A guide to builder's risk – who, what, when, where, and why

In the complex ecosystem of construction project management, insurance is the cornerstone that safeguards against unpredictable situations than can derail progress or cause financial strain.

One of the main safeguards is builder's risk insurance which essentially insures a structure while under construction. In this guide, we will summarize the 5 W's of builder's risk from the viewpoint of an owner or developer.

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1 What is it?

Builder's risk insurance, also called **"course of construction insurance"** is a form of property insurance specifically designed to cover property damage or losses during the construction phase of a project. This may include building materials while in transit or awaiting installation.

It protects the project owner from financial setbacks including a range of events such as damages due to fire, wind, theft, vandalism, and other perils. It also covers the general contractor and subcontractors and their materials that are part of the construction.

2 Who should buy it and who should hold the policy?

As the owner/developer, there are many assumptions that occur in the investor proforma analysis that can cause property damage and resultant project delays. Builder's risk insurance is designed to shoulder the financial burden resulting from such incidents.

The advantages of the owner purchasing the builder's risk policy compared to the general contractor are:

- Loan covenants are between the owner and the lender, NOT the general contractor.
- General contractor's programs may exclude Loss of Business Income coverage as they do not have an estimate of income or an insurable interest.
- As the first named insured, the owner will control the reporting, adjustment and settlement of any claims which is of critical concern to delay in start-up/business income loss.
- Avoidance of sharing sensitive financial details (i.e. loan financing terms, rents/income, etc.) should delay coverage be triggered and owner is a named insured on the general contractor's policy.

3 When should it be considered?

With the high cost of materials, labor and land along with rising financing costs, accurate insurance forecasting is extremely important and must be considered early in the proforma. In a hard insurance market, these prices can vary dramatically especially for frame and catastrophe (CAT) exposures.

Policy limits should equal your construction project's anticipated costs, which may include:

- **Hard Costs:** Physical property and tangible assets associated with project
- **Soft Costs:** Non-tangible items (fees, insurance, tax, interest, marketing, permits, etc.)
- **Business (rental) Income:** Loss of income due to delay in opening

Builder's risk insurance can strategically enable higher return on investment (ROI). Price should be only one consideration when looking for coverage.

Strategic Checklist:

- [ ] **Talk to your insurance advisor early:** Get a realistic estimate for your pro forma and then again at least 3 months before the start of the project to solidify rates if possible. Depending on the type of construction, or if in a catastrophic (CAT) exposed area, the market will release quotes closer to the project date.
- [ ] **CAT Modeling:** If the project will be in a CAT exposed area, it is prudent to understand and mitigate the associated risk.
- [ ] **Lender compliance:** Speak to a professional to ensure compliance with limits, deductibles, terms and conditions with insurance requirements, as well as language on certificates of insurance.
- [ ] **Budget for necessary safeguards:** Consider the cost of fencing, lighting, or security on site. Some projects in certain jurisdictions are required to have stringent security which can increase the cost of your policy.
- [ ] **Check policy language:** What are the exclusions in your policy? Does it list earthquake, mold, pollution, wildfire, etc? Know the difference between soft costs and business income and how to properly evaluate potential expenses the general contractor will not cover.

4 What are the perils in the policy?

Insurance policies for builder's risk insurance are based upon a combination of traditional perils and unique exposures, which allow the coverage to respond appropriately to the unique risks presented in a construction project.

Most sophisticated builder's risk policy forms use a traditional approach to common perils, covering “all risks” of direct physical loss unless the loss is caused by a peril that is specifically excluded. As such, the common “all-risk” perils of fire, lightening, collapse, wind, explosion, etc., are automatically included. Also, like most traditional permanent insurance policies, many perils must be added on by endorsement, or require special underwriting and deductibles, such as flood, earth movement, windstorm, hail, wildfire, etc. All these perils require consideration of the risks to specific regions of the country or elevation of the project.

The following are exposures that are more unique to construction risk management and merit close attention to detail. The policy forms may either exclude the coverage or the perils are sub-limited to values well below the potential exposure to loss:

Foundations and Underground Utilities: Some perils, such as subsidence or earth movement, could damage foundations and underground utilities, and unfortunately, these can be either overlooked when calculating the value of the project’s hard costs or may be sub-limited by the policy. Many owners incorrectly treat these values as site development expenses, and thus these values are excluded from the calculation of total project hard costs.

Materials in Transit or Stored in Offsite Locations: The value of construction materials that are being shipped from suppliers or are being stored in temporary offsite locations can be substantial. Care should be taken to understand these values and properly insure for them, otherwise they may be subject to the sub-limits of insurance that might be minimal in scope.

Scaffolding, Forms or Falsework: Construction sites include a variety of systems in this category, including traditional scaffolding, construction hoists, elevators, mast climbers and swing staging. The loss to these materials, which are not intended to become a permanent improvement could be significant. There is also a cost to reerect such items.

Water Damage: Buildings under construction are exposed to the elements, such as rain, snow and sleet. Damage resulting from these perils can be significant, but materially sub-limited by the policy. Or, water damage may fall under the definition of “flood” which may be totally excluded. Sometimes this category is expanded to include sand and dust. Another area falling under “water damage” is damage from internal plumbing. Some carriers have sub-limited this exposure as well.

Increased Cost of Labor and Materials: The risk of higher costs for materials and labor in the future (not locked in by current contracts) may be significant. Ensure your project costs kept pace with the rising costs of construction materials, which can exceed the rise in CPI.

Testing and Mechanical Breakdown: The testing of systems, often known as hot or cold testing, can result in damage to the systems being tested or resultant damage to the overall improvements. Hot testing needs to be specifically included.

Pollution Clean Up and Removal: The degree to which policies sublimit this exposure merits consideration for higher limits, or a separate policy for contractor pollution and legal liability coverage.

Existing Building: When an existing structure is being renovated or extensively repaired, such improvement may be totally excluded. When a loss occurs, it could be difficult to determine the exact cause of loss or if it occurred within the existing structure. Failure to include existing structures can lead to finger pointing between insurance carriers, and substantially delay the project until the dust settles.

Soft Costs and Business Income: Are expenses separate from direct physical loss to the improvements and betterments of the project? There is a misconception that soft costs and business income are the same – this is an area that needs to be carefully reviewed. The failure to properly insure for these expenses can totally derail a project as easily as under insuring for physical losses. This is a subject matter that merits a full analysis.

- **Soft costs** are reoccurring costs that would arise if there was a delay in construction such as: interest expense on loans, property taxes, insurance premiums, project management, legal fees, new permits, architectural and engineering fees and delay in income.
- **Business income** comes from the proforma in your lease up expectations of the building. It addresses loss of revenue/income which would have been earned absent a delay. It's comprised of the sum of net profit or loss and continuing normal expenses.

There are many other exposures that are not necessarily unique to construction risks but are commonly sub-limited. These should be examined including ordinance or law, debris removal, valuable papers and claim preparation expenses, and others.

As the above demonstrates, developing a comprehensive policy that includes all the perils and unique exposures associated with a construction project requires special analysis and underwriting. It behooves owners, brokers, lenders and other stakeholders to carefully think through the amount of coverage required, and make sure that all perils are properly considered and insured.

Finally, as the above shows, there is a significant amount of complexity to properly structuring a builders risk policy, which when properly done, makes it superior to simply having a "course of construction" endorsement on a standard permanent property policy.

5 Where do CAT and non-CAT exposures fit into the market?

The marketplace for builder's risk is a tale of two cities – non-CAT and CAT exposed areas. For projects in non-CAT areas, the insurance market has reversed course with steady and adequate limits available with the exception of frame buildings. In CAT exposure areas, the market is very fluid due to a combination of different factors such as natural disasters (Hurricane Ian) and reinsurance treaty renewals.

When looking at more predictable projects with non-CAT exposures, that have a proven track record, rates can be competitive.

Although a project might not be in a CAT exposed area, projects that are urban areas have a concern for crime scores. In areas of higher crime scores, carriers require enhanced security, fencing, lighting, camera services, etc. Additionally, urban locations face exposures such as arson or aggregate issues when a loss event impacts a large concentration of properties. These factors lessen the capacity given to projects in these areas and increase rates.

If a project were to be in a CAT exposed area prone to wildfire, earthquakes, hail, convective storm, Tier 1 wind territories or other natural disasters, there continues to be a challenge with high rates and deductibles.

Many reinsurance treaties are shared between marine/builder's risk and property teams. This has led to an additional strain on catastrophe pricing as well as deployed capacity.

How can we help

To ensure the best terms and conditions, you should work with an insurance advisor who is an expert in this space and can prepare your submission to the marketplace early with all the relevant underwriting data. Having the right advisor can make all the difference when it comes to negotiations in a hard market.

Ultimately, builder's risk insurance is not just a box to be checked in the process of a construction project. It is a critical tool that protects the project owner from unexpected financial and legal liabilities.

Contact an MMA advisor for builder's risk policies on your next project. Contact Fortress Risk Consultants for outsourced risk management and lender compliance services.

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John George is a Vice President at Marsh McLennan Agency (MMA), who has spent nine years in property management and over 10 years in the insurance industry focusing on real estate and development. He is a true advisor to his clients. He builds relationships with his clients, understands what challenges they are facing and applies his expertise to their specific circumstances. In addition, John has built a powerful network of investors, developers, brokers, attorneys, accountants, and finance professionals that help him facilitate business connections for his clients.

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Mr. McDaniel formed Fortress Risk in 2012 after spending 15 years with a number of national and regional insurance brokerage firms, including Wells Fargo Insurance Services, Wachovia Insurance Services and Hamilton Dorsey Alston Company. During that time, Mike served as the Client Executive in charge of all relationship matters for his clients, including risk management consulting, policy marketing and placement, claims management and loss prevention. Mike has worked with clients of all sizes, from large national property accounts to local technology companies.

Fortress Risk Consultants specializes in providing high-level risk management consulting advice, including providing insurance due diligence and program reviews. Fortress has particular expertise assisting financial institutions and their loan origination teams evaluate the adequacy of the insurance programs of their borrowers to determine compliance with insurance requirements. Mike and his colleagues have years of experience and familiarity with the insurance requirements of multiple capital sources, including balance sheet lending, preferred equity, mezzanine and GSE's.

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