UK INSURANCE MARKET COST OUTLOOK Q2/2022

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In Q2 2022 the UK experienced significant upward inflationary pressures. These are influenced by rising oil and gas prices and associated energy prices, sharp increases in critical construction materials, and ongoing labour skills shortages that are at least partly attributable to Brexit. The Ukraine conflict is compounding the situation.

Pricing volatility is likely to continue through 2022's Q3, with a potential easing towards the end of the year. However, supply-chain disruption is likely to continue to be a key driver of insurers' rising claims costs, which are affected by uncertainty within the UK construction market. Issues that were initially brought on by Brexit and COVID-19 have become more complex. Ultimately, demand is outweighing supply in several sectors. This is impacting the insurance industry with repair costs increasing and supply chain pressures prolonging lead-in time for replacement equipment and materials.

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MARKET SNAPSHOT

- CPI ▲9.1%
- UK Unemployment down to ▽3.8%
- War in Ukraine impact on Commodities
- Removal of Red Diesel Rebate
- Metal Price Rises (2021 - 2022) ▲16%
- UK Economy Expanded ▲0.8%
- Forecast construction Labour needed to meet output 2022-26 ▲266,000
- Forecast Inflation ▲10%
- Stagflation Looms for UK Economy
- UK Base Interest Rate ▲1.25%
- All Work Material Price Index ▲ 24.5%
- UK Construction Output ▲3.8%
- Major changes to Building Regulations

GDP - Gross Domestic Product
CPI - Consumer Price Index
TPI - Tender Price Index
Stagflation—BoE forecast potential persistent high inflation and slow or stagnant growth

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Introduction

With lingering impacts from Brexit and Covid-19, surging energy costs and the Ukraine conflict, the UK is facing inflationary pressures.

Sanctions, and Russia's retaliatory measures, have created volatility. We also observe:

- Commodity prices increasing,
- Record rises in fuel and energy prices,
- The removal of the red diesel rebate,
- Increased unit prices and rates for labour (skilled and unskilled) and materials, which are pushing tender prices higher.

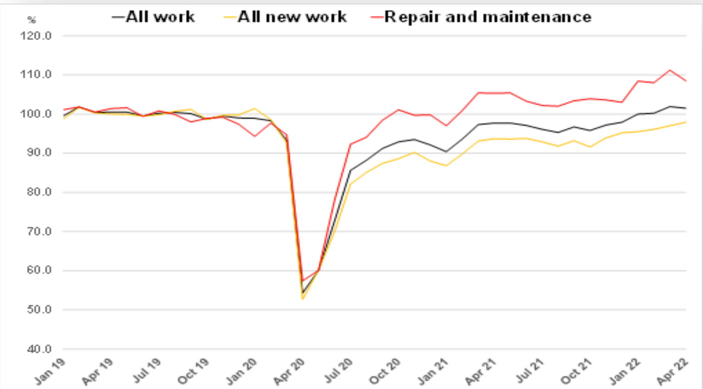
The Consumer Prices Index (CPI) rose by ***9.1%*** in the 12 months to May 2022, up from ***9.0%*** in April. This is the highest CPI 12-month inflation rate in the National Statistic series, which began in January 1997.[i]

With rising inflation and slowing growth, the UK is potentially heading towards recession: this may be due to reduced consumer spending and potentially the Bank of England raising interest rates.

Construction Output

Construction had an encouraging start to 2022. In Q1, output grew ***3.8%***, driving up the size of the industry to a new high. [ii] Overall, all construction sectors grew; the sharpest growth was observed in private industrial, housing, repair, and maintenance. Public non-housing and infrastructure were the only other sectors to retract in Q1.

Figure 1: ONS Construction Output April 2022



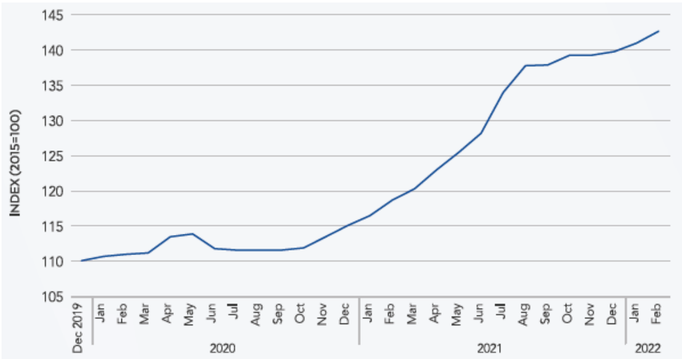
Increase repair and maintenance work was a key driver of output growth, influenced by adverse weather in February (Storm Dudley / Eunice), with a ***13%*** year-on-year increase highlighting the growth in this area and possible risk exposure to insurers. [iii]

Material Prices

During 2021 and Q1 2022, material shortages were already on the rise due to Brexit. The Ukraine conflict has caused sharper increases: in Q1 and Q2 the Building Cost Information Service (BCIS) Materials Cost Index has increased at rates not seen since the 1980s.

In March, the Department for Business, Energy and Industrial Strategy (BEIS) 'All Work Construction Material Price Index' rose **5%** month-on-month with a cumulative increase of **25%** in the year to date. [iv]

Figure 2: BEIS 'All Work Construction Material Price Index



In June the Construction Leadership Council (CLC) reported inflation of around **23%** for construction products and materials over 2022's Q1 and Q2. [v]

According to a BEIS report nineteen of the twenty-nine materials tracked have risen by more than ***10%.*** With increases in steel, timber and rebar all above ***25%.*** [Vi]

Figure 3: BEIS Key Material increase year – on - year in % terms

Price Adjustment Formulae Indices (PAFI), Series 4 Civil Engineering and related Specialist Engineering, also show annual increases to April 2022 of more than ***25%*** per Fig. 4: [Vii]

Figure 4. Material Annual & Increases.

Material	% Annual increase
Aluminium products	43.2 %
Pre-cast Concrete Structural Components	36.2 %
Lifts and escalator materials	29.0 %
Metal structures	26.7 %

The growth of PAFI Gas Oil (Diesel in Construction) showed an annual increase of ***175.3%*** to April 2022, incorporating both increases in the price of oil as well as a one-off percentage uplift of ***40%*** applied to reflect the removal of the Red Diesel rebate.

British Steel announced recent increases on all new orders:

- March 2022: ***£250/tonne***, and

- Early April 2022: a further ***£100 / tonne***, an estimated **25%** increase. [Viii]

For the near future valuing materials will remain a challenging environment for risk managers due to market volatility.

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Labour

In the first five months of the year, unemployment fell from ***4.1%*** to ***3.8%.*** There are now more jobs than people unemployed, with concomitant increasing labour costs. [ix]

Construction vacancies are at record highs. The Office of National Statistics (ONS) June figures show average weekly earnings in the construction sector increased ***7.6%*** in February to April, the highest monthly growth since Q3 2021.

According to the CPI, inflation in April was ***7.8%***. ONS' June data indicated that in the UK economy basic pay fell by ***2.2%*** in real terms, while total pay - including bonuses - rose ***0.4%.***

In April, the rise in Employers' National Insurance contributions (to 15.08%) also fuelled labour cost increases. [x] In May, the Construction Industry Training Board (CITB) forecast that that the industry needs to add ***266,000*** extra workers to meet the UK construction output forecast 2022-2026. [xi]

Tender Prices

In May material price inflation was higher than expected, with the effect that tender prices are likely to continue to increase. Early estimates from the (BCIS) shows a ***1.5%*** increase between Q4 2021 and Q1 2022. The Q1 2022 Tender Panel Price Index (TPI) shows an increase of ***6.5%*** in the year from Q1 2021.

In recent weeks leading construction consultancies have raised their forecast annual tender price increases between ***8%*** and ***9%*** with the expectation it may reach double figures by the end of 2022.

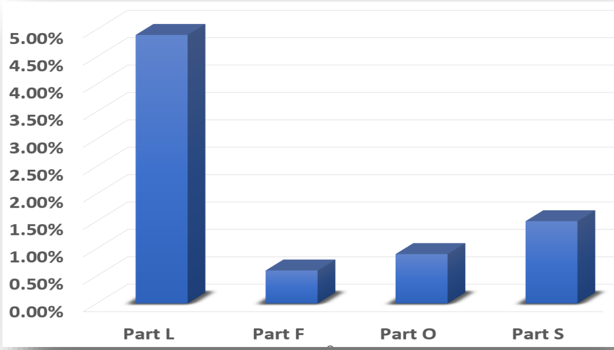
According to the BCIS Tender Panel, stakeholders were requiring more time to tender, due to difficulties in securing prices from suppliers. Contractors are finding it difficult to secure price commitments from supply chains leaving the question as to who assumes this pricing risk.

Volatility in the current market is causing contractors to become reluctant to supply fixed-price tenders; some are avoiding fixed-priced projects.

The Construction Products Association noted ongoing inflation was now forcing contractors to ask for additional clauses to be inserted into contracts.

Changes to ***Part L*** of the Building Regulations (which relate to efficient use of fuel and power in new buildings and a major step in the UK Government's drive to become carbon neutral.) are likely to impact housebuilders. A recent Federation of Master Builders survey indicated that ***52%*** of builders surveyed were not prepared for the changes. A recent BCIS Survey showed the estimated average additional cost to meet the new requirements is ***4.9%.*** [xiii]

Figure 4. Shows BCIS Estimate average cost increase

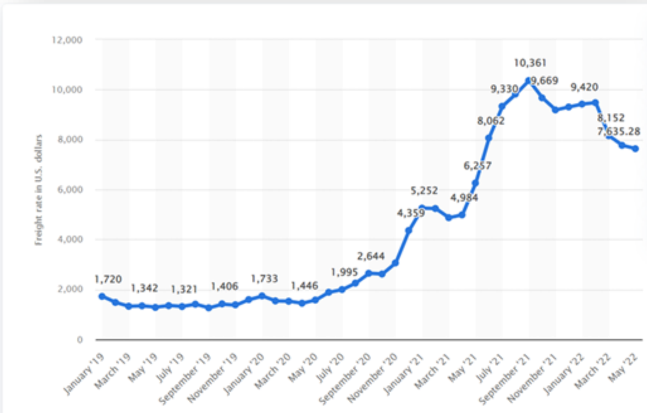


Supply Chain

Supply chain complexity and the residual impacts of Brexit and Covid-19 have been compounded by the Ukraine conflict. According to a recent Global industry survey report ***c.94%*** of respondents indicated lead-in times had increased. [xiv]

Average shipping costs have increased dramatically by ***c.450%*** since January 2019 and due to unprecedented levels of disruption caused by Brexit, the pandemic, and the Ukraine conflict, traditional 'just-in-time' delivery models have now changed to 'just-in-case' delivery models in attempt to reduce risk and build resilience. [Xv]

Figure 5. Shows Global Container freight cost Index '22, Statista. [xvi]



Impact on Insurers

For insurers with UK exposures, the impact and volatility of inflation, construction costs, material and skilled labour shortages and longer lead times makes valuing values at risk and potential loss scenarios challenging: what was accurate just three (3) months ago, may no longer be. Keeping abreast of market rates is imperative when assessing risk and claims exposures.

With supply chains under pressure from material supply shortages, congestion and delays in shipping and skilled labour shortages, impacts are also affecting post-loss reinstatement costs .

There is also a certain inevitability that, in line with inflation, claims values are likely to increase . In common with other regions, what may not be fully appreciated is that longer re-instatement periods may have a greater financial impact on insurers than labour or material unit price increases. Longer periods affect physical damage claims as well as time-element exposures such as business interruption or delay in start-up (DSU).

With increased uncertainty on project pricing, there is increased use of fluctuation clauses and amendments in contracts. There is a risk that projects may be under insured. With so many variables and volatility affecting insurers' reserving and reinstatement exposures, a proactive and expert-led approach to claims' assessment is vital.

A LOOK AHEAD... The next 12 months

With Brexit and on-going supply chain backlogs, for Q3 2022 there is a broad consensus that we are likely to still see further price increases in materials, again most likely with energy intensive processes such steelwork, aluminium and concrete. Energy prices are likely to continue to increase beyond Q3, as we get to the UK's Winter period,

Continued stretched lead times are also likely to remain a concern in Q3 and beyond, as there do not appear to be any quick fixes. Labour shortages will also continue to be a challenge for 2022 and indeed may worsen in the coming quarters.

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Source Reference

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xi) CITB, UK Construction is set for a new era of skills demand and job opportunities report, pg.6
xii) Statista, Global Container Freight Index https://www.statista.com/statistics/1250636/global-container-freight-index/
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