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Inherent Defects Insurance: An Overlooked Tool in GCC Construction Projects

As construction growth remains strong in the Gulf Cooperation Council (GCC) region, structural defects to completed properties continue to expose numerous stakeholders to financial risk. In the GCC region, as elsewhere, a variety of insurance solutions are available to mitigate such exposure, but at the same time there are misconceptions surrounding the effectiveness of various insurance strategies, including the use of inherent defects insurance.

Construction outlook is positive in the GCC

According to the World Bank, GDP across the GCC is expected to increase 2.1% in 2018 and 2.7% in 2019. The region's construction boom continues to be driven by diversified economic growth; a growing, younger labour force; and local factors including national vision objectives, Expo 2020, and the FIFA World Cup 2022.

Short-term prospects may have been slowed by a decline in oil prices and consequent government actions to more closely review budgets and prioritise expenditures. However, the sheer volume of construction projects — both planned and in progress — and the wider strategic initiatives being set in motion by the region's governments, give cause for optimism in terms of future construction expenditure and activity.

These developments command significant capital, meaning that developers and project owners must manage a variety of risks to protect their investments. One area with high potential exposure is inherent defects for constructed assets.

Despite the potential significant balance sheet exposure should such defects cause structural damage, there is relatively little awareness about the issue in the GCC region.

Typical insurance strategies for GCC construction projects

Too often, a "tick-the-box"mentality prevails in the GCC region with regard to compliance of contract conditions between the project developer/owner and the contractors. There is, perhaps, not enough emphasis on risk management, risk evaluation, risk minimisation/mitigation, and risk transfer options for many projects in the region, which can be under significant time schedule and cost constraints. Also, some property development projects are sold to other entities during construction, and selling property "off plan" is not unusual.

During the construction phase of a project, insurance coverage is normally granted under a construction or erection "all risks" (CAR/EAR) policy, which provides funds for the repair, reinstatement, or replacement of material loss or damage to the contract works. Following the completion of a construction project or contract, a property "all risks" policy is usually arranged that covers the operational phase exposures. However, such operational policies typically provide limited or no protection for damage arising out of an inherent defect of the building or structure.

Inherent defects

Inherent (or latent) defects are those that can be traced back to faults in design, plans, materials, specification, or workmanship during the planning and construction of a building or structure, which are only discovered or result in material damage after the practical completion of the building or structure. Inherent defects affecting the load-bearing structure must be considered as a severe exposure for a building. A major collapse of a load-bearing structure, or the threat of such a collapse, would likely give rise to a substantial financial demand for expedited rectification and recovery.

In the GCC countries, civil codes exist that make contractors, engineers, and architects/designers legally responsible for costs associated with structural defects occurring to the completed structures for a period of 10 years from the date of the practical completion certification (PCC). Often these codes impose a joint strict liability, which would mean that the contractor and the designer are jointly liable regardless of whose fault it is that damage occurred. However, these civil codes do not place an obligation for insurance to be procured to cover such decennial liability.

Moreover, contractors engaged in certain projects are often organised as joint ventures, special purpose vehicle companies, or other transient (shell) entities. This makes it difficult for project owners and developers to prosecute the contractors or rely upon them to provide the necessary reinstatement or repair costs, some years after construction completion in the case of legal liability under respective codes. Even after a successful prosecution, there may be issues with the financial stability of the liable contractor in the event of a major structural defect loss.

Project owners and developers can make the procurement of decennial liability insurance (DLI) a contractual requirement for the contractor. However, this has rarely been seen in the GCC region over the past 15 to 20 years.

Where such a contractual obligation existed, there have been cases where the contractor either did not know how to arrange this class of insurance or tried to arrange it near to practical completion, thus making it extremely difficult or impossible to arrange cover, or with economically unviable terms.

When such coverage is purchased directly by the developer or project owner, it is known as inherent defects insurance (IDI). Whilst the core of the cover is the same in both cases, the parties acting as a policyholder and designated as "insureds" may be different. There is a widespread lack of understanding of IDI/DLI products across the GCC region, with questions regarding such areas as its procurement, scope of coverage, terms and conditions, inception, and the related independent technical inspection service (TIS) process.

Many construction professionals feel that the premium requested by insurers for IDI/DLI is too high compared with other classes of insurance (for example, CAR/EAR and property "all risks").

In response, specialist IDI/DLI insurers will typically point to the need to reserve their claims capacity for the period of construction plus 10 years. Also, there is not significant market capacity for IDI/DLI in the GCC region — if more policies were purchased, the price of coverage could likely be reduced. In addition, if the same professionals fully consider their continuing balance sheet exposure following completion of the construction works, the costs may seem more attractive.

The role of professional indemnity insurance

The perception of professional indemnity coverage also plays a role in how IDI/DLI is viewed. It is often thought that structural defects imply defective design, planning, or specification, and will thus be covered by the designers/contractors professional indemnity (PI) policy. In fact, professional indemnity notifications and subsequent contractual disputes are prevalent in the GCC region. However, many of these claims are directly linked or caused by faulty materials or workmanship and therefore are not covered by a PI policy. Added to this, it is common in the GCC for contractors to purchase PI policies that are not designed to cover contractor exposures and therefore provide limited or no coverage, whatever the cause.

Any claimant hoping to take advantage of a PI policy held by a negligent designer must go through the often lengthy and costly process of proving that the contractor, architect, or designer had been professionally negligent. Decennial liability is a strict liability whereas professional liability needs to be a proven legal liability resulting from a breach of professional duties. As a result of this lack of understanding and various misperceptions, the take-up of IDI/DLI has remained relatively low in the GCC region.

Where IDI fits

A property "all risks" policy — purchased upon completion of construction — provides coverage for damage arising from nearly all fortuitous causes, subject to policy specifics. However, such policies normally provide limited or no protection for damage arising out of an inherent or latent defect in a building, structure, or civil works project.

Because of this exclusion in traditional property damage policy forms, the asset owner may be faced with serious problems upon discovering a defect in its building, bridge, structure, or other project. These problems will be aggravated if the asset cannot be used and funds are needed quickly to meet the cost of repairing the damage and making the asset stable and fit for operation or use.

Also, it may be impossible to recover the cost of the required remedial work from another party. Even when recovery is possible, such recovery is likely to be difficult, time consuming, and costly, and may include significant legal fees.

Insurance against inherent defects in buildings is designed to overcome such problems. IDI covers the cost of repairing an asset should an inherent defect in the structural works (deemed to be the load-bearing structures, external walls, and roofing) cause damage or threat of imminent collapse during a period of typically 10 years following practical completion of construction.

An IDI policy can be assigned to future tenants or purchasers, providing some security against future defects causing damage. Many developers in other regions purchase IDI cover in part as a sales/promotional aspect of their developments or projects.

Quality of construction can be a concern for developers in the GCC region, heightening the need for consideration of this risk. Project owners and developers must consider inherent risks, which can present significant balance sheet exposure if defects manifest after practical completion of the project or contract.

Technical audit process

Insurers will not provide IDI/DLI without a TIS provided by an independent entity as appointed and paid for by the policyholder. The appointment of a TIS should be made prior to construction site activity and be approved by the quoting insurer (see Figure 1). The purpose of the TIS is to advise the insurer (and the purchaser of this insurance) regarding the quality of the construction and that it has been undertaken according to proper and relevant standards, using appropriate materials, and with due care and attention to project quality/contract delivery.

The TIS is required to give impartial technical advice; therefore, it must be independent of the project owner, the construction companies, the architect, the design office, and site management. In addition, if damage occurs, the TIS should not act as a loss adjuster on a building or structure it has audited.

Based on the coverage offered by IDI/DLI insurers, the activity of the TIS applies in the following areas:

- The design — calculation hypotheses, specifications, and drawings.
- The materials — specifications, test certificates, and implementation methods.
- The work on the site — construction methodology, execution in accordance to specifications.

The involvement of the TIS audit process can be considered as a seal of quality not only by the IDI/DLI insurer, but also as a tangible benefit for the developer/owner of the building or structure.

FIGURE 1

A chronological procurement process for IDI/DLI

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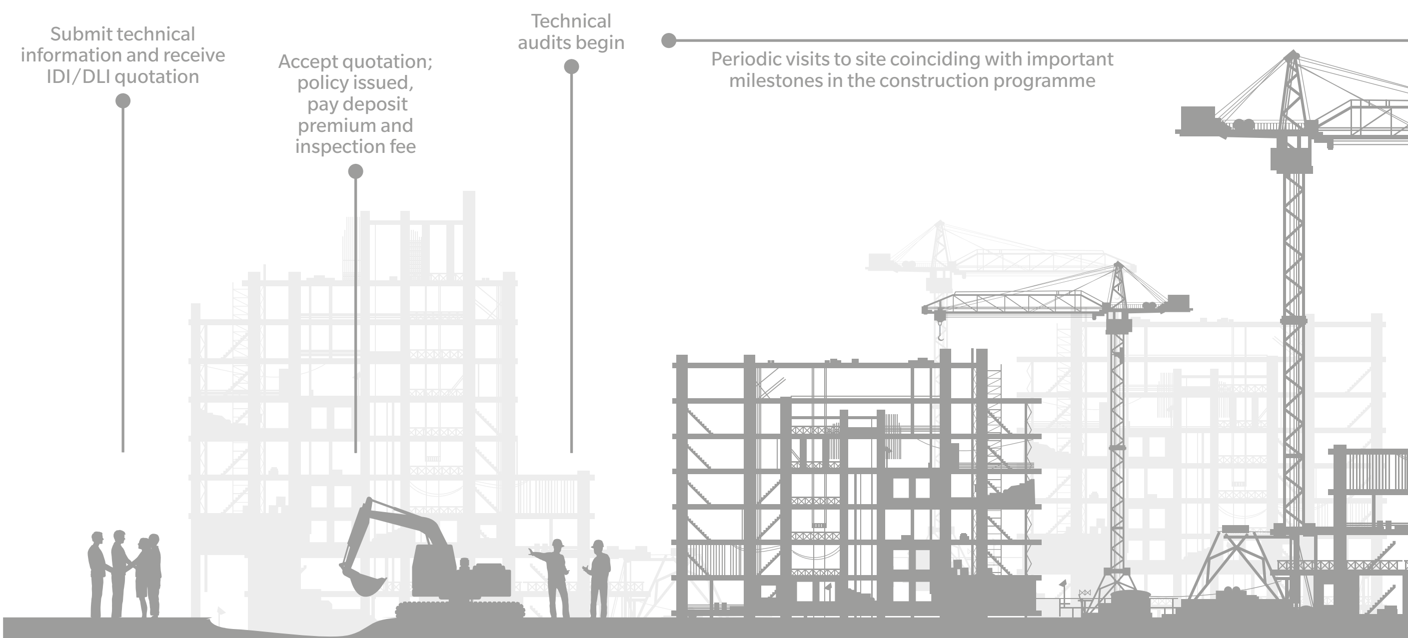
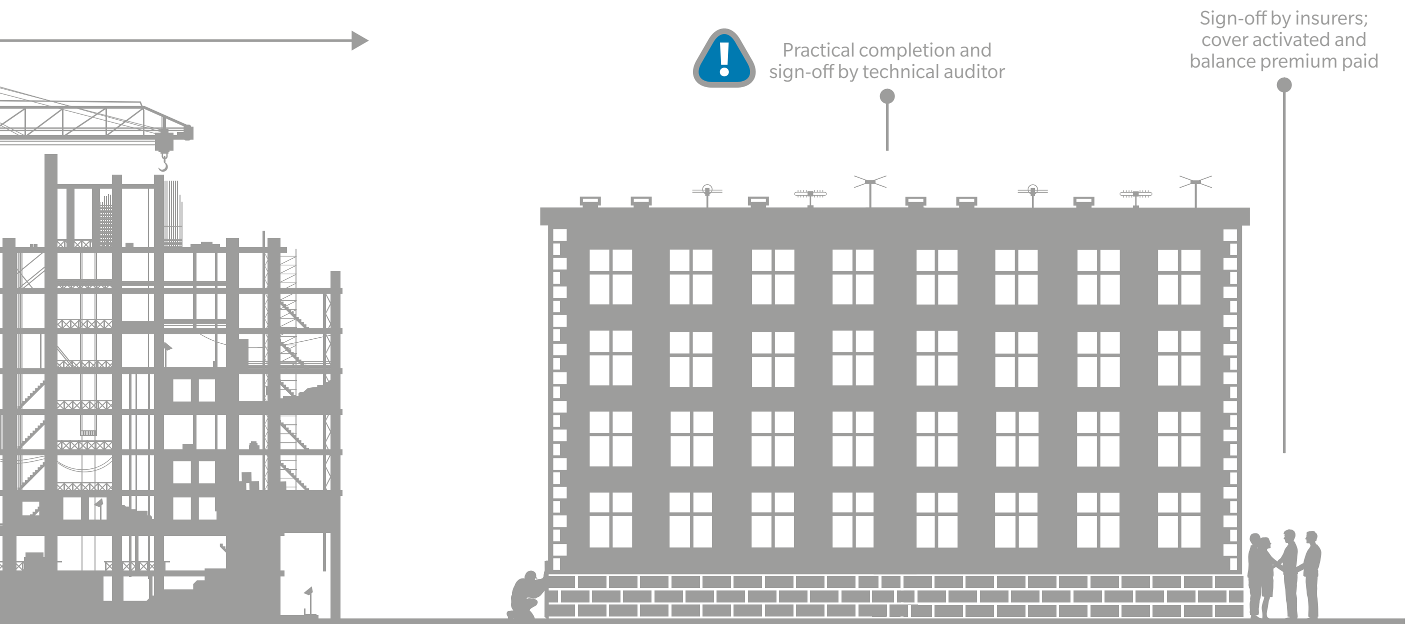


1. The technical audits will flag potential defects to the client and insurer during the contruction process. If these are not adequately resolved before practical completion, it will be flagged in the technical audit sign-off to insurers who may then consider altering their initial quotation.

Benefits of IDI/DLI

- As a first-party policy there is no requirement on the policyholder to establish fault, negligence, or liability of the party(ies) to the construction contract.
- Insurance can be called upon quickly if the insured property suffers physical loss or damage, or there is a threat of imminent damage due to a latent/structure defect, within the terms and limits of cover.
- Costly, burdensome, and time-consuming litigation typically does not need to take place before repairs can be carried out, which enables the building to be returned to use in a more timely manner.
- The policy is assignable to future owners and/or tenants of the building who, in current market conditions, are increasingly reluctant to assume the risks associated with building defects and may be more attracted to a building where IDI/DLI has been arranged, as opposed to one where this protection does not exist.
- The technical audit process may identify defects prior to practical completion, allowing such defects to be rectified before the owner/developer takes over responsibility for the building/structure from the contractor. This independent audit during the construction phase ensures not only quality but also compliance with plans and specifications, as well as the ultimate availability of insurance cover.
- Provides insurance protection to repair/replace damaged property even if contractors and/or the professional team are no longer trading.
- Provides balance sheet protection.



2. As part of the sign-off process, clients will be expected to provide:
   a. Practical completion certificate.
   b. Snagging list.
   c. Reinstatement valuation to ensure that the correct value is being covered.

TABLE 1

IDI/DLI insurance varies from other types of property insurance in the following important ways*:

	IDI / DLI	Construction/erection "all risks" (CAR/EAR)	Property "all risks" (PAR)	Professional indemnity (PI)
When is it arranged?	At the start of a construction project, albeit the cover does not incept until practical completion of the project. Only then is it assured that technical inspection service is in place from the design phase, and the IDI insurer may grant approval to the engaged TIS company and TIS mandate.	At the beginning of the construction project or contract. Cover period includes actual construction works period plus a maintenance period of 12 to 24 months following practical completion of construction.	Usually arranged following practical completion of construction. Policy is usually arranged to cover damage arising from any fortuitous cause during operation.	Typically, annual policies for architects, designers, engineers, and design/build contractors. Can also be set up specifically for a project.
What does it cover?	Damage to structural works arising from faulty design, plans, specification, workmanship, and/or material. Cover is triggered by damage, therefore generally quick to respond to cover repair costs. IDI insures damage or imminent damage caused by defects of materials, design, plan, workmanship, and specification, but also offers indemnification to rectify pure defects and improvements, if necessary, for the load-bearing capacity to comply with local requirements. IDI damage can be of a sudden nature, but also of a gradual one. No fault or negligence at law has to be proven. IDI cover is assignable to subsequent owners and, often, tenants.	CAR policies insure material damage to the contract works. Post completion there are varying levels of defect and maintenance cover available. The international standard position would typically be for LEG2/extended maintenance. Extended maintenance would only provide cover for damage caused by on-site activities, such as workmanship, and not for any damage manifested by offsite pre-construction phase defects, such as design, specification, or materials. LEG2 would reduce any indemnity payable by the maintenance provisions by deducting the cost that would have been incurred to remedy the defect prior to damage occurring, thus further reducing any available indemnity.	Property "all risks" policies cover damage most fortuitous causes. In typical property policies, there is an explicit exclusion of inherent defects or at least an exclusion of gradual deterioration. (Even if covered, an evolving defect can be difficult to allocate to a given policy year).	Professional indemnity policies cover legal liability for breaches in delivering professional services including design work. Negligence has to be proven, which can mean a lengthy claims settlement period. PI is a "claims made" basis, so the PI policy must be in force when the claim is made. PI policies have an "aggregate" policy limit, so the potential can exist for other claims on other projects or contracts to reduce or fully exhaust the available PI policy limit.
Policy term	Typically for 10 years after Practical Completion Certification (PCC).	Typically from the beginning of a construction project to the date of the PCC plus a maintenance period.	From the date of PCC. Typically renewable annually.	Typically purchased as annual policy, or as per contract requirement. Project-specific policies generally for 10 years or more, including extended reporting period requirements.
Typical limits available	Up to US$600 million (estimated IDI/DLI market capacity as of this writing).	Full contract or project reinstatement value (no limit/cap).	Full reinstatement value of asset (no limit/cap) or on a selected loss limit basis (in excess of the assessed probable maximum loss).	Limits of US$100 million or more are generally available for annually renewable PI policies and single project PI policies. In the case of annually renewable PI policies, the actual limit purchased will vary from firm to firm depending upon size, nature of activities, and appetite for such insurance. Single project PI placements for large or complex projects should have limits commensurate with the potential exposures; however cost certainly influences the final limit purchased. Contractual liability caps may inure to the benefit of the construction professionals and serve to limit their overall liability.

*Note: This table outlines general conditions for the above coverages and is not intended to be descriptive of any individual policy, the terms and conditions of which may vary.

Conclusion

Inherent defects/decennial liability coverage can help fill gaps left by other classes of insurances, including construction "all risks", property “all risks”, and PI.

IDI/DLI is tailor-made to respond quickly in the event of damage affecting a building or structure that involves structural defects discovered during a set period, typically 10 years, after project or contract completion. It makes funds available quickly, and relieves the insured from the uncertainty of whether the contractor is able to fulfill its legal liability some years after the project or contract completion, in accordance with respective civil code. As a general rule, contractors, architects, designers, and engineers do not purchase IDI/DLI insurance, so all costs associated with remedial works for structural defects as defined in the civil codes are funded purely by their balance sheets, with no other risk transfer mechanism to provide funds for the repair or reinstatement costs.

Finally, the TIS that comes alongside the product fosters quality in the design and execution of the project or contract — adding value in itself. The GCC region will benefit through increased awareness of IDI/DLI by the key stakeholders in most construction developments or projects — developers, project owners, contractors, legal, financial advisors, and the regional/international project financiers.

Looking forward

Recent developments in the region have seen both the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia plan to make the procurement of IDI/DLI mandatory for contractors and engineers. If and when this is formulated, the UAE and the Kingdom of Saudi Arabia would be the first GCC countries to have a mandatory IDI/DLI regime, making it likely that other GCC member states and Middle Eastern countries would follow.

About this report

Marsh hosted a roundtable/open forum in the GCC region involving property developers, project owners, contractors, legal advisors, and specialist inherent defects insurance (IDI) underwriters to discuss the issue of structural defects to completed properties, the associated exposures to numerous stakeholders involved in the construction project or contract, and the subsequent operational phase of the completed asset. The discussions included the various available insurance solutions linked to the exposure of structural defects, and the perceptions — or indeed misconceptions — regarding this area of risk. The insights in this paper reflect much of what was said during our discussions.

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