



ARCHITECTS & ENGINEERS PROFESSIONAL LIABILITY

# The effect of economic conditions on insurance rates



**Insurance is a bottom-line business. It's a simple concept: collect a premium now for what you can predict is the future need for coverage of the transferred risks. In practice, however, it is a complex and somewhat speculative wager on factors that are beyond the insurer's control. In today's disruptive environment, when material prices are unpredictable, inflation is rising, claims are increasing and disputes take much longer to resolve, predicting the cost of future claims becomes even more uncertain.**



# Professional liability claims in Canada

There was a time in our not so distant past that commercial borrowers for the construction of capital assets demanded that professionals build projects quickly and cheaply—a recipe for construction defects and design claims. Then, claims happened.

Many insurers of design firms raised rates significantly, stopped insuring design firms or went bankrupt because they had not anticipated the drastic increase in the number and cost of claims. Other insurers rushed into the market, collected high premiums for insuring design firms and then non-renewed firms before claims happened. This was not only chaotic for design firms, it also [disrupted insurance markets](#) and the rating system.

Today, the frequency of Canadian professional liability claims against design firms in [Victor's Architects & Engineers Professional Liability program](#) continues to rise. The cost of those claims also continue to rise because of the increased costs of energy, materials and money.





# A look at current external factors

Recently, the world's largest real estate company, Coldwell Banker Richard Ellis (CBRE), [predicted a 14.1% year-on-year increase in construction costs in the United States by the close of 2022](#), citing financial pressures such as inflation, labour shortages, supply chain challenges, COVID-19 and the worldwide impact of Russia's invasion of Ukraine. It is the largest jump since CBRE began making cost projections in 2007. While CBRE predicts that cost inflation will fall to 4.3% in 2023 and 2.9% in 2024 as supply chain problems recede, it calculates that delays in material deliveries, labor scarcity and product shortages will endure. This is no different in Canada.

In a Statistics Canada report, ["Building construction price indexes, third quarter 2022,"](#) it states that building construction costs for residential construction rose 18.7% year over year in the third quarter, and 12.5% year over year in the third quarter for non-residential construction.

The construction industry prospers when there is predictability in project demand and costs, but it will face continuing challenges and volatility, thereby making estimating and managing costs more difficult—and, cost recovery efforts through claims, more likely.

**Supply chain issues** [may not improve in the next three to five years](#). Lack of improvement will mean: 1) unpredictable delays; 2) disruptions in design and construction schedules because of the need for substitutions; and 3) design modifications in response to shortages that result in increased costs and a potential for decreased quality in putting capital assets in place.

**The impact of inflation** may be somewhat reduced in the next few years, but how the free-market system self-corrects is unknown. While [some experts predict prices will begin to drop in 2023](#) in the near future, the costs of materials and labour may continue to increase, which not only affect the initial cost of capital assets, but also raise the remedial price tag for solving any design and construction problems.

**Interest rates** may continue to increase in order to [help reduce the effects of inflation](#). Since the cost of money can affect initial design requirements and the desire to build quickly, higher interest rates can have a major influence on the quality of project and the costs of claims.

**Experts predict that severe weather events** [will increase](#), and the climate variability and volatility will amplify demands on the built environment. Support for firms to

design with resiliency in mind—by anticipating changes that might happen and convincing project owners to make the investment in hardened and adaptable facilities—may not happen in a marketplace of rising capital costs, which can then lead to future professional liability claims.

**Insurance market capacity** will have an impact on what coverages some insurers can offer, how quickly they can grow and whether they can continue in a market at all. Challenges to the return on investment may force some insurers to curtail some coverages to limit their risks.

To ensure that a carrier stays solvent, it cannot sell policies that could potentially result in more losses than the carrier can absorb. This creates a limit on the amount that an insurance company can cover in its total policies because underwriting capacity represents an insurer's ability to retain risk. The more risk that an insurance company assumes by underwriting new insurance policies, the more premiums it can collect and later invest.

When an insurer accepts additional hazards through the issuance of policies, it also increases the possibility of insolvency. Striking the right balance is essential to maintaining and improving the financial health of the insurer.

**A skewed mix of project types** can lead to more claims that challenge an insurer's viability. With a huge increase in federal government-sponsored projects, the increase in the size of infrastructure projects is likely to result in an increase in the remedial amount demanded in a claim. The larger the price tag for a project, the larger the remediation costs can be if something goes wrong.

The increase in complexity of publicly funded projects—that incorporates new energy, environmental and societal requirements—may also lead to an increase in disputes and professional liability claims.

In addition, overall government projects are increasingly a source of claims as the government attempts to protect taxpayers from cost overruns and deficient project performance. Because the scale of exposure to claims is dependent on the type of project and who is funding the project, design firms and their insurers have to take special care to assess appropriately the risks intrinsic in government funding.



## The bottom-line business of insurance

Most professional liability claims are a result of market conditions. As market conditions become increasingly difficult to anticipate, the cost of insurance has to include a calculation to accommodate the uncertainty that the design and construction industry and its insurers face.

Just as policyholders want a stable and responsive insurance program, so do insurance companies. However, recent conditions show that past historical norms can no longer guide insurance loss predictions. Claims

are taking longer to resolve, leading to higher demands by plaintiffs and increased defense costs.

In the professional liability insurance environment for those working in design/construction, claims cost more today than they did two years ago due to inflation, increases in costs of materials, labour and supply chain challenges. Insurers anticipate that this trend will continue.



# Managing exposure in a time of change

Architects, engineers and other design professionals should be especially prudent in their pursuit of projects—the client, the project type, the project location and the delivery system are now of even greater concern. The possibility of poorly timed value engineering; the need to perform additional services because of substitution requests and the likelihood of contractor demand for a change in the contract price or contract time (unless taken into account in the contract for construction), could ensnare the design team in prolonged litigation.

Demands for these professionals to design above code in order to meet climate volatility, government requirements for energy efficiency, environmental protection and social goals add a new level of business and professional risk.

Design firms must recognize their risks. Through their contracts and their internal procedures, they need to serve their clients and the public while remaining sustainable as a professional practice. Firms are encouraged to speak with their insurance brokers about the professional liability insurance options available to help them navigate during these disruptive times.

For more information about [Victor's Architects & Engineers Professional Liability](https://victorinsurance.ca/ae) program, visit: [victorinsurance.ca/ae](https://victorinsurance.ca/ae).





Visit us at [victorinsurance.ca](https://victorinsurance.ca) to learn more.

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