Construction & Infrastructure

Regional variations in insurance

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Empower Results®

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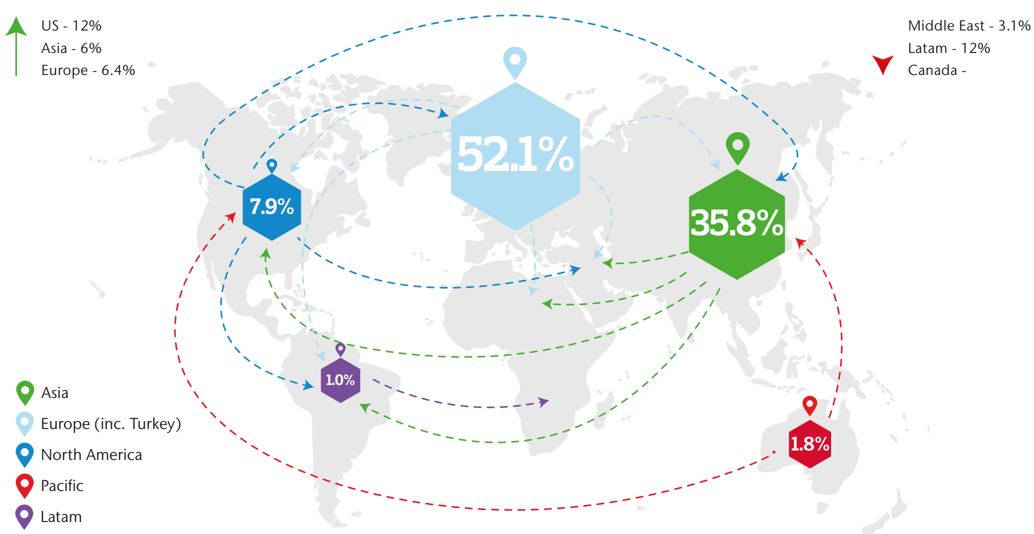
Introduction

Now, more than ever, major contractors are looking outside of their own regions for construction opportunities. In 2017, the top 250 contractors generated USD 482 billion outside of their home countries. China's rapid expansion, particularly in Africa and other emerging markets, has been well documented but European contractors are also expanding their footprint in new regions. In fact, 52.1% of all international revenues are now generated by European contractors, with important focus on North and South America. The diagram below indicates the relative volumes of work being done by contractors outside of their home base regions.

How the Top 250 International Contractors Shared the 2017 Market: The Top International Contractors generated $482.4 billion outside their home countries up 3.1% from 2016



ENR International 250 Contractror Report 2018

This growing trend comes with new insurance challenges. Contractors embarking on projects away from their normal business environment must adapt their approach to risk management, and insurance procurements procedures, to reflect local requirements and practice. This has created a new dimension and potentially competitive tension that contractors are able to leverage as they develop their global insurance relationships. It allows them to test their current insurers and brokers as they seek support and solutions for the insurance needs of their projects in new regions.

Estimating the cost of insurance per region

Notwithstanding the legal, compliance and socio-political pressures involved in working in new regions, Aon understands that cost will always be a key factor in any construction project. We therefore wanted to drill down further into the pure cost of insurance for contractors and how it varies globally. We conducted a study using our global bandwidth and our regional construction experts' knowledge of regional market conditions to calculate the costs of the main classes of insurance that would be required to run an identical project in various locations worldwide. The parameters of the project we selected were as follows:

Project parameters:

Base case for the exercise, levelling the playing field

- $1.5 billion road construction in a non-cat area and good underground conditions
- Includes $500M of tunnelling work
- $300 million 24 months revenue
- 5 years
- 1 TBM at site for 2.5 years
- Reputable and experienced international Contractor with a strong balance sheet
- Broad manuscript wordings; standard regional deductibles

Lines of Business

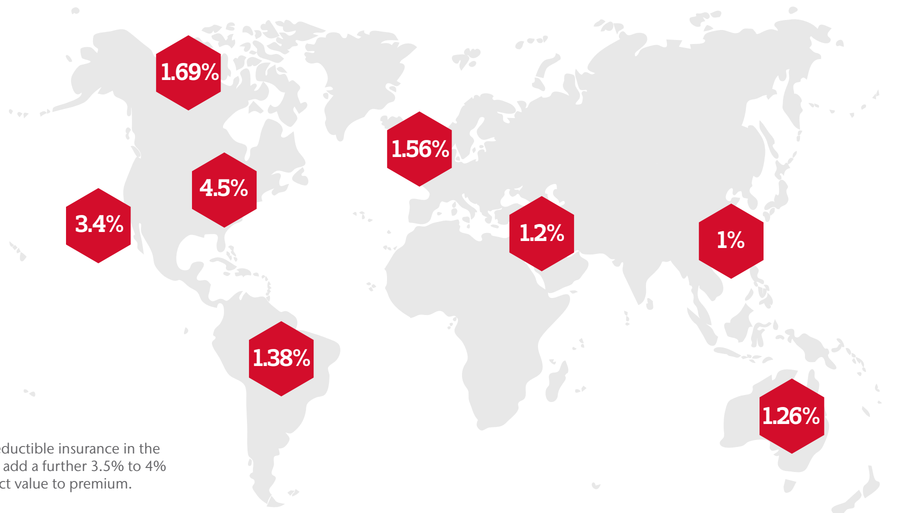
- Engineering Lines: CAR, DSU, CPE
- Liabilities: $200 million General Liability limit; $50 million Pollution limit
- Workers Compensation/EL (if non state covered)
- Surety
- $50 million Professional Indemnity limit (5 year ERP except 10 for US and ME)

Regions:

Europe (UK); Asia (non Hong Kong); Middle East (ME); US (NY and outside NY);

This global approach to assessing the cost of risk transfer is what we do at Aon for our international clients and, the results are as indicated in the diagram below:

Estimated Cost of Insurance as a % of Total Contract Value (TCV)



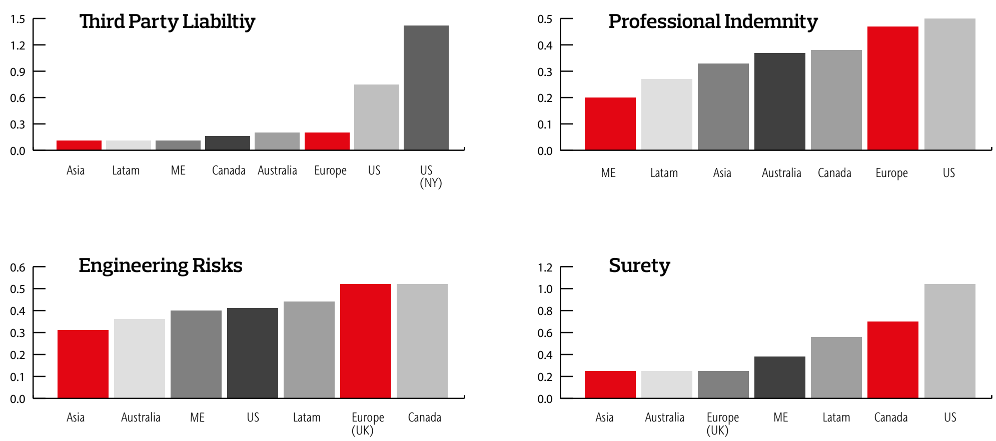
Note: Deductible insurance in the US could add a further 3.5% to 4% of contract value to premium.

From a headline perspective, the total insurance costs in the US (NY) could be up to nearly four times more expensive than in Asia, the region where insurance costs are the lowest. There is no real surprise that a major infrastructure project in New York will cost significantly more than anywhere else in the world and this disparity is mainly driven by the cost of Liability insurances including Third Party Liability, Workers' Compensation/Employer's Liability, Professional Indemnity and Surety. If we add the costs of deductible insurance in the US, the difference in costs in respect of other regions could increase up to eight times.

Insurance can clearly have a significant effect on contractors' profit margins, which are becoming increasingly tight, and understanding the cost implications of the insurance programme required for any project is essential.

Other territories tend to be more competitive from an insurance costings point of view but still have their peculiarities, illustrated in the diagram below.

Cost (TCV) per Class in Total Premium per Region as a Percent of TCV



The most striking finding is that Liability premium could be up to 10 times more expensive in New York than in Latin America or Asia, despite significantly higher retention levels also applying. Professional Indemnity is a fairly low-priced coverage in the Middle East but represents a more significant cost in Europe and North America.

Once the insurance policy limits have been defined for all regions, the main feature impacting the differences in the liabilities classes of insurance is the claims experience and litigiousness of the region or country. Professional Indemnity costs are also especially sensitive to local idiosyncrasies; such as extended reporting periods, deductible levels and scope of wording required (Mitigation of Loss cover and Insured vs Insured clauses for instance).

For engineering risks (including Builders Risk also known as Construction/Erection All Risks), we understand that the differences of +/-50% are based largely on the location's access to the insurance market. The UK (for UK contractors) and Canadian markets are the most expensive and this is because UK contractors only have one hub (London) competing for their business while in Canada capacity is constrained due to license issues. Costs for projects in Europe outside the UK have not been assessed for this report but we would expect these to be significantly lower given that at least two hubs would be competing, ie London and local markets.

At the other extreme, we have Asia, which tends to be very transaction driven, and is the region with the most competitive rates. Asia is followed by Australia, a market that also accesses the Asian (Singapore) hub for its risks, bringing competition between the local markets and the London market, which is also very active in Australia. The US is placed in the middle, more competitive than UK and this can be explained by the huge capacity and the interest of markets to position themselves in the region with the best global construction growth outlook. European contractors will often take their own insurer relationships to the US and this adds competition and drives cost down further.

Aside from the financial health of the contractor itself, Surety costs are mostly driven by the percentage of contract value usually required, the nature of the actual bond (conditional/unconditional) and the capacity available in the region. Costs are particularly significant in the US – four times more expensive than in Europe and Middle East, where there is a requirement for higher percentage than anywhere else (up to 100% of contract value), followed by Canada with similar requirements.

Surety costs in Latin America are also considerable. The percentage required to be insured varies from 10% to 25% across the region, and nature of the bond varies from country to country. Against this, the Surety capacity for Latin America is lower than in other regions, which tends to drive up costs.

Navigating local requirements and optimising the use of global insurance programmes

When a contractor expands into a new territory, it is understandable that they would ideally want to adopt the centralised insurance strategy that has been developed for the organisation but this is not always possible.

One primary issue to establish is whether a county allows non-admitted paper or not. In the Middle East, Africa, Latin America and most parts of Asia, there is a requirement to use a local insurer to issue paper and this often involves complicated procedures to gain approval from the local regulator. Nigeria, for example, is a case in point where the regulator plays a very central part and enforces "cash before cover" requirements plus oversees the optimisation of the local insurance market before any access can be made to international reinsurers. This can create a number of issues for new entrants to countries such as Nigeria where local insurers often do not have internationally recognised security ratings and as such, it is difficult for contractors to work with insurers that meet their normal minimum security specifications.

The US and Canada both have very strict requirements for licensing, more so in Canada where it has a direct effect on the cost of insurance by restricting the competition available in other territories.

Other obstacles that will demand moving away from a centralised strategy in favour of a local approach include: claims management issues; locally regulated premium rates and premium taxes; legal codes for decennial liability and environmental insurances; mandated insurance requirements (ie in the Middle East all foreign workers are required to have their own medical insurance), market retention requirements and the compulsory use of a broker.

Some of the key issues to be considered are summarised below:

Main Region Differential Factors in Construction Projects and Impact in Insurance

- Risk Allocation
- Political Stability
- Legal Framework
- Economic Stability
- Currency Exchange
- Regional Insurance Hubs
- (Increasing) Average Building Costs/Inflation
- Litigiousness
- Nat Cat Exposure
- Lack of Skilled Labour
- Construction Period
- OCIP or CCIP
- Surety Capacity
- Economic Stability
- Cash Before Cover

Risk allocation is often an issue because of competition in new territories, where contractors are being asked to take on more and more of the risk – this has not always been the case. With certain Middle East metro projects, we saw that contractors were required to take the risk of "unforeseen soil conditions" on underground works. The Asian contractors accepted this requirement and, to compete, the European contractors had to sign up to something they would never have been expected to retain in the past. This has become a standard contractual condition. The ability to benchmark contractual risk allocation norms globally can help contractors mitigate risks in every region they operate in.

Conclusion

There is often a conflict when contractors choose to operate in a new region as they understandably value the security of their global insurers. However, it is not always possible for clients to simply engage their global insurance strategy as they need to consider local requirements and make sure they comply with regulations and requirements on the ground or potentially face difficulties in the future.

The issues that need to be addressed by contractors are many and varied. Each territory has its own peculiarities and understanding the local requirements is fundamental to ensuring the success of the project.

Our job as a broker is to understand our contractor clients intimately, including their risk tolerances and insurance market relationships, and support them in developing the best risk management solution in any territory. At Aon, we use our global network of offices with on-the-ground professionals to support our clients as they enter new territories and help them make the right decisions on insurance arrangements, all aimed at driving down the total of cost of risk.

Success in new territories requires planning, sharing local insight, understanding the conditions and matching the global approach with local requirements.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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