



Inherent Defects Insurance (IDI)

Project-based construction insurance solution

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Executive Summary

Lockton is pleased to present this paper on Inherent Defects Insurance (IDI), also known as Latent Defects Insurance (LDI) – an alternative “first party” project-based insurance model covering structural defects in buildings and other structures post construction completion.

IDI evolved from a similar insurance product known as Decennial Liability insurance; a mandatory insurance product covering strict liabilities imposed at law in various jurisdictions around the world. Decennial liability was first enshrined in French law back in the early 1800’s with the introduction of the French Civil Code of 1804. As an imperial power, the French system of law spread to other parts of the world and as a result the list of countries that have similar “decennial” style liabilities imposed on building contractors is quite extensive; the list includes Argentina, Belgium, Brazil, Canada, Colombia, Egypt, Indonesia, Philippines, Saudi Arabia, Spain, Tunisia and UAE.

IDI and Decennial Liability have been designed and mandated (in the case of Decennial liability insurance in some jurisdictions) to deliver protection to building owners for defects to structural components of buildings resulting in damage and/or imminent collapse.

In addition to the direct protection afforded to building owners and developers, there is anecdotal evidence to suggest that these insurances also improve the overall quality of construction for individual projects and across the construction industry. The data collected and underwriting protocols administered by insurers (specifically the use of Technical Inspection Services described later in this paper) have assisted in improved monitoring and control of the quality of construction projects.

Whilst these policies have historically shown to deliver improved protection to building and apartment owners, as well as building integrity outcomes, they are not the “silver bullet” solution to all risks facing stakeholders of construction projects. The policy can also be adaptable to meet the needs of large civil infrastructure projects and may assist in providing additional comfort to lenders’ and other incoming investors, i.e., governments and institutional funds who require additional due diligence to be undertaken to satisfy the requirements of their committees and investors. IDI should be viewed as complimentary to (and not a replacement for) existing contractual, legal and insurance protections currently afforded to owners, contractors, suppliers, and other building practitioners.

IDI is currently available in Australia, providing meaningful additional insurance protection and improved building quality for construction project owners, however is not currently widely procured or required by project agreements. It is estimated that there is currently, at the date of this paper, approx. USD 600 million of available IDI capacity in the market (PI capacity is currently ~USD 70 million) available through some of the world’s largest insurers who have considerable global IDI underwriting experience.

IDI Coverage

IDI is a **first party** cover taken out for the benefit of the property/asset owner, however, can be drafted to remove future liabilities of the construction contractor that takes out the policy who typically will be required to carry a third-party Professional Indemnity (PI) insurance policy for six or seven years post a projects practical completion.

What Does IDI Cover?

IDI is an optional insurance product that covers damages to and/or a threat of imminent collapse of a building or other structure caused by inherent defects in the structural components of that building/structure. The defects can arise due to faulty design/specification, faulty materials, or faulty workmanship.

IDI is a first-party cover that is triggered by damage or imminent damage, and unlike professional indemnity, does not rely upon proving a legal liability to pay. IDI provides a long-term warranty against material damage caused by a structural defect.

What is the Period of Insurance under an IDI policy?

IDI policies usually run for a single policy period of up to 12-years after a project's practical completion and/or commercial operations commence.

Who is covered under an IDI policy?

An IDI policy covers the ultimate owner (and subsequent owners) of the building or structure being insured, however can be (and often is) purchased by developers or contractors involved in delivering construction projects.

Advantages and Disadvantages of IDI

Advantages

- Provides full reinstatement value and cover can be procured with indexation to cover inflationary uplift;
- Policy can be used as a single and direct point of recourse;
- Subrogation waivers as standard typically included (protects stakeholder relationships);
- First party policy with no requirement to prove fault or negligence (unlike PI) to achieve indemnity -avoids need for costly and lengthy legal disputes;
- Policy is non-cancellable and will remain in force for 10-12 years, as agreed, and is fully transferable;
- Affords a form of recourse to interested parties who were not part of original construction contract(s); and
- Additional coverage can be endorsed to meet purchaser's individual risk appetite requirements.

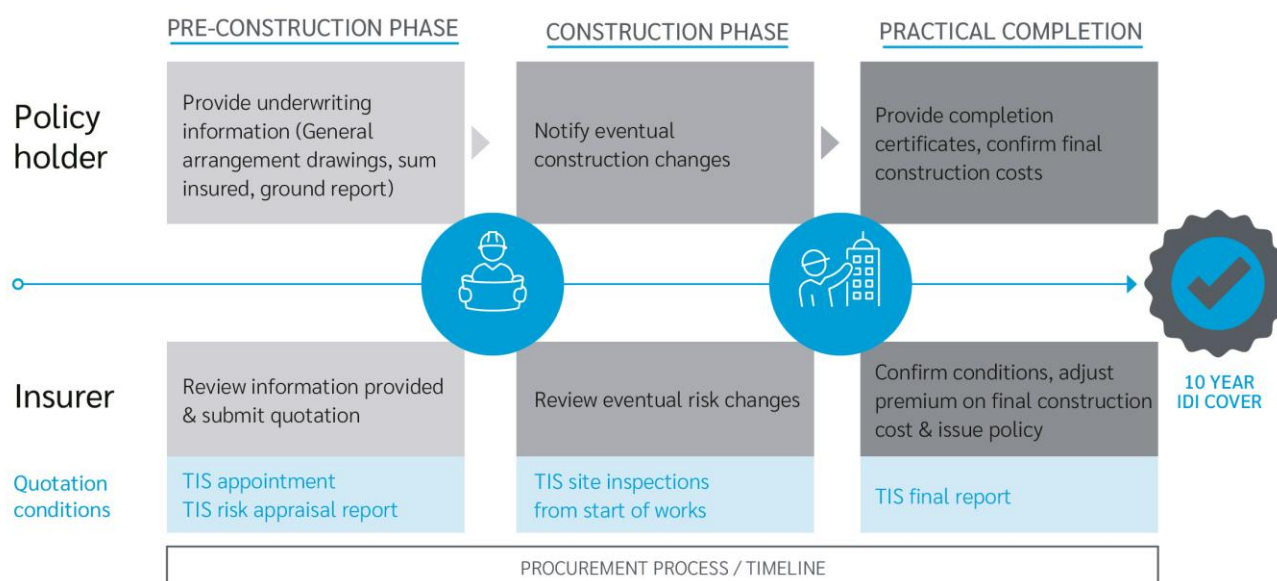
Disadvantages

- If policy is not procured well in advance of construction, cover may not be available or if available, subject to significant restrictions and premium loadings;
- The policy, subject to market environment, may require an excess of 1-2% of sum insured; and
- Premiums for basic cover range from 1-1.5% of contract value, with larger projects closer to 2%.

How do you purchase an IDI policy?

The process of purchasing an IDI policy is quite extensive and needs to start prior to construction commencing.

The graphic below provides an overview of the key steps and milestones:



The party seeking coverage under an IDI policy will need to provide the prospective insurer(s) with a completed proposal form together with other relevant underwriting information regarding the construction project prior to construction commencing. If they agree to underwrite the project, the insurer will provide a formal quote outlining the terms and conditions of coverage and the prospective policy holder will need to pay a deposit premium up-front; noting that the formal policy documentation will not be issued until construction completion.

An independent Technical Inspection Service (TIS) will be appointed by the insurer (and paid for by the policy holder) to review the quality of the construction, including critical elements of the design, specification/use of appropriate materials.

Before the insurer formally issues the insurance policy, the policy holder is required to provide the following:

- Final TIS report (including a list of outstanding defects to be completed by the building contractor during the maintenance period)
- Certificate of Acceptance
- Declaration of final construction value / property reinstatement valuation
- Balance of the premium due

Satisfactory acceptance of the above by the insurer will then trigger commencement of the IDI policy and a formal policy will be issued, which normally runs for up to 10-12 years.

What is the Technical Inspection Services (TIS)?

TIS is the appointment of an independent consulting engineer to review and monitor the construction. The insurer will engage this specialist on behalf of the policy holder. The fees and expenses relating to the TIS are charged to/paid by the policy holder.

The TIS is responsible for most or all of the following tasks:

- Reviewing the building plans, permits and drawings as part of the initial underwriting submission (prior to construction);
- Inspect and examine construction activities and procedures ensuring they reflect the design intent;
- Evaluate the specification, testing and certification of materials to be incorporated in to the building;
- Issue technical reports to the insurer; and
- Review and sign off formal construction documents (including Certificate of Acceptance).

If any issues are identified during the TIS process that represent an unreasonable risk to insurers, they often have the right to not issue the policy or modify the insurance coverage until those issues have been rectified and/or appropriately addressed.

What IDI does not cover?

IDI is not a replacement for any existing contractual, legal or insurance protections currently afforded to building owners, contractors, suppliers and other construction practitioners. Most notably, IDI does not provide protection for the majority of the professional liability risks typically covered under a construction practitioners Professional Indemnity insurance (PII) policy.

The list of insurable risks that this product does not cover is extensive, the following is simply a sample of some of the most relevant ones as it relates to other insurance products:

- Professional liabilities for structural components of a building where there has been no damage and no risk of imminent collapse;
- Professional liabilities relating to non-structural components of a building;
- Property damage from other causes and/or to non-structural components of a building;
- Liabilities to other third parties (e.g. neighbours);
- Defects required to be fixed by the builder as part of any maintenance or defects liability provisions under contract;
- Consequential loss, loss of use or additional costs; and
- Defects known or discovered prior to policy inception (i.e., patent defects).

Conclusion

IDI can assist in filling gaps left by other classes of insurance and is most helpful when used as a missing piece in the implementation of a holistic risk management strategy for a project and its many stakeholders.

Lockton has developed strong relationships with clients and insurers in the IDI space and is at the forefront of understanding not only the key requirements and nuances in this sector, but also the ever-evolving developments in the IDI space and how these can impact your project. Lockton has in-depth experience in arranging and advising on IDI policies globally.

Feel free to reach out to any of the contacts below to discuss not only your IDI needs, but any other construction related requirements.

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