Developments in Construction Insurance and their Effects on General Contractors

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Abstract

Before a construction project can begin, insurance must be purchased by each involved construction player to ensure the financial and physical health of the project and those working to complete it. The necessity of construction insurance on every project has turned it into a behemoth of a market sector, one that significantly affects the construction industry as well as a plethora of others. Although many are unaware, developments and shifts in construction insurance deeply affect the well-being of the public, from the roads they drive on to the buildings they live and work in. This research piece will delve into the primary developments that are transforming the construction insurance industry. A combination of academic papers and interviews with construction insurance professionals are used to obtain the necessary research for this project. In this accumulation of knowledge, it becomes evident the two primary developments in the construction insurance industry are the popularization of Single-Parent and Group Captive Insurance Entities. The inner workings and benefits of these developments to both the construction and insurance industry are explored to explain their increasingly widespread adoption.

Key words: primary developments, construction insurance, financial health, Single-Parent Captive Insurance entity, Group Captive Insurance entity

Introduction

Construction has long been one of the riskiest industries in both financial and safety terms. A result of this is significant monetary commitments by general contractors in insuring their projects and companies through construction insurance. Chris Kordell, a former CEO and construction insurance expert with United Insurance Agencies, dived deeper into construction insurance in a personal interview. Kordell explains that this insurance transfers part of their liability onto a separate entity, helping to reduce their overall risk. Construction insurance typically includes builder's risk insurance,
general liability insurance, worker’s compensation insurance, professional liability insurance and others. Financial protection through construction insurance carries a tremendous price tag, as general contractors pay an average of 3% of their total project cost in insurance premiums. Additionally, this premium is paid in contract terms set by the insurance entity that is insuring the project, limiting the rights and considerations given to the general contractor. While construction insurance has remained relatively standard for the past couple of decades, there has been a variety of recent developments in the construction insurance industry. (C. Kordell, personal communication, March 1st, 2023) The most significant of these developments are the popularization of Single-Parent and Group Captive Insurance Entities.

Although construction insurance is massively important for construction professionals to understand, it is largely ignored in the Construction Management curriculum at Cal Poly San Luis Obispo. A dearth of knowledge surrounding construction insurance could pose a challenge for young industry members, as it can have a monumental impact on the financial success of construction projects. This lack of understanding is what sparked my interest in gathering research about the developments in the construction insurance world to help build the general base of knowledge held by Construction Management students.

Methodology

In order to understand and effectively communicate the popularization of Single-Parent and Group Captive Insurance, knowledge was accumulated from interviews, studies, and academic pieces. Academic sources provided a plethora of information about the two types of insurance and their uses. However, in order to understand their recent popularization more current information was needed. To do this, a series of three interviews were conducted with construction insurance professionals from separate companies that were geographically dispersed. This location and business diversity allowed for the developments to better reflect the construction industry, not just a singular region or company.

Summarization

While construction insurance helps to reduce the risk of the general contractor on the project, it still requires a hefty premium to be paid to the insurance agency to transfer risk. Whether or not that premium is exhausted, it will remain with the insurance company after completion of the project. General contractors across the nation are committing significant resources to the improvement of biometric and ergonomic technologies and practices. While advancements such as these reap some short-term benefits, they are geared toward and primarily benefit the safety of construction workers in the long run. Because of this, contractors do not see an adjustment in their Experience Modification Rate (EMR) since the benefits of the ergonomic and biometric improvements are not immediately recognized. These safety improvements are costly, increasing the expenses of the contractor but providing benefits only to the insurer of the contractor as they retain the premium. In order to preserve the financial benefits that are reaped through improvements to safety, general contractors have begun electing to retain the risk that is typically transferred to the insurance company. To do this, general contractors have recently turned to Single-Parent or Group Captive Insurance Companies.
A captive insurance entity is an alternative form of self-insurance in which a company or group of companies form a private insurance establishment. The general goal of these entities is to allow for self-creation and management of insurance policies to take control of risk instead of contracting a third-party group. These entities are typically domiciled in territories outside of the United States such as Bermuda, the Cayman islands, or the Caribbean. (C. Kordell, personal communication, March 1st, 2023) Low-capitalization areas such as these allow for minimized overhead within the captive entity which will maximize its financial efficacy.

Captive insurance entities can be sorted into two categories: Single-Parent and Group Captive insurers. Single-Parent Captive insurers are entities that completely manage the retained risk of a single general contractor. These insurers have absolute discretion and can operate in any fashion permitted by the region the insurer is domiciled. While the captive insurance company is technically a separate entity from the parent company, the “captive insurer usually is monitored by a risk manager or financial officer at the parent company and managed by a captive management company located in the captive insurer’s domicile.” (Chansky et al., 2021) Amy Wagner, a producer and captive insurance expert with High Ground Insurance, details that Single-Parent insurers are typically entities created by a general contractor with $1 billion of revenue or more per year. This group consists of some of the biggest names in the general contracting business, with companies such as DPR, McCarthy Building Companies, Swinerton, J.E. Dunn, Turner Construction, Bechtel, and Fluor Corporation. Organizations that are multi-national and use complex operational strategies over large geographic areas typically utilize the Single-Parent Captive insurance option. On the other hand, Group Captive Insurance entities consist of various companies that come together to form their own insurance company. Wagner continues that these companies are usually made up of contractors with an average of $25-750 million in revenue per year. While contractors in a Group Captive entity are typically homogeneous, they can also be completely heterogeneous in market sector, business type, and risk management needs. (A. Wagner, personal communication, March 1st, 2023)

Coverages provided by a Captive Insurance entity encompass several different types of insurance required by general contractors. These lines of coverage include Workers’ Compensation, General Liability, Automobile, and Automobile Physical Damage. Specific insurance coverage premium percentages are determined by two factors: cost of occurrence and frequency of occurrence. For example, a general contractor utilizing General Liability insurance through a Captive Insurance Agency can expect to pay 80% of their premium to cost of occurrence coverage while the other 20% will go toward frequency coverage. The split of these coverages into cost and frequency of occurrences allows for group captives to identify and impose measures on captive members who are using their insurance premiums quickly. While this process requires significant monitoring, it ensures the financial strength of the group captive entity and provides an opportunity to release unsound members.
While the funding structure of a Single-Parent captive entity is very simple, Group Captive financing is much more complex. Figure 1 illustrates the setup of the funding structure for group captive entities. External influence is negated, which allows for the group members to decide the coverage limits and premiums required. If a member’s premium is exhausted, specific reinsurance coverage is provided through reserves of the captive insurance entity. Specific reinsurance, which is applied per occurrence, is monitored by the members of the group captive. While extremely rare, specific reinsurance may be depleted by particularly costly occurrences. In this case, the umbrella coverage of the group captive would cover remaining financial exposure. For a member to draw from the specific reinsurance or umbrella coverage of the entity, it must be approved by the members of the captive. In Figure 1, the Group Captive has elected to set a maximum of $300,000 for basic coverage and $1,000,000 for specific reinsurance. (ICS Group Captive Review, 2018) This means an occurrence that requires financial backing of over $300,000 will require approval from the group captive before the member can receive the reinsurance.

Captive insurance has been relevant in the construction insurance industry for decades, but its popularity has not been significant until the late 2010s. Sustained and dramatic growth of captive insurance over the past several years has brought it to be a primary player in the construction insurance industry. Captive insurance premiums have surpassed $100 billion while the number of American captive insurers has grown beyond 6,000. (Chansky et al., 2021) This explosion in popularity is not a transitory trend, especially in the American construction insurance market. The Swiss Re Institute, in the recent Sigma Research Forecast, predicts an increase of insurance premiums by over 6% in the upcoming two years. Construction companies, in response to these increases are
predicted to flock to Captive insurance for financial protection from this sharp surge in premiums. (Bevere et al., 2021) Tremendous growth in popularity of Captive Insurance entities could potentially lead to it becoming the dominant force in the construction insurance industry, as its benefits become increasingly apparent.

The commercial construction insurance industry revolves around the transfer of risk from the general contractor to the insurance entity, relieving them of financial indemnity in case of mismanagement. This is concurrent in the captive insurance industry, as risk is shifted from the company to its affiliated captive insurance company. However, while captive insurance may “represent a transfer of risk, the business purpose of captive insurance – management of retained risk – is what drives the decision to use a captive insurer for most companies.” (Chansky et al., 2021) Increased control over retained risk is extremely beneficial. Kevin Weiser, a broker and Captive Insurance expert with Newfront Insurance Corporation shed light on the inner workings of Captive Insurance entities and their financial possibilities during a personal interview. Captive insurance provides the general contractor with regulation of retainage percentage, providing flexibility based on the current outlook of the construction market. Unused retainage can be accumulated during periods of economic prosperity and used to offset costs during down periods. This allows general contractors to better weather the boom-and-bust cycles that are common in the construction industry. Additionally, unused retainage can be used for internal financial moves by industry management, as the premium can be used to buy back shares of the company or bail out struggling sections of the business. If the retainage is not utilized for internal use within the company, it can be used for investment strategies determined by the parent entity. High grade securities and bonds are commonly purchased using captive insurance premiums, guaranteeing the safety of the funds while providing monetary benefit through consistent returns on investment.

In an average broker relationship, shifts in investment strategies may take significant amounts of time and cost the general contractor a fee for oversight costs. However, captive insurance entities’ increased flexibility in allocation of the premiums allows for risk management protocols outlined by the parent company to ensure financial dependability. Risk management tools can be utilized to determine if the asset allocation programs are underperforming. If this is the case, the investment strategies can be changed immediately and without any financial repercussions. If investments are determined to be severely inadequate, the parent business may elect to dissolve the captive insurance entity, releasing funds to the parent company. This control of investment strategies for unused premiums is one of the most alluring aspects of captive insurance, for it can be used as a tax-free asset with dependable return percentages. Weiser continues, stating that the most important and financially beneficial feature of captive insurance entities is their ability to preserve the deductibility of the premium. In a typical general contractor and insurance carrier relationship, the general contractor would pay a percentage of their total cost to the insurance entity as a premium. Since this premium has been fully transferred into the control of the carrier, the deductibility of the premium for the general contractor is voided. However, in a captive insurance agency, the deductibility of the premium is preserved since the premium has not been paid out. This allows for the tax sheltering of a monumental piece of the general contractor’s asset pool. (K. Weiser, personal communication, March 1st, 2023)
The final, and most financially significant benefit carried through a captive insurance entity is saving on operating expenses typically applied by the insurance carrier. Unlike an insurance carrier, captive insurance entities have very few employees, as the management and oversight positions are outsourced to the parent company. Similarly, there are no administrative or brokering staff, which usually cost the commercial carrier a large percentage of its overhead costs. Expenditures on staff alone at a typical commercial insurance carrier are around 30% of the premiums. Conversely, expenditures and overhead at a captive insurance company are usually less than 1% of the total premium cost (Bevere et al., 2021).

Captive insurance entities, while highly advantageous for general contractors, can be regarded as risky for potential project owners. Owners will require an insurance entity that is not affiliated with the general contractor in order to accept a bid on future work. To preserve the benefits of the captive insurance entity, general contractors may outsource underwriting to a standard insurance company that is considered reputable by the owner or reinsure domestic carriers that they are buying policies from. The rates and advantages of captive insurance are kept intact, but the policy owner will technically be the domestic carrier. This seating arrangement allows for general contractors to have a front company, keeping clients unaware the origin of the policies for the project are in the captive insurance company. Ultimately, this provides the opportunity for a completely back-end deal, keeping the owner in the dark about the policy while financially benefiting the general contractor and underwriting entity. (Born et. al, 2021) Insurance companies willing to be the front for these policies include some of the biggest names in insurance, including AIG, Chubb Corporation, Zurich Insurance Group, and Liberty Mutual. These well-established businesses underwriting policies for captive insurance carriers allow the policies to seem to be completely legitimate and keep owners unsuspecting of back end negotiations. The backing of Captive Insurance policies by long-standing insurance groups also allows for financial flexibility when general contractors are bidding for a project. For example, a potential owner may inform a general contractor that it is looking for a combined non-construction cost percentage under 12% including General conditions and requirements. In order to reach this percentage, the general contractor may have its captive insurance company create a policy that is low enough to bring the non-construction costs under the goal percentage. Then, it will have the policy underwritten by a well-known domestic carrier, whose name will appear as the front standing company on the policy. This allows the general contractor to adjust its overall price and secure future work with the client through simple policy adaptations and underwriting agreements. While this process does incur a fee from the insurance carrier, the percentage is extremely minimal. (C.Kordell, personal communication, March 1st, 2023)

Conclusion and Future Research

Every part of daily life is touched by construction, and it is a major driver of our national and global economies. Improving the construction process and its individual components inevitably influences the lives of citizens around the world. While often overlooked in the construction process, insurance is essential for guaranteeing the financial security of General Contractors, Subcontractors, and their trade partners. Changes to the construction insurance industry through the popularization and adoption
of Single-Parent and Group Captive Insurance Entities are profound and will continue to shape the landscape of the industry for decades to come. The variety of benefits associated with Captive Insurance Entities increased risk management control, tax advantages, decrease in premiums, and authority over investments of unused premium will continue to popularize this type of organization.

As seen in the development of Captive Insurance Entities, the insurance industry will continue to evolve, and developments will push it in different directions. Adoptions and trends will develop quickly, which provides an opportunity for future research about what is driving the construction insurance industry. Additionally, much of the insurance industry is driven through government policies, which change frequently. This will spark further innovation within the industry, creating more opportunity to identify possible improvements in the industry or monitor what is changing.
References


