AMERICAN GLOBAL

UNCERTAINTY & OPPORTUNITY:

LOOKING AHEAD TO THE 2021 CONSTRUCTION INSURANCE & SURETY MARKET

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A REFLECTION ON 2020

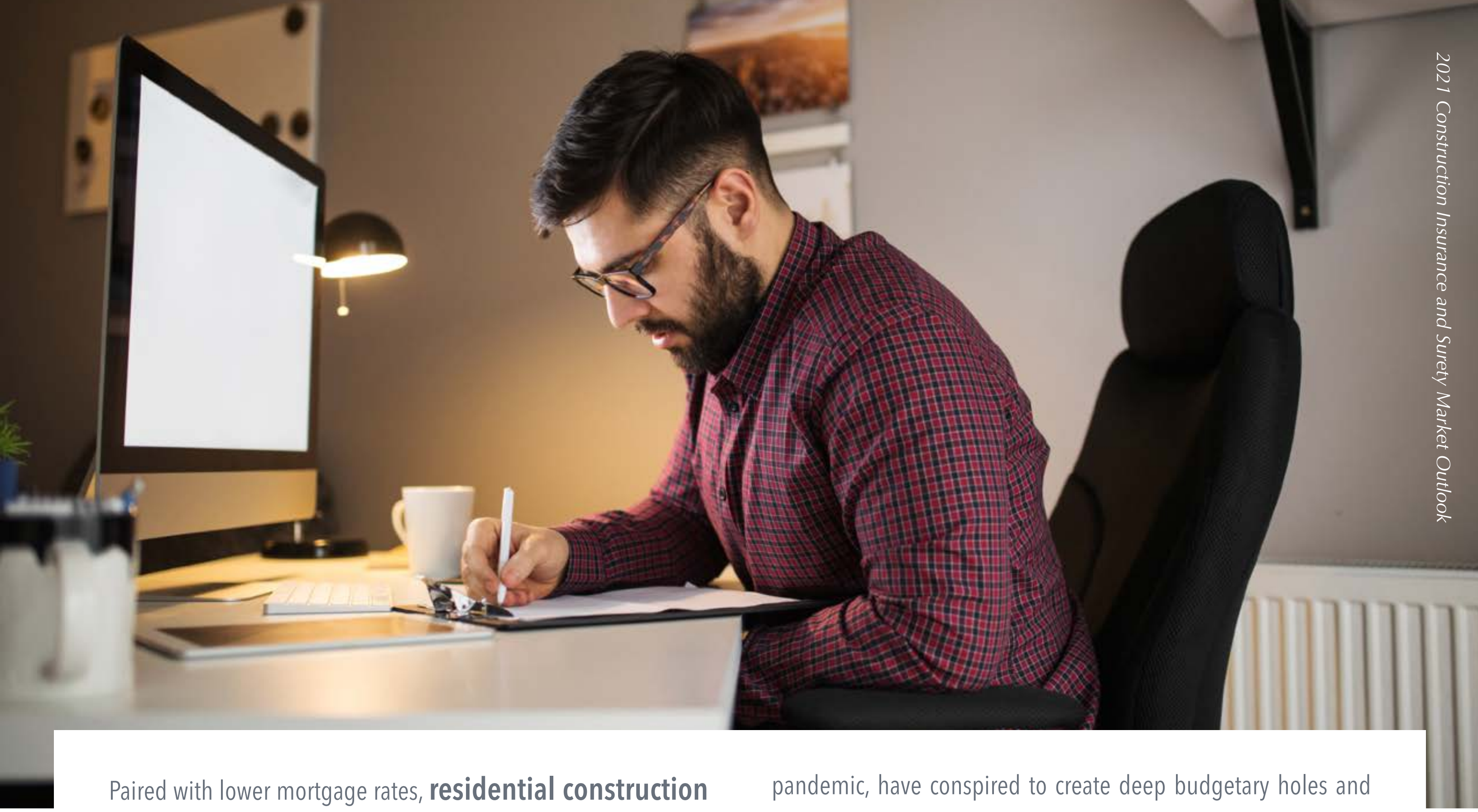
As we collectively reflect on the events of the last 12 months, there is little doubt that 2020 will be a year not easily forgotten. A global health crisis caused by the novel coronavirus, sharp economic contraction, increasing impacts from global warming, and significant political and social unrest in the United States have all coalesced in one calendar year to disrupt our collective world view. The construction community entered 2020 with historic backlogs and optimistic outlooks on what the year would bring. As the virus took hold and shutdowns were implemented, many contractors moved to conserve cash and reduce expenses in preparation for a great unknown. While the depths of the slowdown were significant, the summer and early fall of 2020 marked a time of recovery for many contractors as robust backlogs provided a lifeline and many searched for new work to fill their pipelines ahead of 2021. Of course, a "second wave" of infections wreaked havoc in the US in the fourth quarter, and an uncertain election outcome led many owners to delay or cancel projects that had been planned for 2021. Despite these headwinds, the insurance and surety industries are poised to support the construction industry and enter a new year as a relatively stable pillar in an otherwise shaky global economy.

The economic forecast for 2020 predicted the U.S. GDP growth would decrease to 2.0% from 2.2% in 2019 and the unemployment rate would average 3.5% in 2020 (Trading Economics, n.d.). Absent the pandemic, this would have marked one of the lowest rates since 1969 and far below the Federal Reserve's 6.7% target (Amadeo, 2021); however, COVID-19 struck the United States quickly and severely. While the country continues to deal with the resulting health and economic crises, the pandemic will continue to have an impact on the economic recovery until the vaccine is widely administered.

The U.S. faces an uncertain new year with the expiration of the Coronavirus Aid Relief and Economic Security (CARES) Act, which provided $250 billion in extended unemployment insurance through December 31, 2020 and froze student loan repayments and evictions. With the second wave of COVID-19 infections through the winter months progressing and additional rounds of fiscal stimulus delayed in Congress, a slow recovery is expected at least through early 2021.

Construction spending traditionally follows the overall GDP growth rate and the U.S. GDP is widely expected to grow by 3.5% in the first quarter of 2021 with additional growth possible over the remainder of 2021. Total U.S. construction starts are expected to increase 4% in 2021, after losing 14% in 2020 (Dodge Data & Analytics, 2020). Experts predict the economy will make a K-Shaped Recovery, meaning industries like technology will benefit disproportionately from the pandemic than other industries like construction that may have a more uneven recovery.

The pandemic has also forced many companies to shift from traditional office space to working from home, which has ignited a move from urban areas to suburban areas in search of space.



Paired with lower mortgage rates, **residential construction starts for single family homes are expected to increase 7% in 2021 to $254 billion, the highest increase since 2007.** On the flip side however, construction of multifamily residences is declining as demand shifts towards single family homes. Dodge estimates a decline of an additional 1% for multifamily housing starts in 2021 from the 14% decline in 2020 (Dodge Data & Analytics, 2020).

This work from home shift also creates challenges for specific stakeholders and unexpected benefits for others. For example, the shift to work from home has highlighted the need for high-speed internet connectivity, which is certain to lead to more investment and construction in fiber optic infrastructure. Less cars on the road leads to less wear and tear on infrastructure like bridges and roadways extending their lifespan and delaying some maintenance needs, but less cars on the road also means less tolls collected by governmental entities. As many employers have seen their revenue shrink as a result of the economic impact of the pandemic, governmental entities have also lost significant revenue from income and sales tax collections. These factors, in combination with increased spending by governmental entities on healthcare-related expenses from the pandemic, have conspired to create deep budgetary holes and call into question public spending on infrastructure projects. The impact of reduced public infrastructure spending in 2021 is obviously an important development the construction industry needs to monitor.

The Build Back Better program, President Joe Biden's economic and infrastructure package, was revealed this week and includes an estimated $3 Trillion to $4 Trillion price tag, including roughly $1 Trillion dedicated to roads, bridges, rail lines, and ports, with an aim to create 5 million new jobs. Over the next month or so we expect to learn more as the plan works its way through the legislative process. If passed we will also await the execution of this plan and shovels to break ground, but given the size and scale of this ambitious plan it could significantly increase construction growth projections. There is not clarity around the taxation plans that will be enacted to fund this new work, but the specifics of the proposal will be revealed in the coming weeks. While the details of President Joe Biden’s program are still coming into focus, what is clear is his intention to take bold action on additional stimulus packages and potential infrastructure spending to steady the economy. Now that the FDA has approved several vaccines and phased vaccination is underway, real movement in the economic recovery will be felt.

MARKET DISRUPTORS

POLITICAL & ECONOMIC

The major disruptor has been, and will continue to be, the COVID-19 pandemic for the next few years given the loss of life and economic damage this pandemic has caused. The economy is not expected to return to its pre-pandemic state for months, possibly not until 2022. The pandemic increased the U.S debt to gross domestic product ratio to 127% for the third quarter of 2020, and concern is building that the debt burden is becoming unsustainable (Amadeo, 2021).

Just as most industries are experiencing, contractors will be focused on restoring their financial health left unsteady by economic shutdowns, delayed projects and changes in the material supply chain distribution. The construction industry collectively received more than $60 billion in loans from the Paycheck Protection Program (PPP) under the CARES act and uncertainty about loan forgiveness continues to be a concern.

After the political unrest surrounding the presidential transition, decisions on an additional economic stimulus package are only one piece of a busy agenda over the first 100 days of the Biden administration that also includes accelerating the vaccine rollout and confirmation hearings for key positions within the new government. Additional stimulus is expected by many political commentators, but the form, amount, and timing of the package are uncertain.

HEALTHCARE

As renewed lockdown orders engulf Europe and some U.S States due to increasing COVID cases, the vaccine rollout timeline is crucial to economic recovery. With the FDA approving two vaccines on an emergency use basis in December 2020, the federal government in conjunction with state and local health departments began delivering and administering the vaccine in phases. Phase 1 has been focused on front line workers in healthcare and high-risk populations of those 75+ years of age with co-morbidities. Future phases will focus on different tiers of essential workers with the final phase being administration to the general public. The early days of the vaccination drive have been marked by confusion over eligibility and delays in getting the doses through the "last mile" of delivery from warehouses to arms. In recent days, the Biden administration has made some decisions to increase the supply of vaccine; however, logistical challenges remain, and it is expected that the vaccination campaign will last deep into 2021.

Prior to the pandemic, the Associated General Contractors (AGC) and Sage Survey indicated that six of the eight top concerns among contractors were related to worker shortages, training, and quality (Redling, 2019). Moving into 2021, the second wave of outbreaks will continue to be a health and operational risk for contractors. While labor shortages continue to be an issue, safety and social distancing measures will be more crucial than ever from a worker's compensation standpoint. Since Workers Compensation coverage is governed by state-level statutes, employers must be aware of state-by-state differences in the compensability of a COVID illness alleged to have been contracted on a job site. While such an illness may not be compensable in all states, contractors are well advised to enforce stringent COVID safety measures to safeguard against potentially compensable claims under Coverage A of the Workers Compensation policy and to avoid any liability for claims that may allege willful employer misconduct under Coverage B.

Rising healthcare costs will be of utmost concern and a market disruptor. Healthcare is one of the largest industries in the U.S equating to 17.7% of the GDP, which means an average annual cost of $11,172 per person in 2018 versus $147 in 1960 (Amadeo, 2020). Cost increases in outpatient hospital services and prescription medications have combined with changes in lifestyle to cause healthcare costs to skyrocket. U.S. hospital prices are 60% higher than those in Europe due to higher demand for healthcare services by programs like Medicare and Medicaid which provide medical attention to those without insurance. Further, direct consumer advertising by pharmaceutical companies increases the demand for prescription medication versus treatment modalities.

Lifestyle changes have caused increased stress and chronic disease such as diabetes and heart disease which are responsible for 85% of healthcare spending compared to the healthiest of the population which consumes only 3% of the nation's health care cost (Amadeo, 2020). The pandemic puts additional strain on an already taxed healthcare system due to the significant costs of weeks or even months of inpatient care and in some cases the residual issues of COVID-19 that will require long term care. The pandemic also contributes indirectly to the cost of care associated with increased stress, anxiety and depression resulting from prolonged isolation. These co-morbidities if left untreated, cause the chronic diseases that tax our healthcare system heavily. Healthcare reform and proactive health management will be crucial to manage the rising cost of care which includes the cost of private healthcare insurance, the cost of workers compensation claims and the increased cost of litigation more generally.

ADVANCEMENTS IN TECHNOLOGY

Productivity in the construction industry has declined over the past 40 years for a variety of reasons (Castagnino, Rothballer, & Gerbert, 2016). With rising material costs, increasing labor shortages, and the coronavirus pandemic, 2020 expedited the widespread adoption of construction tech. From predictive analytics that provide insights on scheduling, budgets and safety, to wearable construction technology that collects information on safety and operational workflow; digitalization and automation is here to stay and will only get more advanced as time goes on (Higgins, 2019).

Mobile software technology, collaboration with project partners and the use of technology like robots and 3D printers can help solve labor shortage issues. Although the initial cost of these technologies is high, this investment yields great returns in the long term. Artificial intelligence allows engineering and construction firms to compete for efficiencies and cost savings all while giving their clients real time project status and increasing their brand reputation.

These same technologies, however, can expose firms to risks not previously considered such as cyber security, product liability, and design error liability. In fact, a recent study found that 75% of construction respondents had been victims of a cybercrime. Contractors may store any combination of customer data, employee

A few technology trends that show the potential growth in the construction industry are below (Letsbuild.com, 2019):

- 250 Million smart wearables are predicted to be in use by the end of 2020
- The Global Construction Software market size is expected to grow to $2.71B by 2023
- The Drone Industry is expected to rise in value from $2B to $10B in the next decade
- The Robotics Market is expected to grow by 175% in the next decade
- 360-degree cameras, laser scanning and augmented reality / virtual reality (AR / VR) headsets have become essential to remote project monitoring under social distancing requirements (Marvar, 2020)

files, financial information, project contracts, designs and blueprints. A data breach or ransomware attack which exposes this data can result in significant financial costs. Basic cyber risk management steps include keeping software up to date, enforcing password policies, and purchasing cyber liability insurance (Sawyer & Rubenstone, 2019). Many cyber liability insurers offer complimentary risk management tools to their insureds, including employee training materials, phishing simulations, tabletop readiness exercises, and sample company policies. These important steps can prevent costly breaches that put company reputation at risk.

Product liability arises out of the creation and use of a new technology. Self-curing concrete, use of robotics and similar new technologies may take some time to perfect. The failure of these technologies during or after a project that causes injury or damage to third parties opens the creator/manufacturer of the product to new risks and claims.

Virtual reality and augmented reality can blur the lines between customary designer/contractor/end user roles on a project, allowing each party input into the design and shifting traditional risk allocation. Project parties that engage with VR or AR platforms should carefully negotiate the ownership rights of any intellectual property that may be created using the VR or AR platform. Careless use of VR and AR may increase the risk of accidents. The responsibility for preparing and enforcing safety guidelines for the use of AR and VR technology on-site should be allocated by contract. If the use of VR and AR is not addressed in the parties' agreements, but the technology is used anyway, all project team members involved expose themselves to risk. Parties making these products available on a project must be sure to disclaim liability for use by other parties, and general contractors should include proper use protocols in their safety plans. Construction contracts and insurance requirements should also include a requirement that parties using VR or AR on the project carry cyber liability insurance to cover losses stemming from a data breach.

NATURAL DISASTERS & EXTREME WEATHER

The insurance industry has been hit hard by natural disasters for a number of years. As extreme weather continues to impact the globe, it is expected that catastrophe losses will continue to rise. In fact, 2019 was the fifth consecutive year with at least ten $1B weather events impacting the United States according to the National Oceanic and Atmospheric Administration. Unfortunately, NOAA confirmed that the trend is continuing in 2020 with sixteen $1B+ weather events as of October. **While Hurricanes, Tornadoes, and Wildfires dominate the headlines, remarkably half of the sixteen severe weather events for 2020 were caused by Severe Thunderstorms, Hail, and non-Named Wind events (National Oceanic and Atmospheric Administration, 2020). This trend is an alarming indicator that typically nondescript weather events are becoming more frequent and more costly.**

As for those headline grabbing events, 2020 was a record-breaking hurricane season with 30 named storms and 12 landfalling storms in the continental U.S. according to the NOAA. Along with the frequency concerns comes new research indicating that Hurricanes are retaining strength longer after making landfall due to the effects of climate change (Li & Chakraborty, 2020). This poses obvious property damage concerns for inland locations that may not typically be considered catastrophe prone.

Out West, Wildfire season burned more acres in 2020 than any other previous season. Here too, global warming is having an outsized impact in the form of longer, more intense heat waves as well as prolonged droughts. There is growing evidence that the problem is not confined to typical hotspots like California, with devastating fires in Oregon, Colorado, and Florida in 2020 as well. Aside from the property damage and personal injury resulting directly from the fires, many more Americans are feeling the effects of these fires in the form of rolling blackouts by utilities proactively trying to avoid sparking a blaze.

Firms located, or with activities, in areas that are at risk for natural disasters should consider how climate change and natural disasters impact their ability to conduct business. They should explore strategic ways to address the ramifications of these disasters in their risk contingency and management plans, as this will impact property and builder's risk insurance placements and potentially have consequences for a contractor's supply chain.

In addition to protection of assets, there is a call for organizations to address climate change in their daily operations by reducing their carbon footprint and conducting business in environmentally sustainable ways. Large construction firms have already committed to efforts such as cutting down construction greenhouse gas emissions and water consumption by transitioning to low carbon cement mixes, switching from coal to hydrogen power, or using recycled materials and energy efficient systems to name a few (Morgan, 2019).

MERGERS & ACQUISITIONS

The year 2020 brought a variety of new challenges to many businesses without making any exceptions to the activity of construction mergers and acquisitions.

According to PwC's latest findings in the engineering and construction sector, mergers and acquisitions (M&A) deal values had been averaging approximately $23B per quarter for calendar year 2019. M&A activity spiked in the first quarter of 2020 with $39B prior to falling sharply to only $9B in the second quarter of 2020 due to the impact of the pandemic. The $9B second quarter marked the lowest quarter of the last eight quarters by a wide margin. Of equal concern, the volume of deals dropped dramatically in 2020 compared to 2019 with marked declines in the second and fourth quarters. Generally, activity recovered slightly in the second half of 2020, but merger and acquisitions will continue to be impacted by shifting consumer behaviors that were exacerbated by the pandemic. **Most notably, the work from home movement began long before the pandemic but its popularity is now widespread since many office spaces were closed for prolonged periods. This shift has an uncertain long-term impact on the demand for commercial real estate space as well as the impact on oil and gas producers or street and road contractors as a result of decreased vehicular traffic (Cullers & Sobolewski).**

Businesses locally and across the globe have been forced to adapt to survive today's challenging environment. The shift in how businesses function moving forward has prompted the creation of new business models and the opportunity for new industry leaders. Considering a decline in merger and acquisition activity will likely

continue to strain the engineering and construction market segment, positive opportunities and growth potential remain in select segments with opportunity for stabilization.

With a focus on future merger and acquisition transactions, activity is forecasted to involve entities with a strong liquidity position, those focused on advancements in technology, and who are well positioned to disrupt the market.

INSURANCE MARKET RENEWED FOCUS ON BUSINESS CONTINUITY

From its early days in London, the industry has traditionally been viewed as a relationship business that thrives on personal connection and in-person deal-making. Almost overnight, the pandemic forced the insurance community to reconsider how the business of insurance is conducted and the platforms by which relationships are forged. Like other industries, the entire insurance industry had to pivot quickly to remote work environments as the pandemic was gripping the world in early 2020. With few technological missteps, the industry was able to carry on renewing policies and paying claims while also eyeing the long-term impact of this "black swan" event.

The pandemic forced many industries to rapidly adopt new technologies or more fully utilize technologies that had previously been implemented. Previous investments in technology that digitalized the industry's massive library of data were now crucial in allowing underwriters, brokers, and insureds to transact business in a virtual environment. In person meetings were replaced by video calls or webinars, and less commuting time to the office or meetings meant more time available to review submissions, issue quotes, or adjust claims. At the onset of the pandemic, the industry had to evaluate some of its underwriting processes due to limitations on in-person gatherings. As an example, loss control meetings went from physical inspections of jobsites, to video calls that explored an insured's operations and risk control measures. Some of the underwriting focus also expanded to how customers were managing their risks associated specifically with COVID. The protocols insureds put in place to prevent or control an outbreak are now crucial for underwriters to understand given that potential liability from an outbreak could have significant implications for an insurer. The insurance industry has been flexible and creative in finding new ways to efficiently transact business, and many of the technological and underwriting advancements are likely to stay long after the pandemic subsides.

Ultimately, insurance is a consumer-driven business and markets adjust constantly to changes in consumer behavior. For an industry accustomed to moving at a more glacial pace, the pandemic brought seismic shifts in consumer behavior and forced carriers to react quickly. With reduced vehicular traffic due to lockdowns, many vehicles were off the road for a prolonged period meaning carriers were charging premium for vehicles to sit idle. As another example, many General Liability insurers charge a premium based on revenue or payroll that was essentially frozen by the lockdowns. In some cases, carriers were being asked to return premium in real time to assist struggling insureds, or to alter policy terms and conditions such as audit provisions to allow for return premiums to be given. The market responded to varying degrees. In some instances, insurers returned premiums in the early months of the pandemic given the unique set of circumstances; however, other insurers took a "wait and see" approach by delaying any adjustment until the next policy term. Still other insurers took the approach that the policy language and underwriting methodology in place prior to the pandemic would govern despite the extreme event. The varying responses reflect an industry trying to grapple with balancing customer acquisition and retention while also trying to ensure its own self-preservation in the face of much uncertainty.

The main question insurers are struggling with today is what will the post-pandemic world look like and when? The balance sheets of many of their customers are clearly under duress and some insurers are reacting to help, but the economic fallout is taking a toll on the insurers themselves. Many carriers are using this event as an opportunity to accelerate the reevaluation of their underwriting appetite and refocus on business segments that have traditionally been profitable for them. Others are viewing this event as an opportunity to be more aggressive and capture market share in a "hardened" rate environment. Still others will be looking to acquisitions to secure their financial position as interest rates remain low and valuations are attractive. In the end, the long-term health of the industry is directly correlated with the financial stability of its customer base, the future of which is very much to be determined.

INCREASED LITIGATION & LARGE JURY AWARDS

One major disruptor for many industries over the past four years has been increased litigation and jury awards across various lines of business (Liberty Mutual Insurance, 2018). The combined ratios for US carriers have been over 100%, driven by a few of the following factors:

1. Change in legal landscape – Investors are fronting legal fees in exchange for potential settlement judgments. This investment allows plaintiff's attorneys to litigate claims to trial rather than achieving an early settlement. In addition, allegations of traumatic brain injuries which are expensive to defend are becoming common in cases. These factors lead to escalating legal verdicts.

2. Social Inflation – The concept that the entity with the deepest pockets must be held responsible for injury or illness sometimes regardless of the level of negligence.

3. Medical Trends – Medical care inflation, the epidemic of opioid use, an aging workforce and medical management challenges all lead to expensive and prolonged care for the injured and ill.

4. Violent Acts – Increase of active shooter incidents in the U.S. are causing insurers to respond to this emerging risk and prompting organizations to evaluate their risk and response to crisis events.

> **Despite these headwinds, the insurance and surety industry is poised to support the construction industry and enter a new year as a relatively stable pillar in an otherwise shaky global economy.**

HERE'S WHAT TO EXPECT BY LINE OF BUSINESS

SURETY

Surety runs in cycles like other products written by Property & Casualty (P&C) insurance carriers, albeit in different, more credit-focused cycles than P&C insurance products. This counter-cyclical nature is one reason why P&C companies like having surety as one of their offerings. The other reason is the very high profitability surety provides when properly written. Coming into 2020, we were already beginning to see some hardening in surety and, as is not normally the case, this time the hardening in the surety market is taking place simultaneously to many insurance products. The arrival of the COVID-19 pandemic closures ordered in March 2020 and the economic fall-out have so far had minimal impact on contractor failure and the resulting losses to sureties have been limited. This is due in large part to how effectively Paycheck Protection Program (PPP) loans have stabilized construction companies. As everyone is watching how 2021 may play out, the larger question is how much new work will come online in 2021. Both in the private sector and in public works, construction funding is an area being watched very closely. Many have speculated that the federal government will include a significant infrastructure investment as part of a stimulus plan. Both the timing and what form that legislation takes will go a long way to indicating how 2021 will pan out in both the construction industry and for sureties.

Construction is still experiencing M&A activity despite the pandemic. A large portion of this M&A activity is driven by the rise of international contractors buying domestic construction companies or establishing new operating entities in North America. As it relates to M&A activity, due diligence activities for contractors preparing to buy or sell a company should include a thorough review of your surety indemnity agreement. Today, almost all surety indemnity agreements contain provisions which require prior consent by the surety to a change in control event. Failure to obtain this consent could result in the loss of capacity going forward or a demand for collateral from the surety to secure against future loss. The best advice is to inform your broker when considering M&A activity and to work with them to review Surety obligations and the best way to communicate with your surety to obtain their consent.

Recent losses on international and other surety programs are beginning to impact underwriting by many carriers. In addition, the reinsurance community, who provide surety carriers with loss protection above a retained level also play a critical role in surety. Reinsurers offer their loss protection behind the scenes, and this allows sureties to provide extra capacity to contractors because they are protected by reinsurers from a catastrophic loss. These reinsurers have taken a large share of recent losses, which is impacting pricing, capacity offered to some sureties and the surety capacity they will provide. These changes ultimately flow down to carriers and impact both the size of surety programs offered as well as their cost and other terms and conditions.

While important, the concerns addressed above do not indicate a crisis in the surety market. **There is still plenty of capacity available in the surety space including several new entrants, but we are approaching an inflection point as we monitor a potential uptick in loss activity.**

GENERAL LIABILITY

Expect shuffling from insurance carriers who have historically quoted on engineering and construction risks. Carriers will be looking at the type of work performed and the safety programs in place as their risk appetite changes. As a labor shortage plagues the industry and increases the numbers of inexperienced workers at sites, carriers may expect a rise in general liability claims and rate the policy premiums accordingly. The use of technology and the risks associated with new systems will also play an integral role in the rating process. In addition, given the increase in litigation costs and payouts, **general liability rates may increase up to 20% from the prior year.** This problem is enhanced by the fact that carrier capacity continues to shrink in the construction space.

Program structures may change as well. For example, some carriers who typically offer the option of $1M per occurrence; $2M general aggregate; $2M products and completed operations general aggregate may now need to provide higher limits to obtain excess coverage to attach over them. Coverage restrictions have begun to appear in the form of limitations on excess of wrap and professional liability carve outs. In the Excess & Surplus marketplace, Communicable Disease exclusions have become more popular as a direct result of the pandemic. The use of data and actuarial studies ensures retained risk levels, and thus risk transfer premiums, are efficient. Increased attention should be paid to retained risk strategies such as deductibles and captive options.

AUTO

The auto line of business has been struggling for several years due to various factors affecting loss ratios. Entering 2020 when the economy was doing well and unemployment rates were low, businesses had more trucks and drivers (both experienced and inexperienced) on the road, increasing the frequency of automobile accidents. Other factors impacting the macro automobile liability market include loss drivers such as distracted driving, the frequency of severe losses, social inflation, and adverse nuclear jury verdicts. Commercial businesses are targeted by plaintiff's attorneys due to high policy limits. Insurance companies are bearing the burden of increased allocated loss adjustment expenses (ALAE) to defend these claims.

Given the changes in the legal landscape and the availability of third-party capital to finance litigation, plaintiff's attorneys are in some instances well-funded to take cases to trial, which increases the chances of larger jury verdicts. To further enhance the pain, employees who collected under worker's compensation policies after an auto accident are also filing uninsured/underinsured motorist claims against their employers after colliding with an uninsured/underinsured vehicle. The current litigation landscape is driving the loss ratios and wreaking havoc on insurance carriers' bottom lines.

Furthermore, as technology in vehicles has increased over the years, the cost of the typical auto repair has ballooned. As carriers strive for profitability, rates for liability and physical damage continue to increase. **For this upcoming year, rate increases of up to 30% can be anticipated. Program structures may change as well. For example, some carriers who typically offered the option of $1M CSL may now need to provide higher limits of anywhere from $2M CSL to $5M CSL, depending on the size and make up of an insured's auto fleet, to obtain excess coverage to attach over them.** Increased attention should be paid to retained risk strategies such as deductibles and captive options. The use of data and actuarial studies ensures retained risk levels, and thus risk transfer premiums, are efficient. Insureds should also reexamine their approach to managing risk. Greater emphasis should be placed on proactive measures such as enhanced driver screening, frequent driver training, and increased use of telematics in vehicles.

WORKERS COMPENSATION

Not unexpectedly, COVID-19 has affected the workers' compensation market. NCCI filed a rule change (Item Filing E-1407) to exclude claims identified with Catastrophe Number 12 for consideration by state insurance regulators. Claims attributable to the COVID-19 pandemic and reported to Catastrophe Number 12 will be excluded from experience rating calculations and merit rating plans (where applicable). Catastrophe Number 12 applies to claims with accident dates of December 1, 2019, and subsequent. At this time, no ending claim accident date has been established. Some non-NCCI states, such as California, Delaware, and Michigan, have filed similar changes.

Workers' compensation has historically been performing well and is predicted to continue to do so in 2021; however, while it has been performing better than most other lines of insurance, one should consider the effect that hiring unskilled labor can have on loss frequency and severity. In addition, while the management of opioid use has been instrumental in lowering the cost of workers' compensation claims, alternative pain management treatments like legalized marijuana can cause a host of other potential issues. Employees who want to use medical marijuana as pain management treatment pose a conundrum to insurance companies and employers.

Recently, the Superior Court of New Jersey, Appellate Division ruled in the case of *Hager v M&K Construction* that a construction company's reimbursement for medical marijuana for one of its injured employees was not in violation of the federal law that prohibits marijuana as a controlled substance. Specifically, the Superior Court ruled that the state law that prohibits health insurers from covering medical marijuana does not apply to workers' compensation insurers. This case sets precedent for other states to follow suit in requiring workers' compensation carriers to cover the cost and use of medical marijuana as a treatment form.

Employers will have to determine how to address employees who are cleared to return to full time or on modified duties while still under medical marijuana treatment in environments that recommend or require a drug-free construction site.

Lastly as the financial impact of the COVID-19 crisis continues to linger it is yet to be determined if and how this may impact the Workers Compensation market from an increased claim reporting perspective. Historically during times of macro financial hardship and or economic downturns, the frequency of Workers Compensation claims has increased as recently unemployed workers look for alternative means to source some sort of income.

As with other primary lines of insurance, increased attention should be paid to retained risk strategies such as deductibles and captive options. The use of data and actuarial studies ensures retained risk levels, and thus risk transfer premiums, are efficient.

UMBRELLA/EXCESS

Sitting on top of the stressed general lability and automobile lines of business are the umbrella/excess carriers. Umbrella/Excess markets have been bearing the brunt of costs associated with wildfires, a shortage of skilled laborers, construction defects, and increased litigation across all lines of business, most notably automobile liability. Furthermore, as underlying carriers restrict their underwriting appetite and capacity, so will the umbrella/excess markets.

It is expected that there will be a restructuring of lead umbrellas/excess markets. Carriers will likely cut back on writing certain business risks further or require higher attachment points and smaller limits while at the same time restricting coverage grants, such as excess of wrap and professional liability carve backs. The rates are expected to increase depending on what lines of business they are required to sit on top of and the type of risk profile they are insuring. **Overall, it is likely that rates will increase up to 100% in the foreseeable future with a wide range of variation depending on losses and nature of operations.** Consecutive annual premium rate increases of this magnitude are possible, if not likely for many insureds as the retail excess liability market in the US is heavily reliant upon the global reinsurance market. This market is experiencing a significant degree of turmoil as well on a global basis.

Alternative risk strategies should be thoroughly analyzed to combat hardening of the umbrella liability market. Structured risk solutions, integrated risk solutions, international capacity, and aggregated corridor deductibles are all potentially viable strategies to help mitigate the impact of the hard market.

PROPERTY

Property markets have been hit hard by natural disasters the last few years including the Wildfires and Hurricanes previously mentioned. As extreme temperatures continue to affect the globe it is expected that catastrophe losses will continue to trend upward. Furthermore, carriers continue to tighten underwriting guidelines in specific markets such as traditionally riskier industrial assets (power & energy, waste/recycling, etc.) as losses continue to mount. An overall acknowledgement has set in that rates had been artificially kept too low (below technical underwriting rates) for too long due to plentiful capacity, which has now shrunk considerably.

The effects of the coronavirus have not yet been fully realized in the Property market. On the issue of claims, there is a degree of uncertainty around the issue of Business Interruption. Most Property policies do not recognize losses caused by virus as an insurable event, but a number of suits have been brought by policyholders against insurers trying to compel coverage for pandemic-related work stoppages. While these suits have largely been unsuccessful thus far, it bears watching as it could have a material impact on the industry. The broad economic effects of the coronavirus have weighed heavily on insurers' investment income leading to a greater urgency to realize a profit on the underwriting side. This renewed underwriting discipline is expected to continue into 2021 impacting not only rates for policyholders, but also the capacity that insurers are willing to deploy.

Also of note is the social upheaval that America has witnessed in 2020 around the social justice protests in the summer and the election uncertainty at the end of 2020 and related riots in early 2021. Resulting protests have led to localized destruction of business and personal property. Against this backdrop, it is expected that rate increases will continue through 2021 and availability of coverage in CAT prone areas will continue to tighten.

Expected increases vary by location–businesses located in areas at higher risk for natural disasters can expect to see rate increases up to 30%, while insureds in less CAT-prone areas should expect rate increases up to 15%. Deductible levels may need to be increased to keep costs aligned with the prior year. Additionally, with capacity shrinking for CAT perils, layered and quota shared programs may become more vital to deliver the limit structure that a risk traditionally enjoyed.

BUILDER'S RISK

As is outlined in the property section above, builder's risk premiums are also expected to increase this coming year by up to 20% depending on project location and construction type. Many of the underwriting concerns that have existed in the marketplace for years are expected to remain prevalent in 2021. Namely, capacity for wood frame structures will be limited and the availability and amount of CAT limits (Flood, Wind, Named Storm, Earthquake) will be restricted for areas prone to natural disasters. Less capacity means underwriters can afford to be more selective and as a result, the push for increased scrutiny of project risk profiles is expected to continue, which underlines the importance of providing complete, high-quality information. **Finally, in addition to premium increases there will be rate fluctuation between quoting a builder's risk policy and the commencement of the project.** This fluctuation may impact pre-agreed extensions when not fully defined in policies as carriers will perform their due diligence when extending policies for project delays. Insureds should be prepared to accept higher deductible levels than would have historically been acceptable for a similar project. Also, conversations with counterparties such as lenders or owners should occur early to ensure expectations are aligned with the market reality.

REINSURANCE

Pandemic-related claims have already been brought against insurers with mixed results. The sheer volume and potential scope of claims being asserted has the reinsurance industry monitoring developments closely. One of the most watched insurance lines for pandemic claims is Business Interruption because widespread shutdowns caused businesses to be without revenue for weeks or months; however, a debate has raged throughout the industry as to whether a pandemic constitutes an insurable event under the typical Property policy's language. Aside from Business Interruption, questions around claims and compensability abound for other lines of coverage like Workers Compensation, Director & Officers, and Employment Practices Liability to name a few. Analysts at international law firm Bryan Cave Leighton Paisner have opined that the uncertainty of how pandemic claims will develop could lead to an historic "run on the market" as frontline insurers pursue recovery from their reinsurers:

Analysts say such a development has the potential to grip the reinsurance market in a way we have not seen for some time…Supply chains have been interrupted; large events cancelled; offices closed; travel plans *cancelled and the effects will continue to be felt as the days and weeks go on…The report states reinsureds will inevitably be looking at how Covid-19 related losses may be aggregated in order to maximize recovery under any reinsurance…As there is no direct authority on the aggregation of reinsurance claims related to a single communicable disease/virus, decisions as to aggregation will need to be undertaken with reference to the specific words of the reinsurance policies in issue; the nature of the underlying claims that the reinsured is seeking to aggregate; and some of the authorities on the meaning of "event" and "cause" as discussed above (Wood, 2020).*

Aside from the potential claim impact of the pandemic, other economic factors will challenge the industry for months or years to come. According to Fitch Ratings, the global economic contraction resulting from the pandemic has had a negative impact on premium volumes by driving some insureds out of business and resulting in reduced exposures for many others. Additionally, the ongoing ultra-low interest rate environment continues to stress the balance sheets of insurers and reinsurers making underwriting discipline essential for offsetting poor investment returns. Underwriters remain selective in the risks they will write, the capacity they will deploy, and the coverages they will provide. Furthermore, Fitch Ratings argues that "it could take several months for the total losses to become clear as many claims are likely to be long-tail…[and that] business-interruption and liability claims could be subject to lengthy legal processes, while credit and surety losses will take time to materialize after the economic contraction". (Fitch Ratings, 2020).

Reinsurers frequently serve as the canary in the coal mine for the broader insurance industry, and the impact of adverse loss experience will ultimately take shape in the reinsurance market prior to, or simultaneously with, frontline insurers. Pandemic-related claims, along with the ongoing effects of ultra-low interest rates on insurers' combined ratios, will continue to fuel reinsurance rate increases for the foreseeable future. Certainly, as reinsurers begin to pay pandemic-related claims, price increases will inevitably trickle down to the end buyer.

WRAP-UPS/PROJECT SPECIFIC

Pricing for contractors' practice programs has been consistently inconsistent for the past several years, and we expect this to remain true in the near future. As a result, Wrap-Ups or Project Specific programs have become more attractive to many project owners, as this removes the guess work involved in pricing the insurance costs out over the course of a project.

In the past, many project owners and contractors have utilized Wrap-Ups only as a cost saving tool. As carriers continue to leave the market, especially as it relates to for-sale residential and wood frame construction projects due to an increase in high value construction defect claims, prices are continuing to increase. As a result, the coverage benefits of Wrap-Ups are even greater than in the past as contractors' and subcontractors' policies include more coverage exclusions and many subcontractors are buying lower policy limits to save money on insurance. Lastly project specific programs provide the necessary limit dedication and coverage certainty through a given State's Construction Defect Statute of Repose. These are two critical areas of concern an annually renewing practice program cannot positively address.

Excess Liability carriers are also becoming more apprehensive. In the past, the Excess Liability underwriters relied on the General Liability carriers to underwrite and price the project, and the Excess Liability underwriters followed a pricing system that was somewhat based on trust. **Now, Excess Liability underwriters want to see more underwriting detail. Their review of the geotechnical reports, site safety plans and QA/QC programs has become much more thorough. Furthermore, on a project where they may have offered $25M limits in 2019 or 2020, in 2021 many are only willing to offer $10M or $15M in limits. Many are also increasing their attachment point leaving a void in the lower part of the Excess Liability tower.**

SUBCONTRACTOR DEFAULT INSURANCE (SDI)

The economic dynamics facing surety are also relevant to the SDI market. Unlike many traditional insurance products however, there is a growing number of insurers affording coverage and providing substantial limits of liability vs prior years. This capacity exists despite challenging underwriting results experienced by some of the early market movers. Market conditions continue to be competitive for best in class contractors. Contractors that can demonstrate active and successful subcontractor prequalification processes and mitigation strategies are finding rates, terms, and limits competitive for all but the very largest subcontracts. Loss experience has been more concentrated in certain problem trades including curtain wall, glass, and framers. There have also been some notable defaults of large MEP contractors, yet many active risk managers have steered clear of catastrophic defaults and performed well. For firms with solid performance, rates have remained competitive. More established insurers are looking to tighten terms and reduce coverage for tail and residential exposures yet new market capacity exists should clients be desirous to maintain the broadest coverage and most competitive pricing. There is also innovation in the balance sheet/credit product market with unique offerings from insurers affording among other options, a catastrophic SDI cover offering, as well as a new policy form for large balance sheet events on a particular construction project among a portfolio of projects. Project Loss Insurance was launched in early 2021 by Travelers and affords a new solution for managing economic loss on a construction project.

CYBER

With the growing utilization of technology, construction companies are not immune to cyber-attacks. Construction organizations ranked third in ransomware attacks amongst all industries in North America. The Verizon 2020 Data Breach Investigations Report listed social engineering schemes as one of the leading cyber-attacks faced by the construction industry. In addition, phishing links, a form of social engineering, made up 90% of successful breaches in the last year (Verizon, 2020).

Due to this increasing number of ransomware and social engineering attacks, insurance companies are considering amendments to current programs including, but not limited to, coverage restrictions, lower sublimits for ransomware attacks, increased retentions, and possibly introducing a coinsurance layer so that contractors participate in the loss at a higher level. Looking forward to 2021, we can expect to see a more rigorous underwriting process and a 10-15% rate increase upon renewal of coverage.

FINAL THOUGHTS:

Ultimately, the more the market tightens, and rates increase, the more policyholders will want to shop for better rates and coverage. As a result, carriers across the board will see more submissions and will be selective about what they consider. As the insurance market continues to harden, a high quality submission to the marketplace will be more important than ever. A detailed narrative that tells the story of your operation and proactively addresses your philosophy on loss control will be essential to convincing the underwriting community that your operation is best in class. For accounts with loss activity, demonstrating an aggressive approach to managing claims and providing in depth analysis of claim data will be vital to making a compelling argument as to why you deserve a better result than the marketplace would otherwise dictate. **Striving for longer term partnerships will drive positive outcomes for both insured and insurer. Discussions around pricing, terms, and conditions are more flexible in the context of a multi-year relationship, and underwriters are more likely to stretch outside of the constraints in their rating models if there is a compelling argument as to how and why the risk will improve into the future.**

It is especially important to have the right professional advisor as your insurance and surety partner. Starting the process early and allowing sufficient time to address any and all questions that underwriters may have to evaluate your operations properly is crucial. In addition to having open conversations in preparation and planning for a renewal, technical expertise and strong analytics around program design and structure are required to navigate the higher scrutiny, coverages and rates in today's market. American Global, as your broker, will work with you to prepare you for, and lead you through, a successful 2021 renewal, enhance your balance sheet, and maximize the dollars spent on your risk management program.

CONSIDERATIONS FOR 2021

- ADDITIONAL INVOLVEMENT OF INTERNAL PARTNERS
  - **Quantitative & Qualitative**
- SIGNIFICANT TOTAL COST OF RISK INCREASE
  - **i.e. Premium & Retained Loss**
- EXPANDED RENEWAL TIMELINE
  - **Start Early and End Later**
- DIFFICULT RESULT THAT MAY BE MORE REFLECTIVE OF THE MARKET RATHER THAN YOUR RISK

END NOTES

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