

# Residential Risk: The Impact of the Growing Private Rental Sector in the UK





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## INTRODUCTION

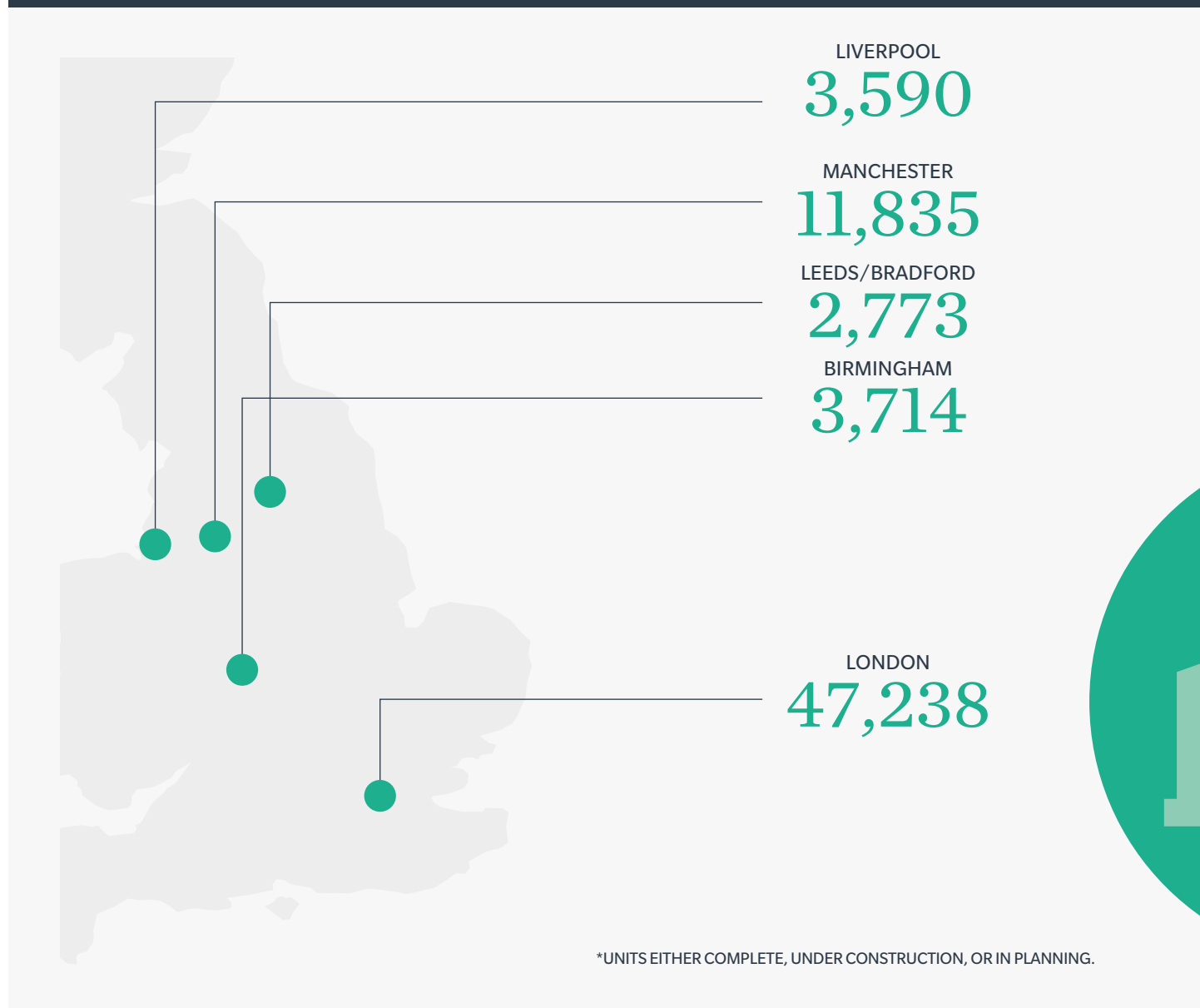
Rising house prices in the UK have contributed to a recent increase in Private Rental Sector (PRS, also known as build-to-rent) schemes. As a result, the UK has seen the number of PRS projects expand rapidly, with 83,650 PRS units either completed or planned.<sup>1</sup> The attraction of PRS projects isn't limited to developers and investors either. Recently, UK Housing Minister, Alok Sharma, said the Government was taking action to create a bigger and better private rental market "as part of our plan to fix the broken housing market"<sup>2</sup>. PRS projects present a unique set of risks during each phase of development due to their size and complexity, as well as the fact that they are typically located in urban areas. Consideration therefore needs to be given to the risks, so that the correct insurance and risk management strategies are adopted and implemented throughout the lifecycle of a development.

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<sup>1</sup> British Property Federation. *Unlocking the Benefits and Potential of Build to Rent*, available at: <http://www.bpf.org.uk/sites/default/files/resources/BPF-unlocking-benefits-potential-build-to-rent-Feb17-FINAL-web.pdf>, accessed 8 August 2017.

<sup>2</sup> Da Silva, Mark. "More build to rent developments needed to 'fix the broken housing market'", available at: <https://www.landlordtoday.co.uk/breaking-news/2017/8/more-build-to-rent-developments-needed-to-fix-the-broken-housing-market>, accessed 8 August 2017.

FIGURE 1 PRS Units by UK City\*

Source: British Property Federation<sup>3</sup>

<sup>3</sup> British Property Federation, available at: <http://www.bpf.org.uk/what-we-do/bpf-build-rent-map-uk>, accessed 8 August 2017.



Over the past 10 years, house prices have risen approximately 22% throughout the UK,<sup>4</sup> making it challenging for some people to get onto the property ladder. As a result, investors and developers have become increasingly interested in PRS schemes, which have the potential to provide a continued flow of income once completed, due to the high demand for rented properties in urban areas close to transportation links, leisure attractions, and critical infrastructure. The British Property Federation has noted that more than half of those planned are in London, but a growing number are located in Manchester, Liverpool, Birmingham, and Leeds (see FIGURE 1).

The Government recently backed the idea that companies should develop more homes directly into the PRS. In 2016, London Mayor Sadiq Khan launched new planning guidance, which supported an increase in these projects. Ian Fletcher, Director of Policy at the British Property Federation, said recently: “The [Greater London Authority (GLA)] has led the field in seeking to have a planning policy on build-to-rent, and this latest guidance is immensely helpful to the sector and the Boroughs with which it works. When you are trying to do something new in housing inevitably you need to develop understanding, and the Mayor, his Deputy, and team

have wanted to be at the forefront, working with planners and investors to cast a sensible planning policy.”<sup>5</sup> This has included the creation of the Private Rented Sector Taskforce as well as the Build-to-Rent Fund.<sup>6</sup>

These projects are also getting larger and more complex. For example, in London, a large PRS project was recently announced that will be located in Ealing and create 500 homes.<sup>7</sup> More and more of these projects are including facilities such as cinemas, gyms, and pools, as an increasing number of tenants look for a more inclusive rental experience.

The Collective, a developer of what has been termed “co-living projects,” has seen a growth in demand for rented schemes that include shared spaces, appealing to young professionals who may be struggling to join the property ladder due to rising house prices.

“There needs to be a change in the way we view how we live. Places just aren’t affordable anymore. You can’t come to London and buy a one-bedroom flat if you are starting out. There doesn’t appear to be an end to this trend, and PRS/co-living could be the answer to it,” the company told Marsh recently.

<sup>4</sup> Global Property Guide. “House Price Changes”, available at: <http://www.globalpropertyguide.com/Europe/United-Kingdom/price-change-10-years>, accessed 8 August 2017.

<sup>5</sup> Mayor of London. “Mayor sets out ambitious plans to deliver 90,000 affordable homes”, available at: <https://www.london.gov.uk/press-releases/mayoral/mayor-sets-out-plans-to-deliver-90000-homes>, accessed 8 August 2017.

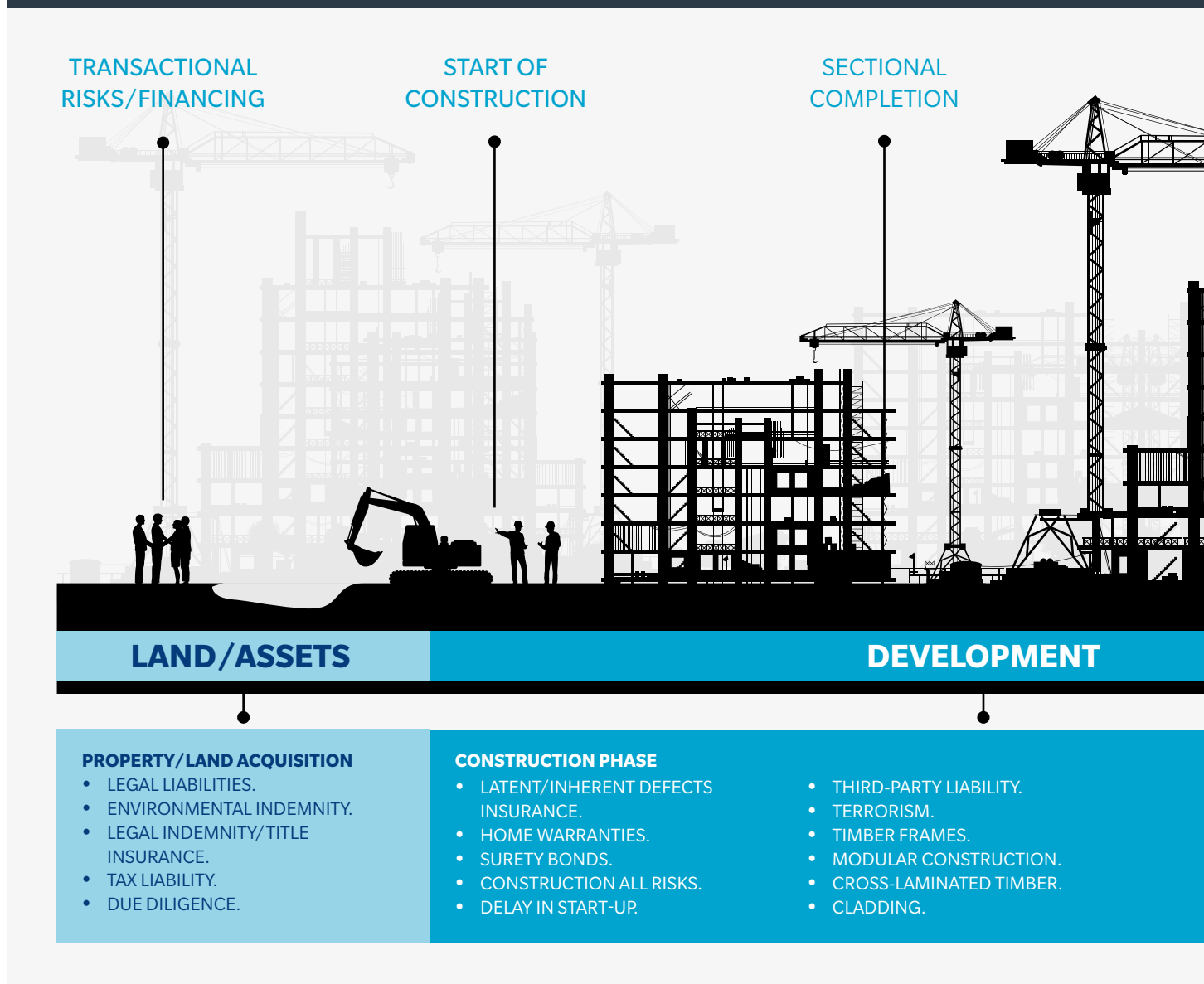
<sup>6</sup> Screen, Andrew. “The Evolution of the Build-to-Rent sector in the UK”, TLE, available at: <http://www.thelondoneconomic.com/property/evolution-build-rent-sector-uk/20/02/>, accessed 8 August 2017.

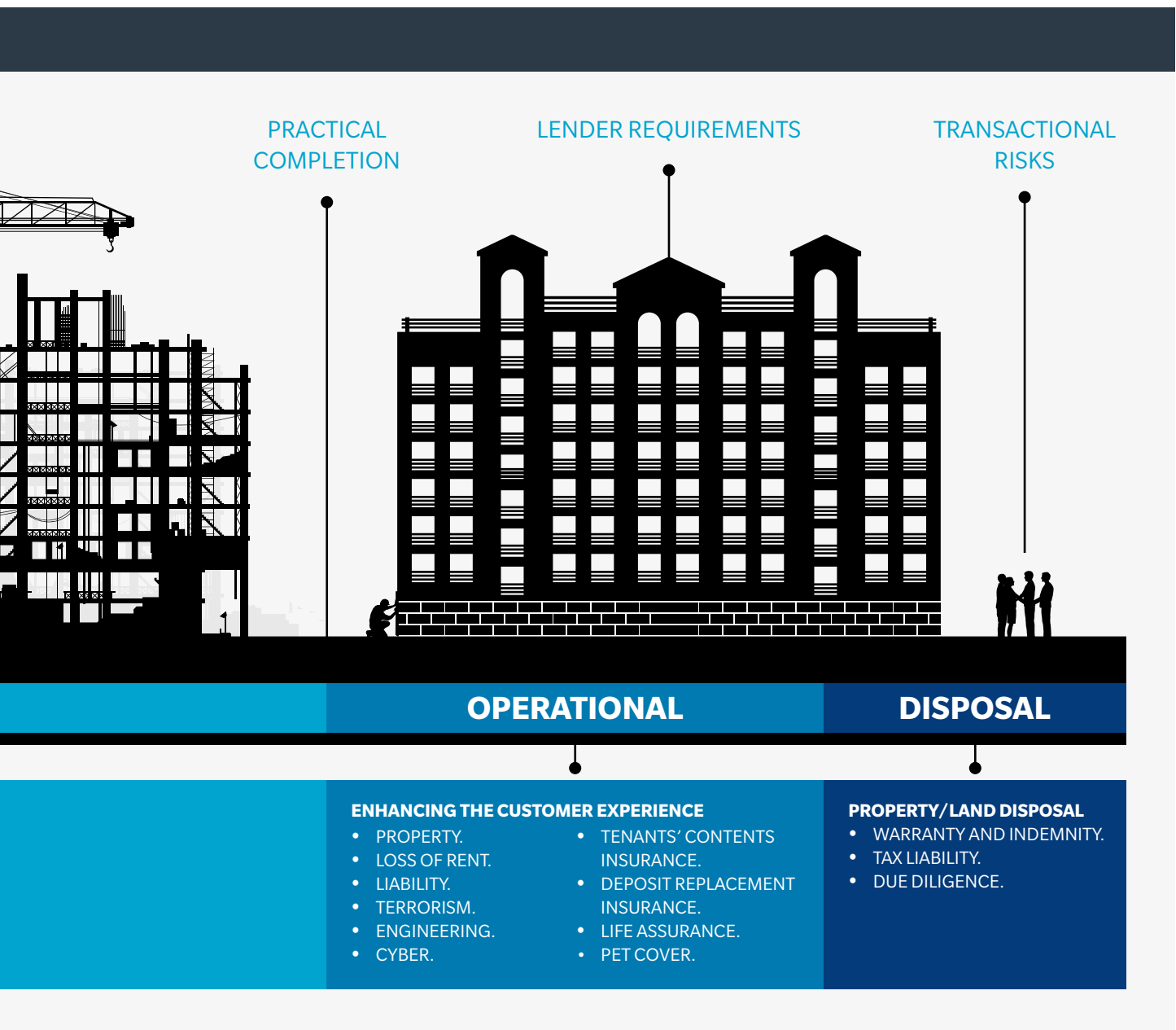
<sup>7</sup> Getwestlondon. “London’s largest ever ‘build-to-rent’ project to be built in Ealing”, available at: <http://www.getwestlondon.co.uk/incoming/londons-largest-ever-build-rent-10868502>, accessed 8 August 2017.

## RISK ISSUES DURING THE LIFE CYCLE

While the popularity of investing in and developing these types of properties is increasing, investors, developers, and building owners need to be aware of the risks and insurance challenges that can occur before construction, during construction, and after the project is completed and occupied.

**FIGURE 2** Risk Issues During the PRS Life Cycle  
Source: Marsh







# RISKS PRIOR TO CONSTRUCTION

## TRANSACTIONAL RISKS

Some developers will acquire or set up a special purpose vehicle (SPV) to run the development. Property acquired through the purchase of shares in an SPV under English Law will inherit the historical liability of that SPV. The seller may be prepared to give the buyer warranties on a raft of matters relating to the SPV, from ownership through to tax, which may allow a claim for damages if a breach of warranty occurs. On many transactions, however, sellers may be cautious around the monetary cap against those warranties.

Warranty and indemnity (W&I) insurance can provide additional recourse to the buyer of an SPV should a breach of warranty occur. If the developer is looking to sell any of its properties via an SPV, the buyer may ask for warranties. Because the warranty period for UK transactions can typically be up to two or three years for general warranties (and up to seven years for tax warranties), then, if the developer is prepared to give warranties, the contingent liability would remain for several years. As a result, this may impede plans to reinvest the profits into more development opportunities.

Alongside uncovering unknown issues at the point of sale that may result in a breach of warranty claim by the buyer, there is insurance available to protect against specific identified issues that come to light during the transaction negotiations or due diligence.

## OBSTRUCTION OF LIGHT

Many of these projects fall into the category of tall towers, defined as those with more than 20 floors. As we mentioned in our report, *Sky-high Risks: The Impact of Increasing Tall Tower Construction in the UK*, tall towers can lead to loss of light, because these buildings can often result in overshadowing neighbouring properties, restricting their access to light. For developers, this potentially means increasing litigation costs and project delays, alongside loss of value/revenue as a result of compensation costs.

“Right to light” rules dating back to the 1920s are in place throughout the country. The rules state that property owners should have at least enough natural light to be able to read an article in *The Times* with only a one-foot-high candle in the room as illumination. However, Section 237 of the 1990 Town and Country Planning Act allows local authorities to take temporary ownership of a development and effectively forces objectors to accept compensation for loss of light rather than allow them to block the scheme altogether through an injunction. In several instances, developers compensate neighbours affected. These costs can be substantial, and consideration should be given to rights of light insurance to provide balance sheet protection for such exposures.

## INHERENT/LATENT DEFECTS

These are defects discovered after the completion of the project, once the building is operational. Developers must consider inherent risks, as there can be significant balance sheet exposure if the defect manifests itself.

Inherent defects found in the building, such as the failure of cladding, windows, heating, or ventilation, may require the owner to ask tenants to vacate while the restoration and repair works take place, resulting in a loss of rental income.

Design specification also needs to be flexible, as many developers consider, dependant on market conditions, switching from PRS to residential sales during the construction or post-completion. This carries risk because, if the housing market changes, developers need to adapt to conditions, and failure to get the design right will mean it is difficult to “flip” from PRS to residential sales.

There are specific policies available in the insurance market that can provide indemnity for the costs of repairs if an inherent defect is found following damage to the structure. For residential projects, developers also need to provide a new home warranty to satisfy the Council of Mortgage Lenders’ requirements.

A source from Essential Living, one of the main PRS developers in London, commented that “although our business model envisages that we will retain assets and have little need for the latent defect/new home warranty cover required for private sale, we must still purchase this to maintain the flexibility for our future. It has also been an important cover from our lender’s perspective and has assisted us in achieving our external funding arrangements.”

The increasing demand for inherent defect and new home warranty insurance from PRS developers is likely to lead to more innovative product development bespoke to PRS schemes.



## RISKS DURING CONSTRUCTION

The construction phase of a PRS project carries many of the risks that a traditional construction project faces. However, as these tend to be large-scale developments, risks such as fire and escape of water can become much more impactful in the event they occur. In addition, due to the substantial revenue exposure of these projects, these events carry significant delay risks.

### FIRE/WATER DAMAGE

The possibility of fire and/or the escape of water represents significant risk to a project's practical completion date. Either one of these events has the potential to cause severe damage to the works and significant delays. This risk is usually multiplied in a PRS structure, due to the high concentration of value. In addition, post-completion fire safety, such as the number of escape routes, is a particular concern in these buildings, due to the high number of occupants. This should be taken into consideration when designing and building these projects, the importance of which has been highlighted by a recent high-profile fire incident in London.

### DELAY

Whether a development project will be finished on time is often questioned throughout the construction phase. The financial consequence of a delay in completion can be colossal. This can be a combination of loss of revenue, continuing debt service payments, and, in some cases, the cost of providing alternative accommodation. While this is a concern on any construction project, it can be particularly significant in PRS developments. A long delay to completion will result in the

developer not being able to rent out units and, potentially, providing alternative accommodation for tenants who have already signed lease agreements. This will have an enormous impact on the developer's cash flow.

### PROXIMITY TO THIRD PARTIES

In addition to risks within a site, property developers are exposed to a variety of third-party risks during the construction. Often, these projects involve working within tight building sites in densely populated urban areas, which are in close vicinity to third parties, heightening risks to people, neighbouring properties, and businesses. Consideration needs to be given to third-party liability limits of indemnity.

### ENVIRONMENTAL

Liability can also arise from environmental damage. Undertaking construction works in an urban area can give rise to several significant environmental risks, especially as developments are often near waterways. Ground vibration from the works can trigger pollution liabilities arising both from so-called "sudden and accidental" events and from gradual pollution events.



#### SPOTLIGHT

### Practical Completion for PRS Projects

Delays to completion can be costly to PRS developers, and present one of the greatest risks for these projects. Often, developers will aim to have a percentage of tenants signed up before the project is completed, and sometimes even getting a project completed by a certain time of year is critical to its profitability. For example, Marsh recently spoke to a co-living developer, The Collective, which identified this as one of its key risks during the construction process. "A completion date around September time is key for us, because that is when a lot of graduates start looking for careers," the company told Marsh. "Making sure your programme is aligned to that date is important. We also aim to open a building with several tenants signed up, as we want to have a buzzing atmosphere." Delays could mean missing their target audience.



## SPOTLIGHT

## The Cost of a Delay in Completion

The ongoing revenue stream of a PRS developer will be left vulnerable should there be a significant delay in the construction project reaching practical completion.

For example, if the developer is building a 350-unit scheme and anticipating GBP300-per-week rental income per unit, a three-year delay caused by major fire or escape of water could cost the developer more than GBP16.3 million in loss of rental income, as there would be no completed units for the tenants to move into.

During this time, the developer is still likely to have ongoing debt service obligations on the money borrowed, as well as potentially having other outgoings, such as alternative accommodation in the event that tenants had already been signed up with an agreed move-in date.

## TERRORISM

We have seen several recent examples of terrorist activity across Europe, from the bombings in Paris in 2015 to the attacks in London and Manchester earlier this year. Construction sites can be targeted by terrorists as a method of slowing growth, and therefore strong consideration needs to be given in respect of terrorism insurance to reinstate the construction works in the event of a terrorist act.

## PROXIMITY TO RAIL INFRASTRUCTURE

Projects may be adjacent to existing rail and/or underground lines. Debris or materials falling on tracks can cause significant delays for rail operators, meaning developers could be liable for high costs that can include travel disruption or damage to infrastructure. For works that are within the zone of influence of rail/infrastructure, property developers may need to agree contractually (under an asset protection agreement) to indemnify rail operators for things such as damage to property, injury, and disruption to the railways. There is usually a requirement for developers to purchase a minimum level of liability cover, and for large schemes this is typically at a limit of GBP155 million. Some operators may not suggest a limit or cap the developer's liability, meaning that even higher limits should be considered.

## ADDITIONAL CONSIDERATIONS

As well as traditional risks, PRS projects can be subject to additional ones, due to the way in which the projects are constructed, particularly if this includes elements of modularisation.

**Modularisation:** Many of these schemes include an element of modularisation, which is becoming a more frequent trend in the UK. Modularisation is often a more cost-effective construction method for developers, when compared with traditional building methods, and can often prove to be quicker (possibly even half the usual time) in terms of project timescales from start to completion.

The modular "pods" are designed and manufactured in a factory, meaning this process happens simultaneously to the ground/early works on site. Once the foundations and supporting structures are finished, these "pods" are transported to site and assembled relatively quickly. Developers also cite the reduced requirement for skilled labour, lower risk of construction accidents, and more consistent quality of build compared to traditional construction.

However, there are risks. Precision units, which are designed and manufactured within millimetres, in terms of accuracy degrees, could have defects and faults, meaning they may not "slot" together correctly on site. At the same time a mechanical or electrical defect in one unit could manifest in all units.

**Conversions:** If the project involves converting an existing building into a PRS development, there is an existing structure exposure. New works will need to be carefully designed to work with the existing structure, and consideration should be given to any defects within the structure.

## OPERATIONAL RISKS FOLLOWING THE COMPLETION OF A PROJECT

Once the project is completed and operational, with tenants occupying the premises, consideration must be given to the safety of tenants, the maintenance of the building, and the possible risk of damage to property, liability, and loss of income.

### LANDLORD AND BUILDING OWNER RISKS

#### **Property damage, loss of rental income, and business interruption:**

Due to the high concentration of assets within the building, property damage from risks such as fire, water, or adverse weather can have catastrophic results once the building is completed. Plans should therefore be in place to ensure the safety of tenants, if an event were to occur.

If a building is damaged, landlords and building owners will face loss of rental income and the cost of alternative accommodation for tenants, in addition to the costs to repair the property, or, in some cases, a total loss of the asset. Cover for the building/property, landlord contents/stock, and loss of rental income should be considered.

**Risks to tenants in communal areas:** The latest generation of PRS projects include communal areas with cafes, cooking facilities, and bars. In addition, gyms and other leisure facilities may also be present. As a result, landlords and building owners must acknowledge the risks if a tenant were to be injured in a communal area, as well as the risk of property damage. Consequently, the landlord will need to consider public property owners' liability cover.

**Terrorism:** As with the construction phase, terrorism risk remains a key concern once the building is complete, and becomes a more

pressing risk once the building is occupied. As such, crisis management and emergency planning should be in place to help keep tenants safe. Due to the high concentration of assets, building owners should think about terrorism cover, which can be purchased in line with the building's property damage insurance arrangements.

**Machinery breakdown and inspection:** Machinery and equipment used in the running of the building, such as lifts, boilers, and air conditioning units, will need regular maintenance and inspections to avoid breakdown or other issues. Engineering and inspection insurance will therefore be required for the machinery and equipment present in the buildings.

**Concierge services/cleaning and valet parking:** Increasingly, PRS buildings are offering additional services, such as concierge services, cleaning, or valet parking. Given that tenants' property is being moved and held under such services, owners and landlords should bear in mind liability, motor, and property insurance covers to mitigate losses if such property is lost or damaged.

**Fine art:** In many of these projects, common areas have been decorated with pieces of fine art, which opens the risk of them being accidentally damaged by tenants, stolen, or lost as a result of water damage or fire.

Due to the high concentration of assets within the building, property damage from risks such as fire, water, or adverse weather can have catastrophic results once the building is completed. Plans should therefore be in place to ensure the safety of tenants, if an event were to occur.

Once operational, a PRS building will hold considerable amounts of data about the building and its tenants... Landlords and building owners need to be aware of these risks and the data they hold, and take the necessary steps to prevent a cyber-attack.

As a result, fine art insurance policies should be considered for any pieces used in these areas.

**Cyber-attack:** Once operational, a PRS building owner/operator will hold lots of data about the building and its tenants. In addition, the increasing use of interconnected systems presents an operational risk should systems be compromised. Landlords and building owners need to be aware of these risks and the data they hold, and take the necessary steps to prevent an attack. Cyber and financial policies, such as crime/fidelity guarantee and professional indemnity, are also available to mitigate against losses.

**Maintenance:** Landlords will also need to contemplate the ongoing upkeep of the buildings, ensuring that they are well maintained and fit for purpose. Keeping the buildings updated in line with tenant demands can come at a significant cost.

**Reputation:** Reputational and branding risks should also be explored. For example, if an event held at the building caused adverse publicity, this can have a negative effect on the building causing potential future tenants to look elsewhere. Landlords need to be aware of the possible consequences when running theme nights, parties, or networking events.

## RISKS FOR NEW TENANTS

Tenants will need to consider the risks to their contents, including bicycles and sports equipment, as well as risks to any pets. They should also think about their personal liability, as well as cover for personal accident, critical illness, and that of any legal expenses, should a dispute with landlords or building owners arise. These can be insured under a package arrangement.

## CONCLUSION

If housing market conditions continue as expected in the UK, developers and investors are likely to continue to see PRS projects as attractive, in order to meet growing demand.

But consideration should be given to the risks present at every stage, from pre-planning to the finished, operational building.

The construction and real estate insurance market, like much of the insurance industry, remains awash with capacity, and is a buyers' marketplace for solutions to the challenges discussed within this paper.

It is critical at every stage of the project that the correct insurance advice is sought and a sound risk management strategy is adopted and implemented into the overall programme.



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We work with clients of all sizes to define, design, and deliver innovative solutions to better quantify and manage risk. To every client interaction we bring a powerful combination of deep intellectual capital, industry specific expertise, global experience, and collaboration. We offer risk management, risk consulting, insurance broking, alternative risk financing, and insurance programme management services.

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