Howden Construction

Latent Defects Insurance



HOWDEN

Foreword

Latent Defects Insurance (LDI), also known as Inherent Defects Insurance (IDI), is one of the first classes of construction related insurance I had exposure to. At the time, the profile of the product was low and therefore many developers were not aware of the benefits.

However, in 2008, the Global Financial Crisis resulted in a significant increase in interest and demand for the product, with many developers, owners and banks worried about the warranties in place being susceptible to contractor liquidation.

In addition, some parties, being mainly property developers, were looking at more efficient ways to manage their working capital, with some leaving provisions on their balance sheet for defects in newly completed and leased properties. The product very quickly grew in prominence and its profile increased significantly.

We are grateful to have been at the forefront of the development of LDI since the beginning; from initially developing options for mixed-use developments, to looking at solutions for civil projects; taking the product to new markets such as the US and other parts of Europe (with help from our insurance partners), to developing a product for the PFI / PPP market on buildings already completed.

This paper provides an introduction to LDI, helps to demystify the product a little and highlights themes we will explore in future papers.

Naresh Dade Ba (Hons) FCII, CFIRM

Managing Director, Global Practice Leader
Howden Construction



What is a Latent Defects Policy?

In the standard form, Latent Defects Insurance (LDI) is a first party policy that covers physical loss or damage to a completed building caused by defects in design, materials or workmanship in the building's structural (load-bearing) elements where such defects were not discovered at practical completion. The cost of repairing water ingress as a result of defects in the waterproofing envelope is also covered after expiry of the contractor's defects liability period (usually 12 months).

The cover operates on a reinstatement basis, including professional fees, debris removal, and costs to comply with public authority requirements, and allows the owner or tenant to claim directly for any losses covered by the policy.

The policy will also respond if there is imminent threat of damage due to the same causes. It is not intended to cover issues normally insured under a property policy such as fire, lightning, flood and the like. Cover also applies for resultant damage to non-structural building elements.



Residential

In the residential sector, there is now a multitude of suppliers providing more traditional warranty options, either complementing or in direct competition with the National House Building Council (NHBC). These options comply with the UK Finance (formerly Council of Mortgage Lenders (CML)) requirements, allowing mortgages to be agreed on new dwellings.

Commercial

Latent Defects Insurance has become far more prevalent in the UK for commercial developments since it was introduced into the UK in the late 1980s and early 1990s. Many large purchasers/ tenants now expect to have the benefit of an LDI policy and therefore procurement of the cover can improve the marketability of a building for sale or let.

Cover options

Structural

The structural section of the policy provides cover for damage caused by any defects found in parts of the building that are critical to the stability and waterproofing of the structure, for example, the roof, walls, foundations and windows. In addition to structural cover, the following options are available:

01

Mechanical and Electrical Equipment

Long-term cover for building services equipment; for example, lifts, boilers and air conditioning systems. This option is becoming more popular.

02

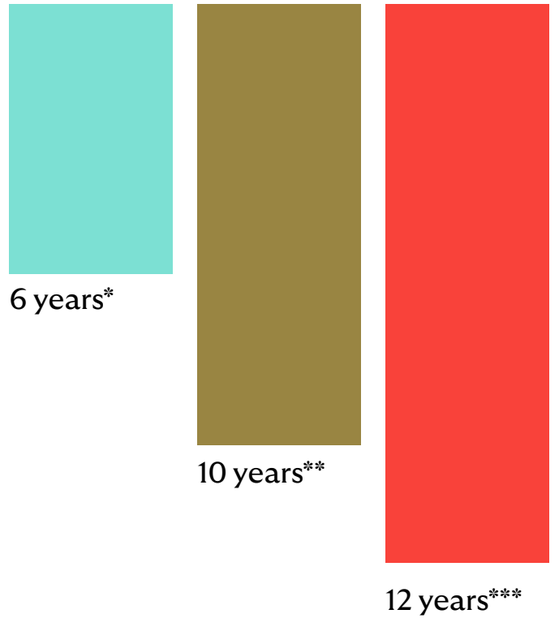
Business Interruption / Alternative Accommodation

Coverage for consequential losses arising from insured damage. This is normally related to loss of rental income or continued liability to pay rent, but other exposures can be considered such as the cost of utilising vzvvalternative accommodation.

03

Period

The cover periods available tend to be for 10 or 12 years post practical completion.



* Reflective of the limitation period where the contract is signed under hand

** Minimum period required by the UK Finance (formely CML) for new residential properties. This is also where the term Decennial comes from and what the cover is commonly known as outside of the UK i.e Decennial Insurance.

***Reflective of the limitation period if the contract is executed as a formal deed.

Who buys LDI?

Developer

The main buyers of LDI. They can pass costs onto future owners or tenants, and cover can be used as a marketing tool.

Receiver

In some scenarios, may purchase when the contractor is in liquidation and there is no recourse route.

Property owner

May purchase in order to protect their own interests. Useful if seeking tenant for buildings or selling on.

In some scenarios, may purchase if contractor has gone into receivership or of poor financial standing.

Contractor

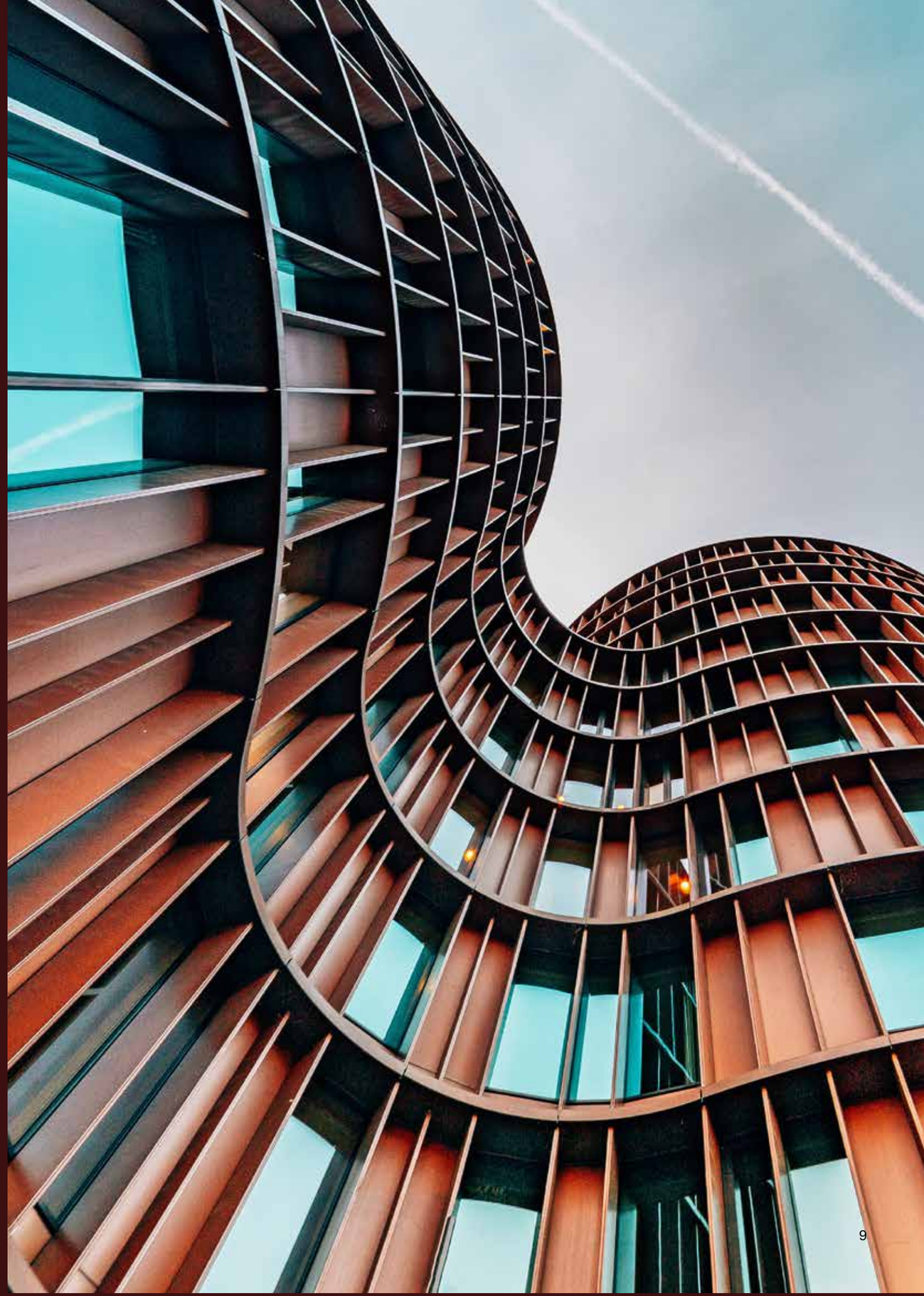
Little demand for cover apart from when associated with the developer and/or property owner.

Tenant

May purchase cover for similar reasons as property owner. Useful if taking on full repairing lease and tenant is concerned about major defects. High excess may be chosen.

PFI contractors

Have purchased primarily where existing structures have been involved and/or where purchase of such cover has eased financing or reduced borrowing costs.



Why buy the cover?

First Party Cover

A Latent Defects policy can mitigate the concerns and fears of owners, developers and tenants alike by providing them with a first party insurance solution that can be called upon to remedy damage caused by a defect and minimise disruption. The associated time delays and legal costs in proving fault or negligence are removed by having a first party cover in the form of a Latent Defects policy. To make a claim, an insured party does not need to prove negligence and needs only to show that the loss has arisen from a defect. We have seen an increase in interest from the lending community as a result.

Tenant or Funder Requirements

Many tenants will now insist on some cover being in place as a pre-condition of signing a lease on a new building. Similarly, funders will often require evidence that the cover is being arranged, particularly forward funders, who will ultimately own and use the developments.

Contractor Warranties/Insolvency

The traditional method to protect against post-completion problems is to obtain collateral warranties from the supply chain e.g. contractor and professional team. This does have value and many warranties will be wider in some respects than the LDI cover, particularly in scenarios where defects exist without damage, however the warranties do present some drawbacks. Limitations include:

01 Contractor / Sub-contractor insolvency

02 Difficulty, cost and length of time for successful legal action

03 Increasing use of liability caps in contracts

04 Limitations in availability of professional indemnity cover for the professional team

The insolvency of a main contractor can leave multiple gaps in protection. A Latent Defects policy allows the owner or tenant to claim directly for any losses covered by the policy.

Balance Sheet Protection

The main reason for buying the cover is to cover a gap in standard property insurance, where the majority of policies will not provide cover for inherent defects; or where they do provide any cover it is very limited in scope. The cover can also help relieve some of the liabilities typically reserved on the developer's balance sheet for defects post-construction.

What about my Contractor's or Designer's Professional Indemnity Policy?

A Professional Indemnity policy will only cover the relevant contractor's or designer's professional liability for their negligence in designing the works. It would not cover their liability for inadequate workmanship or materials.

More importantly, if the contractor or designer has become insolvent, their Professional Indemnity insurance will most likely have lapsed, limiting routes of recourse. This problem will have been compounded if the claim has not previously been notified when the Professional Indemnity cover was still in place.



Assignment of Cover/Onward Salability

The policy is freely assignable to future tenants or purchasers, meaning it can enhance their overall security and make for a more attractive lease or sale agreement. The cover can also help smooth the process of a sale or tenancy agreement, especially where there may be some concern over to the on-going security of the construction team; something we have seen following some contractor insolvencies.

Types of cover

01

Residential Warranties

There are now a variety of suppliers providing options for residential new builds. The driver for cover is primarily to ensure that a mortgage is available to buyers, as UK Finance (previously the Council of Mortgage Lenders (CML) will normally stipulate a 10 year cover post-completion before their members will offer a standard mortgage.

The common elements to most standard warranty products are outlined below:

- Many providers require compliance with a technical manual.
- Often, these will be based on building regulations, but care must be taken to ensure compliance with the manual itself, especially as the technical requirements can change over the period of construction.
- Typically a 24 month defects liability period is required, during which the developer is responsible for defects himself, with the insurance only paying if the developer defaults. Full cover therefore normally starts in year 3, something developers must take note of.
- Counter indemnities are normally required from the contractor and developer for certain areas of cover, notably contractor insolvency, loss of deposits and defects liability period cover.
- Standard cover is for the householder themselves and no cover applies for the developer.

02

Mixed Use Options

Some providers have more flexibility in their residential options, which can provide better cover for the interests of developers and mixed-use projects by:

- Offering shorter defects insurance period requirements i.e. 0, 12 or 24 months defects liability.
- Covering the interests of other parties such as the freeholder, lenders and the original developer.
- Avoiding prescriptive technical manual requirements.
- Offering capacity for major projects of GBP100 million and above.

For major projects, these offer a better blend of risk protection and value than the standard options.

03

Build to rent

Build to Rent (BTR) projects are new build developments designed specifically for renting. They come with a range of perks from longer tenancies to a dedicated on-site manager and purpose-built communal spaces, as well as a premium price tag. Savills reported that over $1.2bn was invested in the UK BTR sector in the first quarter of 2021, making it the highest first quarter on record.

As the dwellings are not being leased and not sold, there is no UK Finance requirement for the developer / contractor to provide a housing warranty, as they would need to do for any new build dwelling being sold. That being said, there are still a number of BTR developers and investors who are buying Latent Defects cover on their developments for the reasons detailed earlier in this paper. In addition, it can add flexibility to the development,

as some insurers allow for the cover to be converted to residential warranties should there be a desire to sell individual units in the first 10 years.





04

Product development

Latent Defects cover for civil engineering structures, such as bridges and tunnels, is available from major insurers and reinsurers and is gathering momentum in certain areas of the world, though this has not yet generally been the case in the UK.

Cover options are also available for owners of asset portfolios and secondary infrastructure funds, where there are variations available, which can assist balance sheet protection and potentially also release funds tied up for lifecycle or handback purposes.

Whilst cover has not been traditionally available for existing structures and completed buildings, there are various insurers who will consider offering cover, subject to the specific circumstances and the correct information being provided. We will discuss these topics further in future papers.

Process of buying cover

The process of arranging Latent Defects Insurance has been simplified and summarised below. In some instances, you will also want to seek advice on making changes to the construction contract to reflect any of the obligations of the contractor and to ensure the relevant site access is available. It is also important that all stakeholders understand the role of the Technical Inspection Service (TIS).



For example

	1 Design phase	2 Construction phase	3 Practical Completion	
Client	Provide underwriting information (General arrangement drawings, sum insured, ground report)	Notify eventual construction changes	Provide completion certificates, confirm final construction costs	The IDI Cover protects your investment for 12 years
		Start of construction	End of construction	Policy issue
Insurer	Review information provided & submit quotation TIS appointment TIS risk appraisal report	Review information provided & submit quotation TIS site inspections from start of works	Confirm conditions, adjust premium on final construction cost & issue policy TIS final report	

Procurement process timeline

12 year IDI cover

Technical audit

The policy is subject to a satisfactory technical audit throughout the construction process, which is why the cover needs to be arranged prior to the start of any major works. Cover is not impossible to arrange after this date, but enhanced rates and / or restrictions on coverage may apply. The audit involves regular reviews of the construction to date and identification of potential areas that need to be rectified prior to completion.

The purpose of this audit is to try to prevent defective construction, which may be detected by an independent specialist employed specifically for that purpose. The technical auditor's role is solely to try to prevent a claim occurring. Their function is to confirm to insurers that, to the best of their knowledge, the building does not present any known defect in design or construction. If they are concerned with any particular issue they will assess the problem with the proposer's nominated representative on site.



Examples of issues that may be highlighted on site:

01 Poor reinforcement placement in a floor slab

02 Inadequate reinforcement specified Absence of wall ties

03 Lack of movement joints

04 Unrestrained columns

05 Inadequate fixing of facade to structure

06 Roof membrane laid incorrectly

If, at completion, the technical auditor considers the building or structure to have been built to the appropriate standard, and complies with the approved drawings and agreed specification, they will then issue the a certificate of approval or acceptance and confirm to the insurer that the building is suitable for LDI coverage.

We have recent experience where this process is thought to have allowed for a better build overall. Clients have valued the early identification of defects, and the attention paid to the rectification of them prior to the completion of the project; allowing for a better product overall.

Common claims

Examples of the types of claim:

01 Defectively designed floor slabs allowing movement and consequent damage to floors and walls

02 Omission of wind posts allowing damage to the walls

03 Subsidence causing damage to the walls

04 Defective cladding allowing water to penetrate

05 Failure of basement tanking allowing water to penetrate

06 Defective roofing allowing water to penetrate

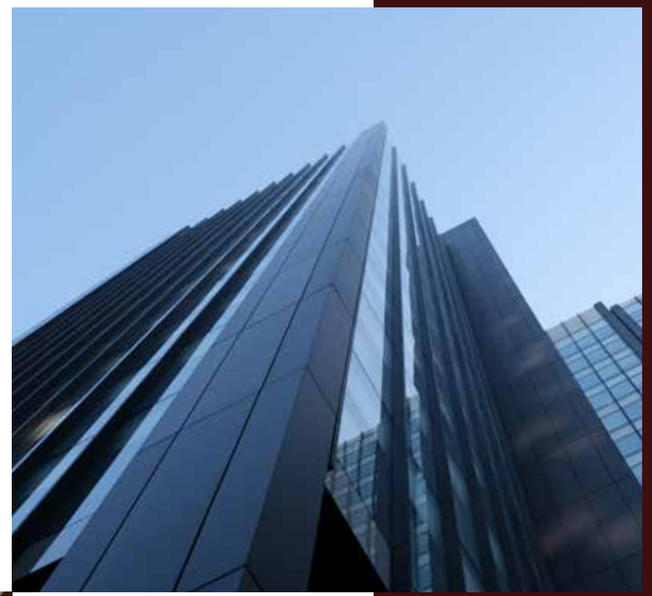
07 Failure of rain screen allowing water to penetrate

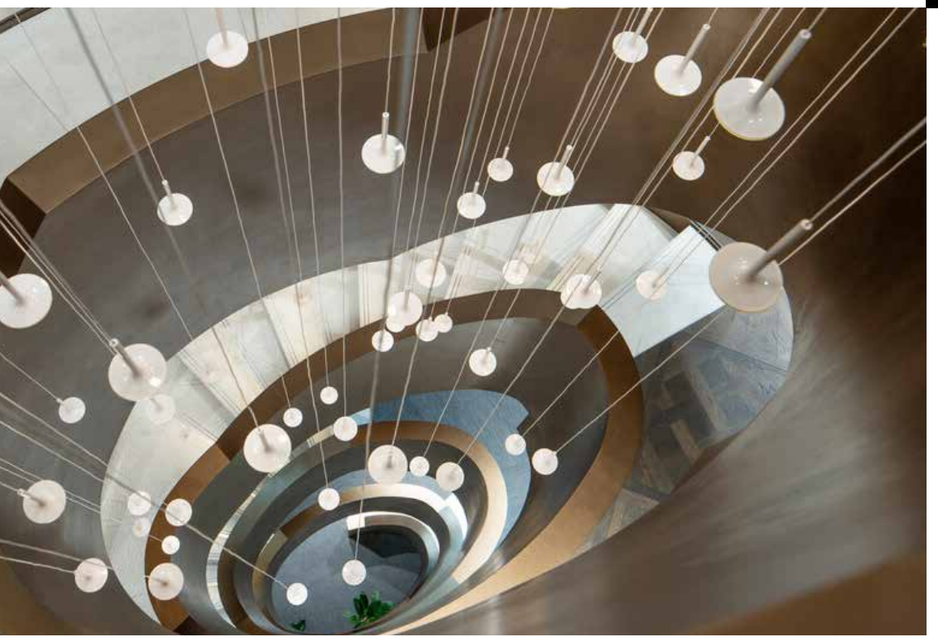
08 Poorly fitting windows allowing water to penetrate



About us

Latent Defects cover is now a key area for all developers and most major building projects will need to consider this. It is important to understand that not all products offer the same protection and better value can be obtained in some cases by careful selection of the warranty or insurance partner chosen. We have a deep knowledge of this within the team together, with a proven ability to innovate. This is a key area where we can add value to projects.





Our experience

Our team has been involved in some of the largest commercial and residential LDI policies in the UK and have been at the forefront of the market for over 20 years. We have extensive knowledge of the Latent Defects insurance market and have experience placing policies for a wide range of construction projects.

$6bn+

Total value

50+

Projects in excess of £100m*

Including...

- Office Buildings
- Shopping Centres
- Residential

* Experience highlighted is that of the actual individuals within our team.

Our Howden contacts



Andrew Birt

Executive Director and Head of UK Projects
+44 (0) 78 0385 1425
Andrew.Birt@howdenspecialty.com



David Lyle

Executive Director Construction and Infrastructure
+44 (0) 75 4883 8841
David.Lyle@howdenspecialty.com



Lizzie Conolly

Associate Director, Construction and Infrastructure Assets
+44 (0) 75 2390 8649
Lizzie.Conolly@Howdenspecialty.com



Georgie Fielder

Associate Director
+44 (0)7821 664700
georgie.fielder@howdenspecialty.com



Jessica Lee

Associate Director
+44 (0) 7133 1233
jessica.lee@howdenspecialty.com



One Creechurch Place, London, EC3A 5AF

T +44 (0)20 7623 3806
F +44 (0)20 7623 3807
E info@howdengroup.com

howdenbroking.com

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