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Charting a course *As construction risk and insurance professionals face a raft of economic and operational challenges in the coming quarters, Deborah Ritchie speaks to Neil Fleming, UK underwriting manager, Construction & Engineering, at QBE about the keys to resilience*

Managing supply chain risk in the UK construction sector *With construction industry output forecast to decline in the first three quarters of the year and supply chain the leading cause of turmoil, the outlook is at best bumpy. Neil Fleming examines the risk horizon, and charts a course through the disruption ahead*

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With construction industry output forecast to decline in the first three quarters of the year and supply chain the leading cause of turmoil, the outlook is at best bumpy. Neil Fleming UK underwriting manager, Construction & Engineering, QBE examines the risk horizon, and charts a course through the disruption ahead

This is a time of great innovation and opportunity in the UK construction sector. The global construction industry is forecast to grow 70 per cent by 2025, while the UK's target to reduce emissions to 20 per cent of 1990 levels by 2050 is creating huge opportunities for companies that design and build greener buildings and structures.

However, the sector is not without its challenges. With uncertainty in the aftermath of Brexit, a growing skills shortage and quality control climbing the agenda, construction firms need to ensure that they are monitoring and actively managing their risks.

The outlook for the industry will be as bumpy as 2022, with output forecast to decline in the first three quarters of the year. Supply chain disruption is the leading cause of anticipated mid-air turbulence. Geopolitics and domestic developments far from the UK will continue to affect access to materials and their price.

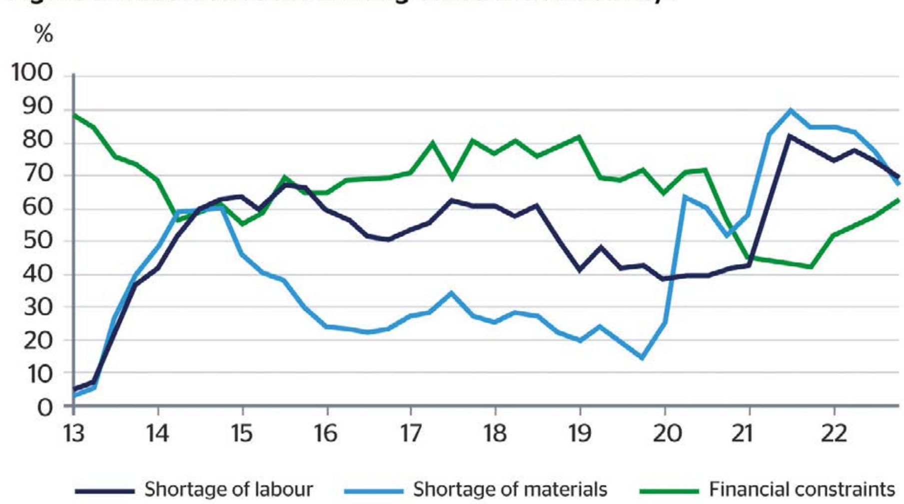
The reopening of China's economy following the end of the zero Covid strategy and the ongoing conflict in Ukraine are two key international drivers of potential disruption. The post-Brexit realignment of UK-EU relations appears to be largely heading in a positive direction, but that could quickly change if the issue of Northern Ireland's customs status is not resolved.

Meanwhile, domestically, demand for the work of the construction sector – particularly in relation to large infrastructure projects, but also smaller projects and homebuilding – remains affected by political vacillating and high demands on public spending. Although elections are unlikely before 2024, 2023 is the year in which the government and opposition will essentially go into campaign mode. Expect big promises on investment in building infrastructure to "level up" the country, which create potential opportunities in the coming years.

Since the first pandemic lockdown, a shortage of material inputs has been the largest factor constraining construction activity in the UK. Scarcity of inputs was cited by an average of 78 per cent of construction firms as a brake on output across the four RICS Construction Market Surveys conducted in 2022, compared with 74 per cent for shortages of labour and 56 per cent for the firms' financial position.

This is the highest percentage balance since the question was first asked more than a decade ago. According to the Office for

Figure 1: What factors are limiting construction activity?



Source: RICS

National Statistics survey evidence released in December, 39 per cent of construction firms attributed this to global production shortages, 21 per cent to the pandemic, nine per cent to increased cost inflation, and six per cent to transport issues.

Looking forward, the construction industry's supply chain is particularly vulnerable when it is reliant on inputs which are not produced domestically and supplies from abroad are sourced from a single or only a few countries. Examples of imported inputs where supply is heavily dependent on particular overseas countries are: bitumen and asphalt (68 per cent of which is imported from the Netherlands), road rollers and tamping machines (68 per cent from Germany) and oriented strand board (38 per cent from Latvia).

There are broader indicators of supply chain concentration risk. Around 18 per cent of total construction material imports are sourced from China, which might be vulnerable to Covid lockdowns or geopolitical risk. While trade data suggests 57 per cent of construction material imports arrive by sea, where issues with ports may be a potential problem.

Profitable turning unprofitable

Research commissioned by QBE shows that three in five (59%) UK construction companies that have been hit by supply chain issues over the past year have seen once profitable projects turning unprofitable.

In a February 2023 survey of senior leaders in the construction industry, 83 per cent of respondents said they had experienced an issue with their supply chain over the past 12 months, while 85 per cent said that they expected supply chain issues to pose a challenge in the next 12 months.

Some 85 per cent of respondents went on to say that the cost of importing construction materials had increased at a rate higher than inflation over the past year. Nine out of 10 (89%) of those impacted by supply chain issues also said that they were currently experiencing a shortage of materials.

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Many of the construction firms surveyed said they are taking steps such as diversifying supply chains (42%), holding greater stocks of strategically important materials (31%), establishing robust monitoring systems of stocks and suppliers (23%) and nearshoring (17%). However the survey found nearly one fifth of firms (18%) have not taken any action.

4 ways to lower supply chain risk

The decision to transfer, or retain and manage risk, is a subjective one for most organisations, based on their risk appetite and various other factors. A key element of this choice, though, is having a clear and accurate picture of one's risk profile and an effective risk management plan.

As part of the plan, there are four strategies that firms can adopt to lower the risk:

1. The first is to shift from the 'just in time' supply chain that was finessed during the period of economic stability around the turn of the century, towards a 'just in case' supply chain to help insure against a period of economic instability that firms are currently facing. The old school methods of boosting stock levels and ordering further in advance than normal still have a place. Albeit, they come at the cost of absorbing capital and storage space, which may require additional external finance to pay for stocks, restore liquidity, or rent warehouses.

2. Secondly, for larger firms, technology can also play a role by automatically ordering supplies when stock levels go below a certain point. Where firms feel they may be left short, a smart move is to invest resources in gaining market intelligence about a wide range of potential suppliers.

3. Thirdly, diversifying procurement to build relationships with a number of suppliers is wise. This diversification can potentially occur across modes of transport or hubs (for example, different ports) suppliers use and the geographical location of suppliers' supply chain to avoid overdependence on production facilities in the same part of the world. Scenario planning for plausible disruption, transport or logistical problems and geopolitical issues is also advisable.

4. Finally, where higher input prices are the likely fallout from supply chain disruption, construction companies could also consider adding a cost escalation clause to future contracts – that allows for an automatic increase in agreed-upon prices if certain conditions change – to provide the option of sharing expenses if they rise uncontrollably.

Neil Fleming, UK underwriting manager, Construction & Engineering, QBE

Charting a course

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The effects of inflation are already being felt in the construction industry. With talk of peak inflation having been reached in the UK at least, what do the next 12 months hold for the industry?

Whilst materials and labour inflation related to residential and commercial building projects is viewed to drop over the course of 2023, government investment in infrastructure and civil engineering works could well maintain higher inflation levels in these sectors. Continued pressure on energy costs and difficulty in sourcing suitable labour should still continue to drive inflation, albeit at perhaps a lower level than the challenges of 2022.

The rising cost of delivering construction projects is a major concern across the insurance industry. Sharp increases to the price of replacement materials, combined with longer lead times caused by disrupted supply chains lead to the potential for significant claims inflation. In the case of longer duration construction project insurance (OCIP policies), claims inflation to this level was not necessarily anticipated by insurers when pricing and terms for the risks were originally set, prior to the contracts starting, often years in advance of the claims materialising.

Rising inflation is also proving problematic on larger project insurance placements. Whilst capacity is largely available on new construction projects being presented to the construction insurance market, existing placements where there is a significant jump in the estimated contract value mid-way through a project, can lead to significant challenges, with the original panel of insurers not having the capacity to maintain their share of the risk. This can be complex for all parties involved, with new insurers joining a project placement often seeking differential terms and pricing in line with current market conditions.

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Despite the challenging outlook, opportunities exist. With this in mind, what conversations are you having with clients when it comes to ESG?

QBE takes pride in listening to our customers and trying to respond to their changing needs. As focus rightly continues to sharpen on environmental and social attitudes in the construction industry, QBE is striving to offer solutions to our customers' changing risk profiles.

Some of the more environmentally sustainable building methods and materials can significantly change the risk profile of a construction project. The obvious example of structural timber, with larger and taller structures using materials such as glulam or cross laminated timber, is one that creates an inherent enhanced fire risk and also significant challenges in managing the risk of moisture and water damage. Our focus as an insurer is educating ourselves around these evolving risks and assisting our customer base in understanding and ultimately mitigating them.

Our challenge is also to understand potentially novel or prototypical materials and processes that are assisting in reducing the construction industry's carbon footprint. Low carbon concrete is one such example that we are discussing with our customers.

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Another welcome move from the construction industry is a bid to reduce waste on contract sites, assisted by an increase in the use of modular construction methods with off-site fabrication. Again, the risk profile shifts from that presented by a traditional construction site with many positive features including: the quality controls of pre-fabrication in a factory environment, the fire risk potentially being improved with

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reduced hot works taking place on site, an accelerated build programme which leads to shorter time spent on a hazardous building site, and of course reduced waste.

The risk profile for modular projects does however come with challenges for insurers, including the problems caused by defective design, materials or workmanship having the potential to lead to serial losses with many multiples of the same defect repeating throughout a project. A shift from the contract site to the factory can also present accumulation challenges for insurers at key suppliers. Claims can also be exacerbated by the reinstatement cost on site far exceeding the original factory build price.

In your experience with 20 of the UK's 30 top construction companies, how have attitudes to risk management changed for the better in recent times, and where are there areas for improvement?
In light of recent global factors such as the Covid pandemic, supply chain challenges, climate change and the Russia-Ukraine conflict and their socio-economic impact, there is now a greater awareness of the need for corporate governance of risk – the need to horizon scan, prepare, plan and build in contingencies to establish resilience into their business.

There is a greater ability to be agile and flexible in the light of dynamic market changes and in particular in relation to supply chain challenges.

Many organisations have come out of the pandemic with a stronger embedded risk management culture. Businesses had never been so challenged in terms of their adaptability and agility and employee engagement in embedding risk management practices was at an all-time high. Many businesses have built on this shift in culture and collaboration with a more open and consultative approach to risk management.

UK businesses increasingly see the value in risk management, but few have successfully created a true risk culture that integrates the management of risk into the daily routine of workers. However, the pandemic has created an environment in which people are much more receptive to measures aimed at improving risk, while management are more aware of the need to build resilience into their business in consultation with their employees.

As part of their ESG agenda, and in particular the "social" aspect, most of our customers have incorporated their health and safety risk management strategies into their ESG frameworks. This has helped to centralise health and safety risk management into BAU as opposed to it being siloed. This is none more so than for the topic of mental health which has gained a much needed greater focus in the sector in recent years.

In terms of areas for improvement, with the move towards more modern methods of construction (MMC), there is a perception within the industry that this is de-risking construction. To a certain extent this is true. Methods such as off-site manufacturing and manually lighter activities will reduce potential waste, project delays, health and safety risk, on-site hot works and traditional quality challenges, but MMC do introduce new risks with evidence that the sector is not fully on top of these. Such risks include accumulation of risk at suppliers, series defects, enhanced transit risks, storage risks and skills shortages.

Enhanced controls will include supply chain resilience assessments, risk assessment of transit and storage arrangements, robust inspection regimes, assessment of labour skills and a response plan.

About QBE

QBE is a global business insurer with operations in all of the key insurance markets.

We have been helping construction and engineering firms to build resilience for more than 30 years. We work with many of the leading firms in the sector – for example, we have long-term relationships with 20 of the top 30 UK construction companies.

Our construction practice is made up of a dedicated team of experts who understand the key issues in the sector and can focus on the real issues faced by our customers. Our approach is to not just provide an insurance policy and be there when things go wrong, but to add value and engage with our customers to understand their risks and business. We believe our collaborative approach to underwriting, claims and risk management support fits our customers' needs and demonstrates that we really do put the customer at the centre of everything we do.

Ask your insurance broker about QBE Business Insurance or see www.QBEeurope.com

You can read QBE's *Supply Chain Risk and the UK Construction Sector* full report at https://qbeeurope.com/sector-resilience/supply-chain-risk-and-the-uk-construction-sector/