Captives Find a Place **Insuring Construction**

The construction sector is forecast to grow exponentially over the next decade, both in the U.S. and internationally. While this is an exciting time to be in construction, the risks and exposures are increasing. As the hard insurance market is expected to continue at least through 2022, construction companies are looking to captives to insure many of their risks.

Written By Karrie Hyatt

STATE OF THE MARKET

A report published in August by Research and Markets claims that the U.S. construction industry will grow by 1.8% in 2021 and by 3.1% in 2022, with an annual average growth of 2.2% through 2025. That is welcome news to an industry that suffered losses in 2020 due to the pandemic-related slowdown.

While industry growth is welcome, it comes paired with a hard insurance market that is making it more expensive to insure expanding business. As it is in many sectors, the construction industry has been hard hit by sharply climbing premiums.

According to Randy Sadler, principal with CIC Services, LLC, "The U.S. construction industry has seen significant growth, but insurance rate increases are also a trend which poses a challenge in addition to increased labor and materials costs, rising health care costs."

The COVID-19 shutdown slowed the construction marketplace in 2020 and while construction projects are now being pursued with renewed energy, COVID-19 has created even more challenges. "COVID created a perfect storm in the sense that construction businesses now must comply with increased regulations may face supply chain disruptions and manage travel restrictions while also ensuring safety protocol for workers. COVID has also created construction delays, or a site may be locked down and inaccessible," said Sadler.

The hard insurance market is making it tougher and more expensive for construction-related companies to adequately cover their risks. While there are abundant new opportunities for the industry, construction companies will need to look to new ways to approach risk.

CAPTIVES AND CONSTRUCTION

The hard insurance market has been an impetus for construction companies to look for an alternative to traditional insurance. However, even before the current hard market, construction was looking to captives to provide coverage for risks that are difficult to insure and to fill gaps in coverage in regular policies.

"Construction companies are uniquely suited to own their own insurance company," said Sadler. "Commercial insurance is often riddled with exclusions that can lead to claims not being paid. Captive insurance fills those gaps and address the complex, evolving risk that members of the construction industry often face."

Like the medical and transportation sectors, construction companies insured by traditional carriers are penalized for others in their industry who may not be so conscientious. Construction companies with a focus on risk management and safety are best suited to form a captive, freeing themselves from the cycle of premiums based on other companies' losses.

"For construction companies, captives are a versatile solution. Captives can replace commercial insurance, insure enterprise risks, insure warranties, insure bonds, insure employee benefits or health care or any combination of these," said Sadler. "Since captive insurance has proven to be very beneficial for construction companies, these companies now make up 20 percent of captive owners managed by CIC Services—up from 10 percent three years ago."

Besides the common risks, such as general liability, property damage, workers' comp, employee benefits, and supply chain interruption, construction companies face a unique set of risks. Since the vast majority of construction contractors do not have the capacity to do all the work on a project, they must subcontract out large chunks of work. This makes them liable for work that that the subcontractors' default on or work that is defective. They are also at the mercy of fluctuating costs of materials.

Construction companies also face environmental and geologic risks, along with fire, weather, and other natural disasters. Compliance with building codes changes or regulatory changes mid-project is another risk. Unique to the construction industry are risks related to labor shortages and seasonal slowdowns.

As the work construction companies do depends on materials over which they have no control, construction defects are a weighty risk they face. Long-term construction defect risk, whether due to materials or mistakes, can be a lengthy exposure, taking years to come to realization. Using a captive, companies can offer warranty coverage for such risks.

Construction captives can be used to insure a company's subcontractors in the event of unfinished work or defective work. "Contractors utilize sub-contractors, and with the captive insurance arrangement, they can bond subcontractors via their captive, providing insurance coverage in the event that this third-party laborer does not complete its work," said Sadler. "One of the most exciting benefits of captive insurance for construction companies is the ability to find a new profit center in payment and performance bonds or in subcontractor default (SDI) insurance, or both."

Subcontractors are also beginning to make use of captives. According to Sadler, "Subcontractors often face as much risk, and similar risks, to the construction companies. They may have multiple crews working on multiple sites at the same time, and face the risk of financial penalties if work is completed late. This risk can be insured in a captive."

In data collected by PolicyAdvice.net, only 15% of construction firms have more than 1,000 employees. For these large firms, a pure captive is likely the best choice, but for most companies joining a group captive makes more sense. "Mid-sized construction companies, in particular, should consider group captives for some lines like auto liability, workers' compensation and general liability," said Sadler. "We don't normally recommend managing these lines in single parent captives unless both premiums and exposures are very large, which they tend not to be for mid-market companies."

He continued, "We often encourage construction companies to write a layer of property, work comp and general liability and other coverages through their single parent captives which offer greater flexibility."

Forming a captive insurance company is an advantageous choice for a construction firm that has a track record of being diligent regarding safety and risk management practices, and it can be an even better choice to join

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a group captive with similar companies. Working together, group captives offer enhanced risk management techniques, the opportunity of a deeper understanding of risk due to larger data sets, and a better understanding of health and safety issues faced by similar companies.

With the construction sector's forecast of strong, steady growth, it is an exciting time for the industry. It's an exciting time for the captive insurance industry as well as it gets to tackle the plethora of new risk that the construction industry brings to the table. Captives and construction companies pair well together. As Sadler stated, "Captive insurance provides a stronger business model, improved risk management, improved cost control, insurance profits, asset protection, asset accumulation and receives advantageous tax treatment."

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.