recommended along with a new requirement for CO_2 monitors in all offices.

What Next?

With continuing financial pressures on consumers and businesses, accompanied by a likely rise in premiums, there is an expectation that we will see increased underinsurance as policyholders attempt to control their rising insurance costs. To protect policyholders for the long term, it is vital that all assets are regularly valued to confirm that they are protected as expected by their policies.

As well as underinsurance being a prevalent issue, we do see some flattening of inflationary factors but doubt it will return to pre inflation levels. Equally throughout 2023 we expect contractors to price more keenly on an increasing basis which our adjusters and surveyors are alive to.

We will continue to closely monitor and react accordingly to any other intervening issues presenting a curveball to an already troubled market.

Authors

Gareth Bowers MBA Dip CILA Dip CII
Head of Major Loss UK & Ireland

+44 (0)7725 255 842

gareth.bowers@mclarens.com

Karl Evans BSc (Hons) MRICS Cert CILA AIFAA BDMA Tech (Ins) AaPS MFPWS
Major Loss Surveyor & Subsidence Lead

+44 (0)7803 627 724

karl.evans@mclarens.com

Richard Gough BSc MRICS ACILA
Executive Adjuster/Chartered Surveyor (Major Loss)

+44 (0)7703 795 983

richard.gough@mclarens.com

With thanks to the contributions from the whole of the UK & Ireland Major Loss Team and Nicola Cattan, Client Development Lead, in researching and collating data.

References

[1] Property Industry Eye (2023) London sees mass tenant exodus as landlords exit the market. Available at: https://propertyindustryeye.com/london-sees-mass-tenant-exodus-as-landlords-exit-the-market/#:~:text=Soaring%20mortgage%20prices%20resulting%20from,core%20reasons%20behind%20the%20exodus (Accessed: 1 April 2023)

[2] UK in a Changing Europe (2023) The impact of Brexit on the UK labour market: an early assessment. Available at: https://ukandeu.ac.uk/the-impact-of-brexit-on-the-uk-labour-market-an-early-assessment/ (Accessed: 1 April 2023)

[3] Allianz (2023) One in five SMEs cut insurance cover amid cost-of-living crisis. Available at: https://www.allianz.co.uk/news-and-insight/news/one-in-five-smes-cut-insurance-cover-amid-cost-of-living-crisis.html (Accessed: 24 April 2023)

[4] Arthur J. Gallagher & Co (2022) Over 40% of commercial properties currently underinsured. Available at: https://www.ajg.com/uk/news-and-insights/2022/december/over-40-percent-of-commercial-properties-currently-underinsured/ (Accessed: 1 April 2023)

[5] Arthur J. Gallagher & Co (2022) Over 40% of commercial properties currently underinsured. Available at: https://www.ajg.com/uk/news-and-insights/2022/december/over-40-percent-of-commercial-properties-currently-underinsured/ (Accessed: 1 April 2023)