Construction & Design Market Outlook

February 2022

Contents

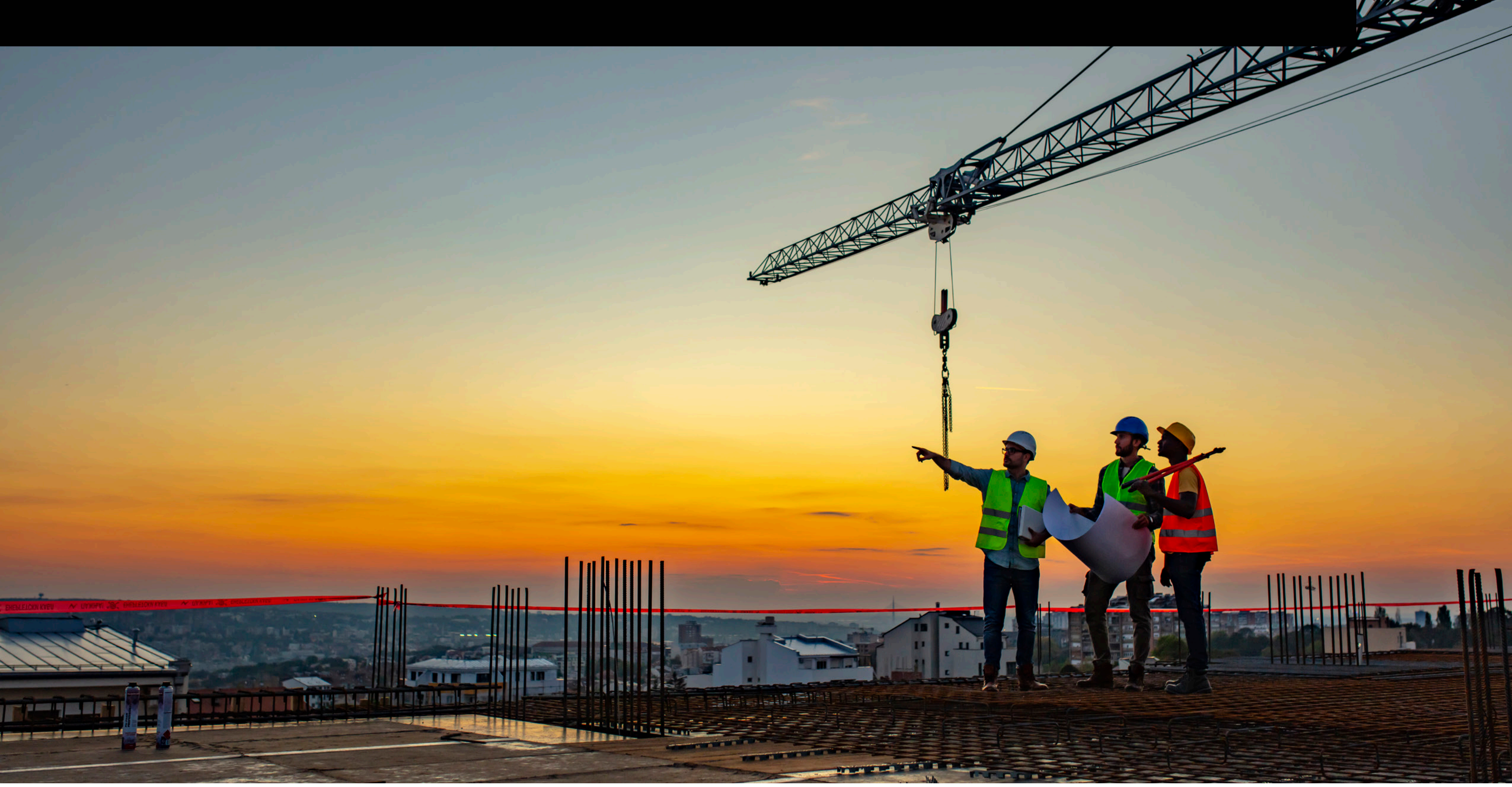
Overview

Heading into 2022, the construction and design industry is expected to experience continued positive growth. The residential market will remain strong, and according to the AIA Consensus Construction Forecast Panel, nonresidential building is expected to trend upward as well.

- Consensus
- Dodge Data & Analytics
- IHS Economics
- Moody's Analytics
- FMI
- ConstructConnect
- Associated Builders and Contractors
- Wells Fargo Securities
- Markstein Advisors

	Actual $	Forecast % Change	
	2020	2021	2022
Nonresidential Total	–	-3.9	4.6
Commercial Total	–	-5.4	5.4
Office	–	-5.6	-0.1
Retail & Other Commercial	–	-1.3	5.8
Hotel	–	-19.9	18.9
Industrial Total	–	-4.4	4.8
Institutional Total	–	-2.3	3.6
Health	–	1.4	4.4
Education	–	-2.1	3.6
Religious	–	-0.9	-0.9
Public Safety	–	-2.1	0.1
Amusement & Recreation	–	-9.9	6.0

See the full AIA Consensus Panel Predictions and Report.



The Infrastructure Investment and Jobs Act (IIJA) is expected to accelerate recovery within the nonresidential segment. As the construction and design industries look to capitalize on this opportunity, they will need to manage a number of challenges:

- LABOR SHORTAGES: Both architecture and engineering firms and general contractors remain concerned with attracting and retaining skilled workers. A September 2021 U.S. Chamber of Congress survey found that 93% of contractors reported "moderate to high workforce concerns and expect the problem with finding skilled workers will remain the same or worsen over the next six months." Design firms share these concerns. A Dodge Data and Analytic report indicated that "79% of architecture firms are not sure that the United States student pipeline will suffice to replace people leaving the profession, a problem exacerbated by the 76% of United States architecture students who indicate they would consider working abroad." Attracting new and diverse talent to the industry remains a top priority for many design firms and contractors.
- BUILDING MATERIALS AND SUPPLY CHAIN CONCERNS: According to the September 2021 U.S. Chamber of Congress survey, 93% of contractors are "facing one material shortage." The materials cited include steel (34%), wood/lumber (31%) and insulation or insulated materials (15%). Accordingly, many organizations are diversifying their supply chain and considering the use of alternative materials.
- PROJECT COSTS AND PROFIT MARGINS: The shortage of skilled labor and materials has resulted in higher overall costs. In some project sectors, this has been coupled with broader contractual transfer of enhanced project and liability risks to both the construction and design teams. More than ever, organizations will need to proactively manage their overall profit margins..

Mergers & acquisitions

The year ahead seems likely to continue or even accelerate the frenetic mergers and acquisition trend that we saw across all U.S. industries in 2021. The first two quarters of last year showed an increase of 10% over the same period in 2019 and a COVID-inflated 352% increase compared with 2020. The construction and design industries saw their share of M&A activity during this period as well.

For design firms, 2021 was a record year from a deal volume standpoint: transactions were up 36% year over year and 16% from 2019. With respect to valuation, this sector has experienced a large increase in valuations as a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA) over the past four years. On average, valuations were 16x EBITDA in 2021, compared to just above 12x in 2018.

Self-performing specialty and service contractors continued to see a surge in M&A activity, as well as valuation lift. Since 2018, both specialty and facility service contractors have seen their valuations increase by 30%+. This has been driven largely by a major influx of private equity capital and geographic consolidation efforts. Conversely, the civil industry has continued to experience low deal activity and valuation stagnation.

For general contractors, strategic expansion was a key theme of 2021 as national firms explored new regions and local firms expanded into regional players.

Private equity (PE) capital continues to deploy within the construction & design industries at an unprecedented rate, especially in the HVAC and plumbing sector. One thing that still remains a hindrance for PE deals is the impact of these transactions on surety capacity. The surety industry experienced some large losses in 2021 from PE-backed contractors. As a result, these types of structures will continue to face scrutiny from underwriters.

Representations and warranties insurance is playing a key role in supporting transactions, and is now being deployed on smaller deals than in past years. In 2021, Lockton's Transactional Liability Practice identified placements on enterprise values as low as $20 million. The increase in demand has created some pricing increase as rates have gone up by roughly 25% across the industry. We expect to see plenty of capacity in 2022.

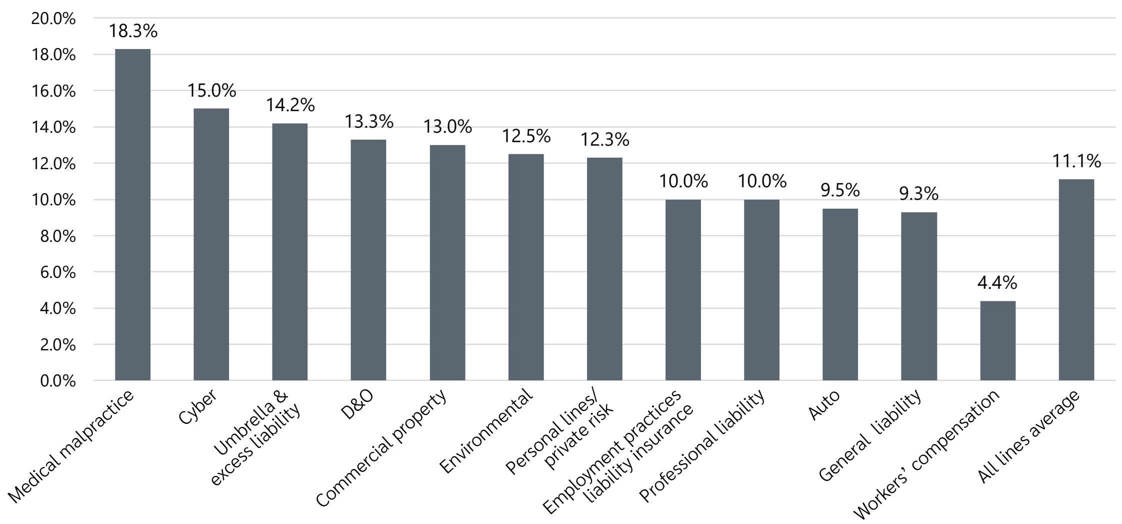
Construction & design insurance market

Workers' compensation

Workers' compensation remains competitive, despite longer-term concerns about an aging population, the continued impacts of the COVID pandemic, inflation, and a rise in mega-claims. As we move into 2022, it is expected that the market will continue to be predictable and favorable for many policyholders. Variations during renewals will vary based on loss history, experience, and industry sector. The market is stable, there are many markets interested in writing workers' compensation, and the segment continues to experience organic growth as payroll forecasts are 6% higher in our latest review.

Commercial insurance pricing is expected to trend upward, but at a slower rate than prior quarters. Despite the fact that the workers' compensation market continues to evolve with results varying based on loss history, experience mods and industry sector, the average projected price change is expected to be nominal at 4.4%, the lowest increase compared to all lines of business, as illustrated below.

2022 AVERAGE PROJECTED PRICING CHANGE BY LINE OF BUSINESS



Source: Alera Group, Inc.

Workers' compensation losses related to COVID continue to evolve due to new operational and settlement processes required for compliance with individual states' workers' compensation presumption acts. Carriers remain concerned with the potential for new variants, the long-term impacts of the disease and the potential for COVID-related claims that were not previously contemplated or expected.

FOUR TOP CONCERNS FOR 2022

According to recently published results from the National Council on Compensation Insurance (NCCI) survey of workers' compensation carriers

1. **Rate adequacy:** Ongoing loss cost decreases mainly driven by declines in claim frequency and the resulting impact on premium levels
2. **COVID:** New variants and their impacts
3. **Shifting workforce and workplace:** An aging workforce with fierce competition to secure and attract younger workers. This includes the possibility of physical vs. remote workplace needs.
4. **Rising medical costs:** Medical cost inflation, seemingly unabated by the rise of telemedicine

Continual use of data analytics to identify key loss drivers will remain vital in implementing targeted strategies for proactive management of future losses in workers' compensation programs.

General liability, automobile & excess liability

PRIMARY

Primary rate increases for commercial general liability insurance programs have ranged from 5%-10%, while commercial automobile is projected to continue at higher rates of 10%-20%. Beyond expected firming of rates, larger retentions and narrowing of coverage terms may also occur due to an increase in loss severity. There is potential for increased renewal competition as additional capacity enters the market.

Underwriters are focused on tightening terms and conditions and making some general liability exclusions standard, such as per-and polyfluoroalkyl substances (PFAS), opioids, traumatic brain injury (TBI), communicable disease and sexual misconduct. Automobile carriers remain concerned with escalating settlements and verdicts, medical costs, and the continual rise in repair costs. These considerations will increase scrutiny of an entity's risk management efforts regarding driver selection, telematics and other controls. For transportation risks, conditions remain highly challenging. Despite these tightening terms and conditions, a competitive market does exist, and it is expected that many carriers will be eager to write new business.

UMBRELLA/EXCESS

Umbrella/excess attachment points have increased, adding more cost in the form of increased general liability or buffer layers. More troubling, terms and conditions vary by tower participant making true "follow form" coverage difficult to secure.

As we move into 2022, we expect to encounter an excess casualty environment supportive of price moderation as a counterbalance to increased market competition. This new market competition is not isolated to nonadmitted capacity. For instance, Liberty Mutual is now able to offer a supported lead while The Hartford, CNA, Cincinnati and others are all consistently able to provide a supported lead of at least $5 million and up to $10 million. This was not the case two to three years ago.

However, excess markets will continue to seek premium increases, higher attachment points, reduced limits and quota sharing. Rate increases in the 5%-15% range are expected. As changes in capacity, attachment and rate begin to take hold, we are beginning to see pricing increases moderate to a degree, especially in the excess layers. Having said this, the market remains disciplined and focused on profitability. Depending upon the individual risk, many organizations are needing to increase their general liability excess attachment point and include a greater number of participating insurers in their tower. The median tower price change for those with more policies for the same amount of limit was 37.5% compared to 12.0% for those with no change in the number of policies.

The median Lead Umbrella price per million (PPM) increase was 6%. This compares favorably to the all-industry portfolio outcome, which was a 12% increase for that timeframe. It also suggests an improved pricing environment relative to the rolling 12-month Construction Umbrella benchmark of 15%.

Controlled insurance programs (CIPs)

Controlled insurance programs (OCIPs and CCIPs) have not been immune to rising rates and diminished excess capacity, compounded by construction industry challenges associated with subcontractor unavailability, skilled labor shortages and construction material cost escalation. On the positive side, the market has provided rate stabilization and selective broadening of coverages for most larger, high-profile commercial projects. Additional market observations include:

- Primary liability rate increases are ranging from 5% to 15% for most commercial projects. Excess rate increases are less extreme but are still in the 10% to 20% range. Rates continue to be impacted by large losses from construction defects, wildfires, hurricanes, civil unrest, domestic terrorism and COVID.
- Larger excess towers involve several carriers that typically quota share layers to maximize capacity and mitigate cost.
- CIP excess volatility remains for residential projects and this has begun to spill further into the CIP general liability layers through rate increases and more stringent risk selection.
- Projects with difficult exposures such as condominiums, apartments and hotels continue to experience larger rate increases in both the primary and excess liability.
- New York, Florida, Colorado and California continue to be difficult states, with reduced capacity driving cost.
- Broader coverage terms are becoming more available depending on the type of project, contractors' safety program, QA/QC and loss experience.
- In response to COVID, a majority of carriers are adding communicable disease exclusions.

Extensions have become a challenge on CIPs. We are seeing them offered only on a limited basis and for significant premiums, or unavailable altogether. It is advisable to take a proactive approach when placing coverage as well as during the construction term.

- Negotiate three- to six-month extensions prior to binding coverage subject to specific project circumstances or changes that would dictate the additional premium charge.
- Monitor construction schedules during the course of the project.
- Review completed operations wording that triggers coverage for project completion.
- Understand the construction budgets (GC and owner) and construction schedule. Identify the detailed components of construction costs, especially the soft costs and business income. This is invaluable when delays result from a covered cause of loss and extension premiums are based on the itemized soft cost under the builder's risk delay in completion coverage.

CIPs continue to afford coverage certainty to owners, contractors, lenders and other financial stakeholders by extending completed operations through state statutes of repose, particularly for residential projects when traditional contractors' insurance contains residential exclusions.

Residential

The residential construction market continues to be a difficult one due to adverse loss development and increased frequency and severity. One factor exacerbating present market conditions is claims activity in litigious states, particularly California, Arizona, Nevada and Florida and more recently Washington and Texas. Despite these ongoing issues, some new primary carriers are expected to enter this market in early 2022.

Excess capacity is still difficult to secure, specifically on accounts with heavy losses. Due to aggregate losses and historical pricing inadequacy, wrap-up pricing remains challenging. If there are delays in projects, pro forma wrap-up pricing should be regularly updated.

The homebuilder warranty market continues to contract with very few markets offering $20 million in limits. No new entrants to the market are expected in the near future. For non-warranty primary programs, large homebuilders are typically identifying a minimum $5 million retention with $25 million excess capacity.

Within the New York construction market, insurers show little enthusiasm for tougher residential construction classes including demolition, roofing, scaffolding, exterior masonry, curtainwall, and bridge work. Market appetite is growing in other coverage lines, including workers' compensation and excess casualty.

The Florida residential construction market has a few insurers willing to write primary and lead excess. Currently, overall capacity continues to be limited, with some insurers completely withdrawing from the market. Insurers are adding more restrictive terms and reduced limits on wrap-ups and a minimum of 100 units for high-rise projects. Underwriters are scrutinizing risk transfer language in subcontractor agreements. Due to the adverse legal environment for construction defect claims in Florida, few admitted markets offer meaningful capacity and coverage is geared more towards the excess and surplus lines market.

Professional liability — OPPI & CPPI

OWNER'S PROTECTIVE PROFESSIONAL INDEMNITY (OPPI)

Rates are decreasing due to continued demand and profitable underwriting results. OPPI placements have increased in the past several years, and we expect this positive trend to continue in 2022.

Although there has been an uptick in design-related losses in 2021, we remain advocates of the value of this coverage for owners and developers. Furthermore, the tightening of the architects and engineers (A&E) professional liability market and declining capacity for project-specific professional liability (PSPL) have driven the cost up for both products. As a result, OPPI coverage placements increased in 2021 as a less expensive alternative for insuring catastrophic errors in the performance of design and other professional services. It should be noted that these products provide coverage to the owner and not to the design team.

For select projects, we have seen a few markets offer lower attachment points (minimum insured retentions (MIRs)). This has created OPPI opportunities for a wider group of project types as well as smaller projects under $50 million in construction costs. However, certain projects such as condominiums and wood frame residential will remain difficult to insure. In addition, we anticipate the options for energy and heavy industrial projects may be limited.

Contractors protective professional indemnity (CPPI)

For the CPPI market, we are projecting a 3% to 5% rate increase. As with OPPI, CPPI continues to be the prevalent coverage choice among contractors and construction management firms due its broad and flexible coverage form and compliance with owners' contractual insurance requirements.

MARKET AND COVERAGE DEVELOPMENTS:

- Communicable disease exclusions (COVID) continue to be common. However, we expect many markets will underwrite with the condition that the insured's COVID losses must result from a covered cause of loss, i.e., directly from the negligent performance of professional services by the contractor or the entities for which the contractor is liable.
- Faulty workmanship coverage remains available subject to underwriting approval.
- Coverage offerings include contractor's pollution liability (CPL) on an occurrence form.
- Several leading insurers are now modifying their mitigation or rectification wording to apply solely to prime design/build contracts between insureds and project owners. Formerly, coverage did not distinguish between the various delivery methods.
- Design/build and engineering/procurement/construction (EPC) are the project delivery methods most likely to experience increases, along with the potential for construction management liability issues in both the agency and at-risk sectors.
- Construction firms engaged in heavy civil construction design/build contracts may also see coverage limitations, especially with respect to mitigation and rectification.

SUBCONTRACTOR DEFAULT INSURANCE

The construction industry continues to navigate and adapt to an economy that is still seeing strong construction activity amidst challenges such as COVID-19, social and political unrest, supply chain disruptions and inflation. Despite all of these difficulties, construction is ongoing; projects are progressing; and owners, general contractors and subcontractors alike are showing how resilient the construction industry can be.

Last year, there were many unknowns regarding the impact of COVID-19 on construction and also about the health of the subcontractor default insurance (SDI) market. Some carriers immediately stopped writing new business while others continued to write business cautiously. Underwriting discussions have now included the impacts from COVID-19 and organizations' mitigation steps. Arguably a benefit came out of these challenges in that general contractors were encouraged to get closer to their subcontractors and suppliers than ever before.

At the same time carriers were adjusting the underwriting process to accommodate the challenges presented by COVID, they were also adjusting loss forecasts in anticipation of an increase in both frequency and severity of defaults in 2021. Thankfully, those fears were not realized. Carriers did not see significant growth in claim frequency and in one case, a carrier saw their notices decrease by 10% in 2021. There was a slight uptick in the cost of remediating claims; this is likely due to increased costs of materials and labor availability.

Due to the efforts of general contractors to manage their subcontractor risk and the carriers' underwriting adjustments, the SDI market remains strong. Six carriers continue to offer coverage and write new business, with a new market, Vantage, slated to start accepting new business applications in Q2 2022. The number of carriers in the marketplace and the varied underwriting appetites have provided opportunities for many new buyers to implement their first SDI program.

Projections for 2022 are similar to that of last year. Most carriers are expecting increased frequency of notifications and are expecting slight increases in the cost to complete work associated with subcontractor default. Several carriers shared a common concern that the patience and collaboration we saw between owners, contractors and subs to share in the increased expenses we saw in 2021 may dissipate as we move into 2022. The concern is that owners will include more aggressive language in construction contracts and that will result in the general contractors flowing that language down into subcontract agreements. With balance sheets that have been somewhat stressed by the economic impacts of the last 12 months, the concerns are that one project with significant price increases could be too much to bear for a subcontractor and lead to a default.

SUBCONTRACT RISK MITIGATION PRACTICES TO CONSIDER FOR IMPLEMENTATION IN 2022:

- Pay careful attention to internal processes, procedures and controls regarding subcontractor prequalification, selection and payment.
- Consider the use of third-party prequalification tools that benchmark subcontractors against their peers to indicate high and low performers.
- Carefully review labor and material breakdowns in bids. During the scope review process, identify major material suppliers and ensure that the supplier has provided firm pricing commitments.
- Consider early procurement/commitments on major equipment and material purchases and assign those to the successful subcontractor.
- Inquire about price reductions for early/more frequent payments and work with the project owner to provide funding to align with these commitments.
- Continue to focus on lien waivers and sworn statements to make sure second-tier subcontractors and material suppliers are being paid on time.
- Engage in continuous dialogue with key subcontractors to understand total backlog and timing of projects with other general contractors.

As noted above, the market remains strong, and capacity is available to current and new buyers of SDI coverage.

Contractor environmental market

As the construction industry continues to grow, environmental placements are following suit. Available coverages to contractors remain flexible with competitive pricing. Carriers are tightening coverage for brownfield projects by including exclusions for construction material removal, dewatering, and fill removal. Broad exclusions for PFAS substances are ubiquitous due to the continued incidence of nuclear verdicts in claims involving these chemicals.

CONTRACTOR’S POLLUTION LIABILITY

The CPL market remains heavily saturated. CPL is intended to cover contractors for unintended contamination during the construction of the project. Pollution caused by contractors can seriously delay operations and impact construction profits. All major carriers offer CPL coverage, with premiums as low as $1,500 with self-insured retentions as low as $5,000, and carriers continue to offer broad CCIP and OCIP coverage with completed operations.

Occurrence-based coverage continues to be readily available, with restrictions on mold coverage for some classes of risk. In 2021 the use of communicable disease exclusions increased. Overall, premiums and coverages are expected to be competitive into 2022, with carriers eager to write policies for any reputable contractor.

POLLUTION LEGAL LIABILITY

Pollution legal liability coverage (PLL), which can include unknown conditions that may exist at a project site, continues to be widely available. The discovery of site pollution conditions can seriously affect property value, health of individuals, and a contractor’s reputation. It is increasingly important for companies to maintain their environmental, social and governance (ESG) priorities. The “E” associated with this has taken on renewed importance as state and federal regulatory agencies push to introduce new standards and restrictions. Organizations are actively taking steps to reduce their carbon footprint, source sustainably and limit exposures to potential environmental risk. Companies are searching for partners who can help them make sense of the new landscape and identify solutions.

Carriers are continuing to offer up to 10-year preexisting coverage, with well-documented environmental reporting, and up to five years for new conditions coverage (although some markets have begun to pull this back to 1-3 years).

Unfortunately, carriers are restricting available policy limits, on average offering up to $20,000,000 of limits with a handful offering up to $50,000,000 aggregate limits. Contractors in the healthcare and hospitality sectors are seeing broadening exclusions regarding mold and legionella. In addition, carriers are increasingly reluctant to offer mold coverages for condominiums or multifamily homes due to major losses in previous years.

Despite the increased frequency of pollution losses, we expect the competition will remain robust due to the entrance of new markets.

Architects & engineers professional liability

As reflected in earlier market reports, 2021 certainly experienced architects and engineers professional liability underwriters continuing to push for corrections in rate and retentions, while trying to manage limits capacity on individual risks. As we engage in discussions with underwriters about Q1/Q2 2022 renewals, there are signs that underwriters around the globe are feeling more comfortable in their position on firms with profitable claim experience. Firms that have experienced rate and retention correction in their professional liability programs over the past two renewal cycles should feel less rate and retention pressure as we enter the 2022 underwriting year. Exposure basis increase or decrease, rather than market pressure, will likely be a key driver of rates for renewals.

Organizations with adverse claims experience and unprofitable loss ratios will continue to see pressure on rate and retention. Capacity at lower retention levels will remain scarce for such firms. Underwriters will continue to be vigilant about services or exposures identified as high risk such as California wildfire, communicable disease, cyber, designers as subcontractors on large design-build projects, megaprojects, residential projects, and building envelope and cladding.

Underwriters are also closely monitoring a firm's ability to properly staff for a continued increase in large U.S. construction projects in the face of a tight labor market. Insurance markets are also focused on the impact of inflation on construction cost estimates, and the impact of supply chain risk on construction cost and schedule. Inflation in litigation cost also remains a major concern.

Will these macroeconomic factors continue to cause inflation in future claim cost? Firms that are able to clearly demonstrate their ability to manage each of these risks will receive the most favorable terms in the 2022 professional liability market. An entity's historic claim loss ratio will continue to be a key driver of renewal results, but underwriters are also increasingly sensitive to a firm's current claim trends with respect to frequency, severity, and project type.

The market for project-specific professional liability (PSPL) insurance continues to constrict, particularly for large (1.0B+) U.S. infrastructure projects. Large design firms that have historically relied on PSPL as a risk mitigation tool will continue to see significant price and retention pressure for this product in 2022. Availability of this product will also be a challenge in the absence of new capacity entering the market. With the growth of project construction values, and the magnitude of project changes during design and construction, firms should be detailed in their review of material variation endorsements and audit provisions in PSPL policies. PSPL pricing for international projects, particularly in the U.K., Australia and MENA region are quickly finding parity with pricing and availability for U.S. projects. International project underwriters are experiencing a significant uptick in the frequency and severity of claims from project placements.

New capacity in the global professional liability practice program market will benefit firms seeking capacity to support competition for the primary and excess layers of their programs. Only time will tell whether these new players will muster the capacity to truly drive terms and pricing, or whether they remain as following capacity to the existing market.

Builder's risk

2022 has started where 2021 left off, with pricing pressure from reinsurers and upper management oversight of field underwriters continues to drive cost, policy retentions and limit total insurance market capacities. Competition and overall size remain healthy for preferred risks (low-hazard scopes in non-CAT zones). The market and capacity for high-risk projects such as power plants, petrochemical plants, marine works, wood pellet manufacturing and risks within high-hazard CAT zones continues to shrink with 3 or 4 markets needed to fill capacity that was previously provided by 1 or 2. At a minimum, most insurers are asking for 5%-10% rate out of the gate for renewals, and some are taking a much more drastic approach on certain risks where there is little competition or where it is necessitated by reinsurance.

ADDITIONAL MARKET COMMENTS

- **Wind/hail deductibles:** Many are accustomed to seeing large or percentage deductibles for named windstorm, earthquake, or flood perils; however, some markets are beginning to push similar deductibles on wind (non-named windstorm) and hail perils.
- **Water damage deductibles:** 2020 and 2021 saw water damage increase from standard/AOP deductibles of $10,000-$25,000 to $50,000-$100,000 at a minimum and upwards of $250,000-$500,000. This trend appears to be continuing in 2022.
- **LEG3:** Similar to 2021, insurers are attaching higher premiums and deductibles for LEG3; however, the coverage remains available in the marketplace. On larger projects, many markets are seeking to include a sublimit for this coverage, rather than allowing for full value.
- **Flood capacity:** Flood (including storm surge) capacity, premiums and deductibles continue to be a focal point of reinsurers and upper management. Of the three major CAT perils, flood appears to be the most impacted by dwindling capacities and exponential rate increases.
- **Policy extensions:** Extensions continue to be heavily underwritten with additional upper-management signoffs required. Unless guaranteed by policy terms, pure pro-rata extensions are becoming less frequent, and almost non-existent for large and/or CAT-exposed projects.

Wood frame construction continues to be perhaps the most common method of building domestic habitation structures in North America and placing these risks in both the London and domestic markets have remained challenging. However, over Q4 2021 and into 2022, we are seeing nominal capacity increases form select wood frame markets likely attracted by growing rates. We are hopeful this trend continues through early 2022 reinsurance renewals, but we expect wood frame rates and selective underwriting will continue to be fluid throughout 2022.

Marine cargo

After two years of significant firming and volatility, stability is returning to the marine insurance marketplace. Rates on 2021 cargo and stock throughput renewals experienced increases between 10% to 25%, but well-performing risks were able to renew with single-digit increases. Entities with more problematic commodities, a high concentration of static exposures in CAT-exposed areas, or complex risk profiles coupled with an unfavorable loss history were likely to experience sharper increases and higher retentions.

We anticipate some additional easing in rate on renewals in 2022. Non-complex risks and well-performing cargo programs may see flat to 10% increases; however, given the implications of the disruption in the global supply chain, organizations should still expect some degree of rate increases. Clients with favorable risk profiles will benefit from the oversubscription on quota shared programs during 2021. Continued competition on new business will also help to ease rate increases.

Some existing and emerging risks are impacting the modest gains realized by the cargo market in 2020. Here are some persisting and new challenges facing businesses and their insurers:

- **Supply chain disruptions and port congestion:** Challenges related to securing and insulating the supply chain from the impact of the pandemic is a major concern for all stakeholders.
  - Container ships are experiencing long delays while being anchored offshore waiting to dock at ports and unload their cargo.
  - Railyards are clogged and experiencing similar back-ups.
  - Port congestion is associated with accumulation of risk because cargo at rest is at greater risk for loss.
  - Not all emerging risks from the breakdown of the supply chain are covered under the standard cargo insurance contract. Examples include loss of market and container demurrage penalties imposed for the late return of boxes.
- **Container collapses:** Container collapses on ultra large container carriers that encounter heavy weather are occurring at an alarming rate. This emerging risk hit hard in Q4 2020 and Q1 2021.

With respect to excess stock placements in London, the news is more encouraging:

- Increased capacity is returning, which is helping to stabilize the cargo insurance market in London.
- The influx of new capacity that is emerging from existing insurers and new entrants in the London market has increased the total capacity to an estimated $1 billion.
- Despite the difficulties caused by COVID, the London market is offering significant vertical limits.
- On average, the London market is continuing to push for single rate rises based on risk exposure and historic losses; however, similarly to the U.S. market, competition helps to ensure that renewal solutions remain appropriately priced.

Cyber

Companies in the design and construction industry are not immune from the growing cyber risks affecting all companies today. Such companies may not worry about data breaches as much as others do, but their heavy reliance on computers for every aspect of their business, from computer-aided design (CAD) to building information modeling (BIM), drones to autonomous construction machinery, industrial control systems to other "Internet of Things" devices presents a large attack surface to threat actors.

Ransomware is the cyber risk companies worry most about today. Recent research determined that the construction industry has been hit with the largest number of attacks in 2020 and 2021. An attack on any computer system can cripple a company. While ransomware used to be less common and easier to resolve, either through restoration of encrypted data or payment of a relatively small ransom, today recovery from an attack is more difficult and expensive.

Ransomware attacks have proliferated due to the growth of "Ramsomware as a Service" business models by cyber-criminal groups. Under that model, the criminal groups allow others to use their sophisticated ransomware in return for a percentage of a ransom. Ransoms have increased substantially over the last three years. Today ransoms are routinely, though not exclusively, in the millions. Ransomware has also become more expensive because threat actors very often steal data that they then promise to destroy if the ransom is paid. If the exfiltrated data is protected by law, then the company will have legal obligations to report the event and to notify the affected parties.

One final point about ransomware: not every ransom can be paid. If the threat actor is on the U.S. Treasury's OFAC SDN list of sanctioned parties or is located in a country subject to comprehensive sanctions, neither the company nor its cyber insurer may pay the ransom without violating U.S. law. While a company may apply for a license to pay the ransom, OFAC has said that there is a presumption that such requests will be denied.

Ransomware isn't the only risk facing design and construction companies. Social engineering fraud, also sometimes called business email compromise, remains a constant threat in 2022. Cyber criminals will access a company's computer system, or that of a third party such as a subcontractor, and fraudulently issue payment instructions that result in money being transferred to the criminal instead of the proper party.

Given these exposures, many insurers are, at best, midway through a process of increasing overall premiums (100% and more is not at all uncommon) to return to profitability on cyber coverage. The increases are being specifically driven by the larger ransoms being paid to end ransomware attacks. It is predicted the market will not experience any significant moderation until late this year, and possibly not until 2023.

Availability of cyber insurance and larger policy limits are becoming increasingly difficult to obtain. Insurers are now requiring good information regarding governance and cyber hygiene. In particular, insurers look for significant cyber risk controls to be in place during the underwriting process. The lack of such controls decreases the availability of securing coverage and if coverage can be found, it may not include coverages like cyber extortion (ransomware).

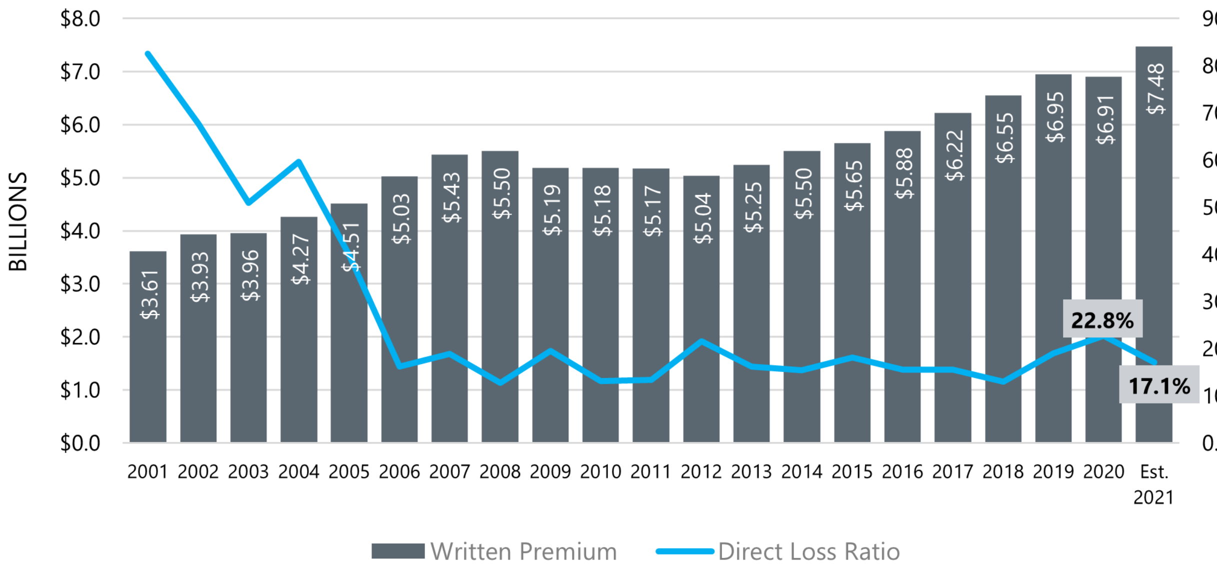
Construction surety

Calendar year 2021 was a welcome reprieve from the broad uncertainties of 2020 following the emergence of the COVID pandemic. Continuing to operate as essential businesses throughout the pandemic and buoyed by confidence stemming from the roll-out of vaccines and relaxation of social restrictions, the construction industry will close out a very strong year of growth and widespread profitability.

Many contractors took advantage of the loans and tax incentives under the CARES Act by locking in capital with the write-off of government loans early in the year. Benefits were also gained from monthly employment tax incentives, as organizations continued to put their employees to work on strong and growing backlogs. Projects that were stalled or delayed during the prior year largely returned, helping contractors rebuild backlogs to pre-pandemic levels.

The resulting effect on the surety industry was an all-time record for written surety premium of $7.4 billion, surpassing 2020 results by 8.2%, and the previous 2019 record by a healthy 7.6%. The jump in premium was boosted by the increase in labor and material input prices but was also a clear reflection of the strength in the industry as a whole. The November 2021 passing of the Infrastructure Investment and Jobs Act (IIJA), a $1 trillion piece of legislation referred to as a once-in-a-generation investment, should add to the strength of the construction market through new investment in roads, bridges, rail and social infrastructure work for years to come.

SURETY INDUSTRY WRITTEN PREMIUM & LOSS RATIO



Source: SFAA reported resuls in U.S./Canada

Challenges with escalating and unpredictable material prices, continued labor shortages, and increasing lead times and project schedules will continue to get well-deserved attention in 2022. Longer project schedules have led to earlier engagement from project owners for work that may not start for years. Owners want to ensure they have commitments from contractors for their projects, while contractors struggle with the ever-changing timeline of those future commitments. While helpful from a future revenue and workforce projection standpoint, this trend is causing at-risk backlogs for large general contractors as they sign contracts for future work much earlier than historically. In addition, project sizes continue to increase with the emergence of higher inflationary factors and low unemployment. Firms taking on larger projects, especially for new owners with no previous experience, should continue to push for favorable payment terms, time extensions and compensation for delays, and appropriate caps on damages clauses.

Surety underwriters will continue to look for signs of trouble with regard to the quality of engaged subcontractors, and the backlog levels of all contractors on a project. Contractors taking on too much work in a hot economy is an obvious concern, but will the government relief programs prevent a corresponding liquidity issue that has driven contractors out of business in the past? So far, the loss data indicates it might.

Contractors flush with cash are using their strong financial positions to execute on longer-term strategic plans, such as ownership transitions, geographic expansion and acquisitions. The surge of private equity capital into the construction industry is allowing contractors to take advantage of the current market environment (strong backlogs, low interest rates) to recapitalize their companies prior to retirement at incredible price multiples. With conflicting perspectives on preferred capital structures and return horizons, the surety industry struggles with underwriting and supporting the private equity ownership groups that continue to emerge. Should the surety industry encounter an event that affects its long-term profitability levels, a strong reaction to private equity-owned contractors would be inevitable. Reinsurance scrutiny on this business is already heightened in the wake of a couple of key losses booked in 2021.

SURETY CARRIER TURNOVER

Given the long track record of surety profitability, insurance carriers continue to view the surety line of business as an area of potential expansion. New entrants bring new opportunities for surety executives, and the rosters at surety senior suite levels continues to evolve and change. COVID, along with an aging workforce and an already-lean cohort of qualified surety professionals will continue to impact surety companies. Like the construction industry, the insurance community (both brokers and carriers) are at war for talent. Travelers, Berkley, Zurich, Argo, Chubb, and Crum and Forster all had recent changes at the senior level in the last six months.

OUTLOOK FOR 2022

As we head into 2022 the surety industry is well-positioned for another strong, if not record, year. The contractor backlogs developed during 2021, plus the pending work to be released under the IIJA, should drive increased bonded project activity into 2023. Despite this strong position, questions remain:

- Are contractors prepared with the people and resources to address this surge in demand?
- Will the labor shortages increasingly drive poor productivity and erode profit margins?
- Will contractors overextend themselves with cash flow or project opportunities on which they cannot execute?
- Will a significant loss event alter the relaxed underwriting standards of a 16+ year soft market and completely reset the market landscape?
- How will rising interest rates change the construction landscape, both at the project financing level and with respect to those who carry significant interest-bearing debt?

While we can't provide definite answers to these questions, one thing we've learned from the last couple of years is that organizations can't anticipate everything. Contractors should continue to address the evolving risks their companies face every day — and communicate the steps they are taking to their suret(ies). Surety partners who are comfortable with a contractor's ability to identify, assess and mitigate the risks of a volatile construction industry will be in an optimal position to provide suitable support.

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