Aon Risk Solutions
Global Construction & Infrastructure

Driving Better Risk Management, Improved Productivity and Greater Profitability Certainty through Funded Retentions

3Q 2017

Empower Results®

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Q: Are there new ways to price construction projects that will help achieve opportunities for the delivery of on-time, on-budget and defect free projects? Yes – and some companies are already changing the way they price their construction projects.

To some, risk management may sound boring but there is no doubt that effective and efficient risk management drives greater productivity and greater profitability. The foundation of risk management is what a company does to prevent or mitigate the risks they take on – otherwise known as risk controls. Risk controls are the first line of defense when it comes to managing risk and they can be divided into two primary categories – operational practices (or the practices your employees implement to optimally manage risk) and operational tools (the equipment, technology, and safety devices, to name a few, that are used by your employees to more effectively manage risk).

Most successful companies have created strong risk controls in order to manage the risks they take on, but the greatest of those companies have figured out a way to incentivize all of their employees to be aware of effective risk controls at their disposal and, more importantly, to always implement the optimal mix of risk controls to prevent and mitigate assumed risks. What are successful construction contractors doing to achieve adherence to the documented risk controls of the company by their employees? Well, some are using innovative insurance structures, with a keen focus on using the power of the insurance policies' retentions to drive better practices. Before we get into detail on what specifically they are doing, let's pause for a moment and look at the major risks a construction project faces, the various insurance policies used by construction project stakeholders and then delve into the power of retentions on key insurance policies (both unfunded and funded).

Overview of Major Risks & Insurance Policies

Let's start with the risks a typical construction project faces. The following pie chart was developed by our Canadian operations and classifies the various material risk events that impacted P3/PFI projects over the past 15 years (we believe this sampling is reflective of most construction projects regardless of delivery model being utilized):

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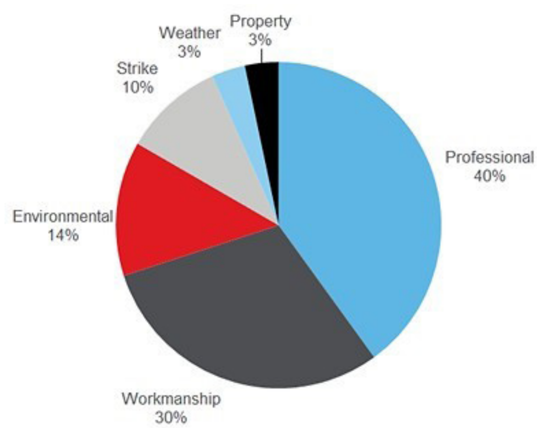

A significant portion of material risk events (84%) came from professional/design risk events, workmanship risk events, and environmental risk events. These risks have the potential to be insured. What are the insurances that offer coverage of these risks? The following policies are critical insurance policies that we believe cover material risk events:

- Professional Liability
- Subcontractor Default Insurance/Supply Chain Insurance
- Environmental Liability
- Builders Risk/Construction All Risk
- Wrap-up General Liability
- Various contractor and design firm practice policies

Of note, the other risks referenced in the pie chart above (strike, weather and property) do have potential for coverage by insurance policies.

The Power of Retentions

Each of the key insurance coverages referenced above come with retentions (the portion of the loss that the insured will pay out of their pocket). These retentions are there to align the insured with the insurer – the retention is a reminder to the insured that they share in the risk. The insurer hopes that this sharing in the risk will drive the insured to prevent and/or mitigate the risk from taking place – not wanting to bear the pain of paying their share of the loss via the retention. This is a powerful concept and can be amplified when the retentions are substantial. Traditionally these retentions are unfunded and any payment for them would come from the insured's balance sheet resources. In recent years, some policies have developed a funded retention structure thereby converting the "stick" nature of the retention into a "carrot" as the insured will have the funded retention returned to them if they successfully manage the risk being insured and therefore incur no claims under the policy. Such a structure has been shown to drive significant improvement in the insured's adherence to best practices that prevent and/or mitigate the risk being insured. This is especially true when the employees of the insured that are directly responsible for the management of the insured risk receive bonuses from proceeds returned from funded pensions. In other words, when the funds being held to cover off the insured's retained risk are returned to the insured given zero claims, those employees that successfully managed the project to a zero claims result are given bonuses for their adherence to the practices that prevented the insured risk from manifesting.

Such a structure has been used for several years under Subcontractor Default Insurance policies in North America and in Europe. Over that period of time, insureds with a funded retention structure have seen a marked improvement in their operational practices related to subcontractor prequalification, subcontractor award, and subcontractor management. This structure has garnered the interest of top management consultants when advising clients on how best to drive adherence to operational best practices – as evidenced by the recent reference to Subcontractor Default Insurance within a recent McKinsey article.

These funded retention structures, if applied to the top risks facing a construction contractor, could revolutionize the way in which contractors account for job profitability. Imagine a series of insurance policies that help protect the contractor and its project from exposure to catastrophic project risk, and further imagine, the profit is actually housed within the funded retentions of the polices covering those key risks. Such a methodology for arriving at a project's profit margin could more accurately price risk and, perhaps more importantly, could more effectively incentivize the construction contractor to manage key project risks.

The Aon Client Promise

At Aon, we are working with our clients to develop such structures and are also working with project owners and lenders to help them understand why such a methodology for arriving at an attractive job profit is a more effective way of helping achieve the goal of on-time, on-budget and defect free projects.

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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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