INSURANCE – GENERAL

Impact of price inflation on construction materials and labour

With demand for construction materials and labour surging, insurers need to be alive the effects that price inflation will have on claims and risk valuation, says Charles Taylor Adjusting's Mr Niall Metcalfe.

Global media outlets have widely reported on inflation as one of the major threats to the global economy in 2022. This has been further magnified by the Russia president Vladmir Putin's invasion of Ukraine causing yet more jumps in commodity and energy prices. Inevitably, such rises have a direct impact on the price of construction materials, impacting both existing projects and future projects alike.

We explore the consequences of inflationary increases from an insurance standpoint.

Factors influencing global inflation

Rising global demand following the reduction of COVID-19 measures, supply chain bottlenecks, constraints in the labour markets and increased fossil fuel and energy prices are some of the reasons the current rate of inflation is increasing at the fastest rate in over a decade.

The price of Brent crude in February 2022 reached $100/barrel, the highest it has been since 2014. The short-term outlook appears to be increasing; the US Energy Information Administration has forecast an average of $108 per barrel for Brent crude in 2H2022. With sanctions in Russia putting global energy supplies at risk, particularly in Europe, this has a knock-on effect across the global economy.

Whilst inflation-easing measures have been introduced by governments and central banks, by way of increasing interest rates, the long-term position on controlling inflation remains unclear. This has direct, knock-on effects on the insurance industry.

Material price inflation

Construction costs have increased significantly since the first quarter of 2019.

Across the MENA region, industry reports have indicated increases in material supply costs of the following:

- Steel +37%
- Aluminum +89%
- Copper +65%
- Iron ore +100.2%
- Timber +227%
- Cement +1%

Whilst the increases above are concerning, the World Bank projected that average metal prices would decline by around 5% in 2022. However, this remains a volatile position when considering the Russia's invasion of Ukraine.

Furthermore, and directly linked to the commodity price increases, containerised freight costs have increased by roughly 400% between January 2019 to March 2022.

With increased volatility in manufacturing countries, valuing risk will remain challenging for risk managers in the foreseeable future.

Labour market increases

During the COVID-19 pandemic, contractors across the MENA region returned a high volume of expatriate construction workers to their home countries and, since then, the region has faced delays in restocking the labour force within the construction industry post-pandemic. As a direct result, shortages of labour have increased cost and added to existing project delays.

Effect on the insurance industry

From a property insurance perspective, noting the volatility of both materials costs and labour

market rates, valuing risk accurately is a major challenge for risk managers when arranging insurance. Attention to current market rates is imperative when assessing value of risk at inception and renewal is vital to ensure risks are adequately covered in the event of a claim.

Whilst traditional policy extensions such as the 85% condition of average clause do provide some leeway where rates have increased over the policy period, in some scenarios the rates of inflation in rebuild cost exceed the allowable sums. Where claims arise, underinsurance is becoming more prevalent as a direct result.

Further consideration must be taken when looking at potential operational challenges faced in the event of a claim incident. With longer lead times due to material supply difficulties, delays in shipping and restricted labour workforces, similar impacts are being faced in reinstating in the aftermath of a loss event. This is exacerbated in a region where maximum indemnity periods are shorter than in the rest of the world and delays in procuring equipment, materials and parts result in maximum indemnity periods being breached.

Similar issues have arisen for contractors in relation to existing projects. The Royal Institute of Chartered Surveyors reported in its 2021 Global Construction Monitor that 56% of respondents from the UAE said that they consistently received bids below a reasonably estimated cost for new projects between 2020 and 2021, based upon market rates. This has the effect that contractors are either absorbing the increased costs or renegotiating contracts where possible.

It is apparent across the claims industry that contractors are facing procurement delays due to cash flow and financing difficulties, materials shortages and labour constraints, which further result in project delays, often over and above existing pandemic delays. Whilst often uninsured, some policies do provide some elements of cover which such delays may impact, such as delay in start-up, advanced loss of profit, expediting expenses and, indirectly, increased cost of construction extensions.

Where projects were already in uninsured delay, in the event of a claim, calculating the insured impact remains a complex issue and is something which should be handled by experts in the field in order to control claim cost as a whole.

It also remains inevitable that in line with inflation, claims values will increase as a result. In any economic downturn, the propensity for inflation of claims values also increases, which is vital to consider throughout the claims lifecycle.

Insurers and insureds alike should be alive to the potential issues which arise as a result of the volatile costs of construction materials and labour across the MENA region. The direct impact faced by insureds in executing reinstatement in the event of a claim is and will continue to be of great concern, especially in the event where risks are inadequately insured.

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