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Build to rent: Risks for property owners and developers

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What are the critical considerations for owners and developers moving into this sector?

Build to rent (BTR) is changing the nature of urban living. Driven by the paucity of affordable city centre apartments, high-standard residential developments are springing up across the UK. They are catering for people who can no longer afford to buy in affluent urban centres, but are seeking vibrant locations, with excellent transport links, and that are a short distance from amenities such as theatres, cinemas, restaurants, parks, and other leisure facilities. Developments are also increasingly popular with people who work away from home during the week and are looking for flexible rental options. An emerging trend for BTR homes is for single family houses in suburban areas.

Between Q3 2020 and Q3 2021, the number of UK BTR developments coming to the market increased by 26%, from 50,798 completions, up to 63,950. And by 2025, purpose-built rented accommodation in the UK will reportedly be worth £146 billion, a huge increase from the £87.3 billion recorded by the sector in 2019.

Such builds might seem like any other development on the face of it, but insurance issues become more complex due to the multiple stakeholders involved.

WHO IS INVESTING IN BTR?

Some developers build for themselves, as a means of creating income and to smooth dips in sales activity. However, rental apartments tend to attract institutional investors, such as banks and pension funds, looking for investments that generate long-term income. Overseas investors are also entering the UK market.

Social housing providers and local authorities are significant investors in BTR properties as well. However, their primary purpose is to provide affordable accommodation, not just a return on the investment.

Complexities of BTR projects

CONTRACTUAL AND COMMERCIAL ISSUES

Complexities can occur when a developer wishes to sell the BTR project on to, say, a bank or a pension fund. They may enter into a development agreement, such as a forward purchase deal, where the owners/investors provide cash up front as a deposit to cover the cost of the build and will settle any remaining balance when the project is completed.

From an insurance perspective, the developer engages a construction insurance broker who will then have to deal with the requirements of the future owner, which may include funding requirements. For instance, the future owner might request to be a named insured or a first-loss payee, or even want a say on which insurers are used to cover the construction risks.

This also brings into question the risk of delay in completion. If the development is delayed, how does the developer cover its exposure to liquidated damages owed to the investor?

The developer should consider whether any penalties can be covered by delay in start-up (DSU) insurance, but it is important to remember the market will only offer cover resulting from physical damage to works.

CONSTRUCTION RISK AND INSURANCE CONSIDERATIONS

Developers and owners need a BTR project to be completed as efficiently and to as high a standard as possible in order to optimise income. Mitigating construction risks should help reduce the risk of delay and lessen the chance of expensive claims.

Protecting against key project risks

Traditionally, developers have believed that insuring a build’s risks is the job of the contractors undertaking work on the project. While contractors all risks (CAR) and third party liability (TPL) cover might be obtained by contractors, there is the danger that there could be gaps in coverage in some areas and over-insurance in others, both of which would be borne by the developer or owner indirectly through the contract price.

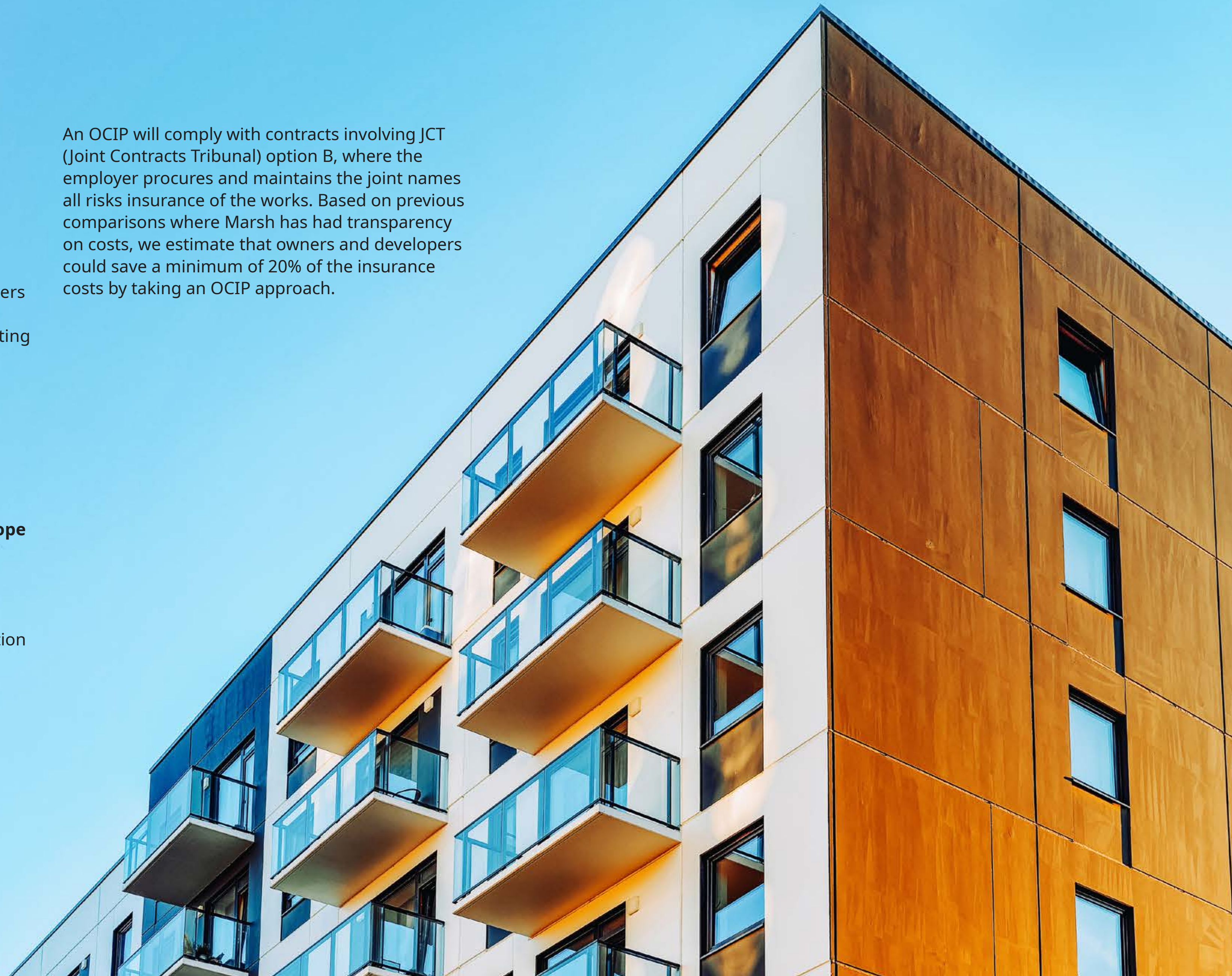
Furthermore, certain insurance, such as DSU, cannot be taken out by a contractor.

Developers should consider taking out an owner-controlled insurance programme (OCIP), a single insurance plan that lasts for the duration of the project, and is designed to cover nearly all liability arising from it. The covers typically included in an OCIP are CAR, TPL, DSU, and non-negligent liability. Ancillary coverage can include: terrorism, contractual liability, weather delays, construction pollution liability, and legal indemnities.

By procuring an OCIP, developers can benefit in the following ways:

- **Fills the gaps in a contractor-arranged insurance policy** insuring against risks not catered for (including DSU).
- **Reduces the administrative burden of insurance** through a tailored policy that covers all of the appropriate parties working on a project for the period of the project, eliminating the need to verify renewal of any annual insurance traditionally relied upon by the contractor.
- **Enables the employer to maintain cover** even if the contractor becomes insolvent or the employer replaces a contractor for poor performance.
- **Provides total control of the premium, scope of cover, and claims management**, which helps satisfy the requirements of financiers, simplifies the claims process, and delivers transparent premiums, as the owner is not reliant on the contractor taking out construction insurance and then charging additional administrative fees.

An OCIP will comply with contracts involving JCT (Joint Contracts Tribunal) option B, where the employer procures and maintains the joint names all risks insurance of the works. Based on previous comparisons where Marsh has had transparency on costs, we estimate that owners and developers could save a minimum of 20% of the insurance costs by taking an OCIP approach.



Read more: Refurbishment

Many BTR developments consist of refurbishments of existing premises. For a developer embarking on a BTR refurbishment project, an OCIP will also be the most appropriate solution, as it may be the best way to comply with JCT Insurance Option C – Alteration to Existing Structures.

OCIPs

Find out more about how owners and developers can benefit from an OCIP in our paper, Improving construction cover with an owner controlled insurance programme (OCIP).

Read more: Tall towers risks

BTR developments are often apartment blocks, so risks related to tall towers must be taken into consideration. Damage and delay are two of the key construction risks that increase during tall tower construction. The escape of water is responsible for some of the largest UK construction claims, and combined with the possibility of fire, both represent significant risk to a project's practical completion date. Either one of these events has the potential to cause severe damage to the work. Risk is multiplied in a tall tower due to the high concentration of value in a single structure.

Tall towers risks

For more information about risk and insurance issues related to tall towers, download our paper, Sky high risk, the impact of increasing tall tower construction

Right to light

Risks particular to tall tower BTR projects include 'right to light' disputes. A right to light is an easement that gives a landowner the right to received light through defined apertures in buildings on their land. As buildings get taller, developers face the increased chance of litigation. The construction of a tower can often result in the overshadowing of neighbouring buildings, restricting their access to light. For property developers, this potentially means an increase in court costs and project delays, alongside loss of value and revenue due to compensation costs.

Right to light cover can be purchased to cover individual developments. It provides protection to developers and funders from financial losses, and the benefit passes on to successive owners of the property and their mortgagees.

Terrorism risks

Five out of 10 of the costliest terrorism events in the world have occurred in the UK. Construction sites are vulnerable as they can be targeted by individuals and groups aiming to cause disruption and threaten economic growth.

Developers need to consider security measures to protect both people and property. Banks and investors will be looking to protect their investment — typically, the contract between all project parties requires terrorism cover. This can be via JCT contracts or similar construction contracts, or even funding or development agreements with third parties.

Modern methods of construction (MMC)

The use of MMC — non-standard techniques and materials, such as modular build (for example, bathroom and kitchen pods, or even whole house/apartment designs) and the use of mass timber construction — is increasing in residential projects.

Construction companies are utilising MMC for its ability to speed up construction and deliver greater environmental and social sustainability benefits. There is also the potential for improved quality, due to whole sections of a building being constructed to exact specifications in a factory environment.

However, currently, the use of MMC brings risk and insurance issues. No two residential developments are the same, and careful thought needs to be given when adapting modules to meet the requirements of each project. Marsh has found that many underwriters are wary of covering techniques and materials that can be considered prototypical. In addition, with modular construction comes the risk of repeat defects, and insurers may look to limit their exposure by applying a 'series loss' clause.

Proximity to third parties

As stated at the beginning of this paper, BTR developments tend to be built in urban locations. Projects often involve working within constrained building sites, in densely populated areas. Risks to people, neighbouring properties, and businesses are heightened during construction. Therefore, consideration needs to be given to TPL and non-negligence liability limits of indemnity.

A significant event, such as a large fire or even a tower crane collapsing, could cause enormous third-party property damage, injury, death, and direct financial loss. Because of this risk, we are seeing clients wanting to buy significant levels of cover. For example, it is common within city centre locations for clients to buy in excess of £100 million in cover. That being the case, several factors need to be kept in mind with regards to third-party risk. They include the fact that litigation costs need to be considered in the insurance limits purchased. Plus, any claim that settles above the limit purchased becomes a balance sheet risk.

Exposure to rail and other infrastructure

Urban developments bring risk and insurance issues beyond TPL. The city centre location of most BTR projects, plus tenants' desire for easily accessible transport links, means many builds are close to railway lines and stations. This situation can make projects more expensive and complex to deliver.

Construction near transport infrastructure involves significant contractual non-damage financial loss liabilities that may not be covered by standard TPL insurance policies. At the heart of the issue are asset protection agreements, a standard element of contracts between developers and infrastructure owners.

If the rail infrastructure is made unavailable by building work, developers may have to pay damages to the relevant train operating companies (even if there is no physical damage to the rail infrastructure), and these can add up to more than £5 million a day for busier routes. Indeed, for asset protection agreements with Network Rail, the minimum TPL cover involved is £155 million.

Coverage can be difficult — and expensive — to obtain; this could leave developers facing huge uninsured liabilities. For more information, specialist advice should be sought from a construction insurance broker.

Latent defects insurance (LDI) and new homes warranties (NHW)

At the beginning of this paper, we listed the types of investors involved in BTR projects. However, if a developer/owner does not intend to sell a project on, there is less of a demand driven by future ownership requirements to purchase either LDI (which covers inherent defects in design, workmanship, or materials resulting in physical loss or damage in whole developments) or NHWs (10-or 12-year insurance policies for newly built or converted properties that protect buyers from structural defects and cover each home within a development).

Some developers purchase LDI so they can pass on the insurance coverage in case they decide to sell the entire or sections of the development. They might also purchase NHWs to cover themselves for the possibility that the BTR market becomes more competitive, and they get less of a return, thereby making more commercial sense to sell the apartments rather than rent them out.

The question for the developer is that if they want to procure LDI, do they purchase NHWs too? Sometimes the decision is made for them, as lenders will insist on NHWs, so that if the lender has to take over the building, they will be able to sell the apartments themselves.

Currently, residential developments must include affordable housing. If this housing forms part of the development (rather than being in its own separate block), then both NHWs and LDI would be required.

It should be noted that an owner might want to provide input into what latent defects insurance is bought. Furthermore, the marketplace for LDI and NHWs is very limited. A construction insurance broker can help to provide quotations and advice in order to select the right approach for a development. Early engagement is essential for this cover in order to set in place a technical inspection programme for the duration of the build, as required by an LDI insurer prior to inception of the policy at practical completion.

ENGAGE WITH A SPECIALIST CONSTRUCTION INSURANCE BROKER

To gain optimum terms in the current challenging insurance market, it is more important than ever to talk to a broker early in the construction process. During a challenging market phase, insurers will require more detailed evidence of a company's risk management processes, even more so if the BTR project utilises MMC or requires consideration of complex commercial agreements that may involve banks, investors, and/or proximity to rail infrastructure. The information-gathering process will take longer, as will the time taken to prepare presentations for the market.

By engaging with a construction insurance broker early in the process, developers give themselves the time to compile and present underwriting submissions that elicit the optimum response from the market, while allowing the broker the opportunity to leverage the trusted relationships they have built with construction insurance underwriters.

CONTACTS

For more information, please contact:

Craig Charles
Senior Vice President
Client Executive, UK Construction
Infrastructure & Surety Practice
Marsh Specialty

+44 (0) 20 7357 5719
+44 (0) 7585 803 405
craig.charles@marsh.com

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