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Adequacy of Sum Insured

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1 Executive Summary

This paper discusses the aspects of the Adequacy of the Sum Insured of project risks by comparing the theory with the underwriting reality. It highlights the importance of establishing the correct basis for the premium calculation and the management of exposures. The paper also addresses the challenges in determining the adequate Sum Insured of project risks and critically reviews the practical application of certain clauses in policy wordings. Several considerations to identify potential areas of concern and to support the underwriter in his daily work are concluding the paper.

2 Introduction

The main product of the insurance industry is the promise to settle legitimate claims fair and quickly. This product is manufactured in a process called “underwriting” which attempts to identify and assess the main exposure elements of the object to be insured. This assessment, combined with the insurance cover required results in a policy (i.e. our promise printed on paper). The price tag of this promise is called premium.

Many of the pricing tools used in the industry define the premium as a percentage rate to be applied on the Sum Insured. Depending on the tool in use, the specific nature of the risk and the various cover extensions can be assessed and priced meticulously. Rebate and loading factors are used to modify the rate which is then further revised in the bidding process to ultimately become the “final rate”.

It is very obvious that the “rate” gets a lot of attention and is one of the most important factors (if not THE most important one) to sell the promise. Competitors will blame each other for undercutting “rates” – but do we actually invest enough effort to assess the “number” (also known as the Sum Insured) on which the rate is applied and which pretty much forms the basis for all that follows (from premium calculation, risk- and exposure management to claims payment)? And what are the effects of getting this number wrong? Are the clauses we use in our policy forms to cater for the variations of the Sum Insured in the course of the execution of the project helpful in achieving the underwriting intent?

The purpose of this paper is to discuss the importance of the adequacy of the Sum Insured, to highlight the difficulties in determining it correctly, to check whether our policy wordings are suitable to address the specific issues encountered in the insurance of construction projects – as well as to challenge a few dogmas and myths by attempting to answer some of the questions raised above.

We will start with a very short description of “the theory” (really very short - so please read on) and also refer to sources which provide much more detailed comments about the topic for those who want to dive deeper (which we would recommend to do).

We will then focus on the gaps that may exist between theory and reality and will do this by stating a few challenges – and explain why we believe there are a few of them in the daily work of an underwriter.

The conclusions we draw will hopefully contribute to raising the awareness not only in determining the adequacy of the Sum Insured but of the underwriting process – including the famous UW judgement - in general.

The paper will mainly deal with the adequacy of the Sum Insured of project risks (CAR/EAR). Clearly, the relevance of getting the Sum Insured right for operational covers is equally important. But the challenges in the insurance of project risks are probably more complex than in operational covers – and some of our findings may be equally applied there.

3 The theory

Let's briefly recap the most important elements in determining the Sum Insured and what they are used for.

Calculation of the Sum Insured – For a CAR/EAR policy, it is typical for the Sum Insured to represent the amount (or “price”) that the Owner will pay to the Contractor(s) undertaking the Works. Where there are separate design- or construction related consultancy contracts awarded by the Owner, then these should also be included within the declared amount. However, there are often various other costs incurred by the Owner (such as land acquisition and financing costs) that may be considered as “non-recurring” costs and therefore not forming part of any subsequent claim for repair, replacement or reinstatement of the Works that may become damaged. Almost without exception, the Sum Insured is provided by the Owner or their Contractor(s) to the broker and in turn the broker provides that information to the insurers/reinsurers. If in any doubt, the broker and/or insurer/reinsurer should seek clarification as to any amounts that may have been deducted and make clear to the policy holder that, unless agreed otherwise, such elements deducted from the amount insured would not be then be recoverable as part of an indemnifiable loss under the policy. In general, it is fair to say the accuracy and indeed adequacy of the sum insured is initially very much dependent upon figures provided by the Owner and/or Contractor(s).

Some forms of contract conditions require the CAR/EAR insurance Sum Insured to represent the contract amount **plus** an additional allowance for debris removal and Professional Fees (typically 5-10% of contract amount). In some cases there are also materials or equipment that may be provided by the Owner and, unless already included in the Sum Insured, these are typically known as “free issue materials”. An amount representing the replacement cost of such material or equipment should therefore be added to the Sum Insured. The importance of all of this is because the policy premium is ultimately calculated and adjustable on the contract sum or “price”.

There are of course a number of variables that should also be considered when initially agreeing upon a Sum Insured and perhaps the most relevant of these are as follows:-

- Selection by the insured of a “first loss” or “loss limit” Sum Insured, rather than insuring the total contract sum. This approach is more common in some geographies (e.g. the USA) than others but would typically be used when the project is linear and spread over a significant distance (e.g. a road or rail project) or when the contract sum is huge and the PML assessment is a very much lower amount. However, such an approach to the Sum Insured by the policy holder is often dependent upon approval of such parties as the project financiers and indeed may require an addendum to the Construction Contract, which would typically otherwise require the insured amount to represent the full contract sum.
- Longer period contracts very often have an agreed sum at inception but with allowances for inflationary increases based upon various indices. In such

circumstances it is perhaps usual for the Sum Insured to represent the agreed amount at inception and then the final sum as declared at the completion of the contract would include the application of such inflationary increases during the contract period.

- Taxes and particularly value added tax (or its equivalent) should also be considered when setting the Sum Insured. Typically the insured would be able to recover the VAT from the Government and therefore not include an allowance for it in the Sum Insured. In the event of a claim insurers would not expect to pay VAT if it was not included in the Sum Insured and therefore premium computation – and of course the insured should not be in a position to recover VAT both from insurers and the Government.
- Many contract amounts contain significant sums for “contingents”. These can include such things as measures to overcome unexpected ground conditions, variations in cost of labour, material, fuel etc. and any number of other unknowns or possible variables that may significantly impact the actual final cost of construction. It is debatable whether these “contingents” should be included in the Sum Insured at inception or simply added during the course of the project when actually incurred, or simply declared as part of the final contract sum/price upon completion of the project. In extreme examples, the “contingents” amount can represent over 30% of the provisionally estimated total contract sum at project commencement.
- Under many policy wordings such things as debris removal, expediting expenses etc. are payable in **addition** to the Sum Insured whereas in others they are included within the Sum Insured. The basis of policy indemnity in this respect needs to be considered by both the insured and the insurers/reinsurers when setting the Sum Insured and calculating the premium respectively.

It is appropriate to note that the policy premium is normally arrived at by applying the agreed rate to what is normally referred to as “final contract price”, the provisionally estimated figure being used for calculation of the deposit premium and then with the insured declaring the actual final contract price upon project completion. In the past it was perhaps more typical for the word “value” rather than “price” to be used in this context, but in reality it is difficult if not impossible to accurately calculate the “value” of the works.

Adequacy of the Sum Insured after inception and/or in the event of a Claim – as always, policy wordings vary but typical clauses that have relevance in this regard are as follows:-

Automatic Increase Clause – this relates to the Sum Insured and is typically a figure of between 10% and 20%. It is designed to provide the insured with what is effectively a pre-agreed amount by which the Sum Insured can be increased during a policy term. However, it is not intended to be used by the insured as an option to declare too low Sums Insured at inception or as a measure to claim more than the Sum Insured in the event of a claim unless they can satisfactorily demonstrate that there had indeed been an increase in the contract sum (e.g. variation order or other contract price increase agreed by the Contractor).

Escalation Clause – this type of clause is designed to provide the insured with the ability to recover a percentage amount above either the sum insured or simply the original cost of construction of the damaged area, depending upon the specific wording of the clause. Whilst perhaps not the topic of this particular paper, the basis of indemnity can itself vary according to policy conditions. In some cases it may be restricted to the value of the damaged Property Insured or Subject Matter Insured immediately before the loss event (i.e. effectively allowing depreciation to be taken into account) or in other cases “actual cost of

repair/replacement” which would imply a more “new for old” indemnity for works that may have been completed two or three years earlier but not yet handed over.

Under Insurance / Average Clauses – some policy wordings contain such provisions so that the insured loss would be reduced proportionally, should it be discovered that the Sum Insured did not represent the correct amount.

Law and Jurisdiction – obviously there are some jurisdictions that are more favourable toward the insured than others in terms of how an innocent and unintended under insurance on their part might be viewed. However, typically there would be some form of “material change of risk” provision in the policy that puts the onus upon the insured to inform insurers of any such material change. This would of course include known increases in the contract sum, especially if due to variation orders or changes of design or work methods when compared to those notified to an insurer at inception.

We would also like to refer the readers to IMIA papers “Cost overrun in Construction Projects” (Paper 96 (16)), the London Engineering Group paper on “Project Values and Sums Insured” published in September 2011 as well as to the Policy wordings provided by specialized Insurers and Reinsurers.

4 How does reality look like?

We have tested the theory outlined above by interviewing our contacts in various markets. We would like to stress again that a very wide range of market practices exist in the various geographies. What is “standard practise” in some regions may be handled very differently in others. Some of our observations may not be applicable in all markets to the same extent. Therefore, we accept that the trends we describe below may not be equally relevant in all areas.

Before we discuss some of the challenges we came across in our working group in chapter 5, we would like to make some general comments about the framework within which many of the projects we insure are developed. Hopefully, this helps to explain why it is so tricky to apply the theory in reality.

4.1 Projects size, duration and complexity are increasing

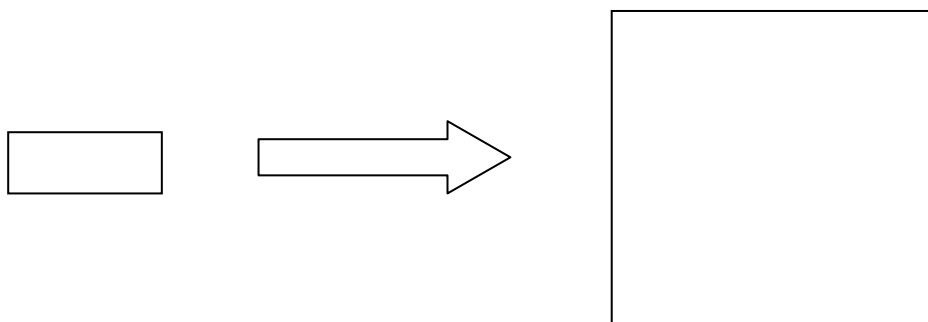
An important element which has rendered the task to define an “adequate” Sum Insured an increasingly difficult one is the fact that the size and complexity of projects has drastically increased over the last two decades. Several years ago, the label “very large project” was put on a risk with a sum insured of say € 250 Mio. Nowadays, “very large projects” easily have values in the range of several billions.

The same holds true for the complexity of projects. Especially in highly industrialized countries, you rarely encounter the situation that “Principal A” orders a “standard project off the shelf” from “Contractor B” which is to be built on an isolated green field (say an isolated power station or a simple road from A to B).

In today’s world, it is much more common to find a situation where, for instance, special purpose vehicles with sophisticated financing features are set up to deliver the construction of new infrastructure in densely populated areas. The management of the many parties involved, including the highly complex chain of subcontracting requires a professional and highly experienced project management organisation.

All major cities are constantly upgrading their traffic infrastructure. Such projects often include work on existing roads and public transport structures. Traffic flows have to be maintained at all times. Such developments often include extensive underground developments, cost several billion Euros and last for 10 or more years (for example the “Zuidasdok” infrastructure project in the city of Amsterdam). Legal requirements in respect of environmental protection tend to become stricter, too, and often may require technologies which have not been tested before. All of this is constantly pushing the limits of technology and risk management and requires utmost professionalism of all parties involved – including those involved in monitoring the evolution of the Sum Insured.

Here is how we try to illustrate the growing complexity and size of projects over the recent past:



4. 2 Policy wordings for complex projects

What seems not to have changed in all these years is the concept of a “standard wording” with the list of typical clauses, including escalation, average clauses and the like. Underwriters still expect to receive a clear breakdown of the main components of a project, including a precise estimation for the “final contract value”. We believe that the framework of clauses we use is good enough to automatically cater for all the changes the projects we insure experience. Are we eventually the only link in the chain of modern project delivery which is not adapting to the rapidly changing environment? Are our methods and processes up to standard to successfully manage the challenges of the fascinating industry we like to insure?

Read on in Chapter 5....

5 Challenges

The following challenges should be used to highlight some issues our trade is faced with and test some of the assumptions we have gotten used to adhere to. For some of these, we can propose answers, for others, there cannot be an easy solution, nevertheless, we hope to provide some food for thought for the interested reader.

Challenge 1:

Who are the parties involved? What are their interests and how well are they aligned?

The degree of “professionalism” of parties involved is a key element for the “correctness” of the process and the avoidance of surprises. An experienced and independent project management is probably one of the most important elements to avoid unpleasant surprises during project execution as is highlighted in the challenges to complete the construction of a new airport in the capital of the host country of this conference. The “commercial power” of many of the parties involved in any project will greatly determine the outcome of the process. The economic expectations of the parties concerned have a determining influence on the outcome. Many of the parties involved have the incentive to take very optimistic assumptions in respect of their ability to execute their contract. Very competitive economic conditions often lead to the situation that companies agree on contract terms (including understated cost) which will not allow them to make any profit – or even end up in a loss making situation.

In larger projects, the number of subcontractors involved can easily reach the hundreds – each of them has to be considered as an individual bidder and the sum of all of these subcontracts will ultimately define the “Total Sum Insured” of the project. The contractual basis on which jobs are awarded to subcontractors may vary considerable (e.g. fixed price versus cost-reimbursable agreement) and may lead to significant need for revision during project execution.

Projects attracting a strong political interest may be subject to optimistic cost estimates in order to get the necessary support.

It is therefore important that the interests of the many parties involved should be duly considered and obvious deficiencies should be addressed adequately. The Sum Insured has to be established in a close cooperation of the insured (Principal and/or Contractor) and the

broker and the insurer on the basis of an agreed policy wording. Elements which are dealt with individually such as free material, design cost depending on the scope of cover, land, specific taxation, incentives by the government such as tax reductions to name but a few, have to be highlighted and adequately documented.

Challenge 2:

How precisely can the final contract price be established before the project incept?

The situation is of course depending on many different factors: The interests of the parties described above are certainly of great importance. The more “political influence” a project attracts, the more attention to the adequacy of the Sum Insured has to be paid. Another important element is the size, the complexity and the “proto-typicality” of a given project. Changes to the project scope will also influence the ultimate value of the works. In complex upgrading projects of existing traffic infrastructure, it may well be that the design and construction methods have to be adapted in the course of the project.

Fluctuations in cost for labour and materials will also have an important effect on the total value of the project.

Delays in the construction process due to technical, legal or financial reasons will also have an important upwards effect on the final contract price.

Additional elements which may influence the contract price are the experience of the contractors as well as “political” influences to keep the initial cost for the project at a very low level for budget and other reasons.

For all these reasons, it is clear that no matter how serious the costs of the project were estimated at the beginning, reviewing and verifying the evolution of the project cost on a regular basis is an essential task for the lead insurer which has to be performed in close cooperation with the insured and his representatives.

Most projects, no matter how well they are managed, will see changes of the cost incurred compared to the original estimate during their execution. And this is even truer for those which are less well managed. An informative list of projects with spectacular cost increases can be found in the IMIA Working Group Paper 96(16) Cost Overrun in Construction Projects.

Challenge No 3:

What do the terms “Cost”, “Price” and “Value” describe and how do they differ?

The contract value is typically established by adding up all prices quoted by the successful bidders after the finalization of the tender process.

The principal is mainly interested in “Price”, the contractor has to manage “Cost” and the insurers are concerned about the “Value” as a basis for the promise they make.

Most policies refer to the term “Value” when defining the “Sum Insured”. In the bidding process, however, the main driver is “Price”. Depending on the economic environment and the commercial and strategic ambitions of the contractors, there can be a wide discrepancy between “Price” and “Value” as can be seen in the sometimes surprising results of bidding processes, when a party wants to secure the job “at any price”. This may result in the situation that the quoted price does not even cover the cost the contractor actually incurred. It is not surprising that the contractor will try to improve his financial situation in the course of the project execution or in the case of a loss event.

The contractual basis on which the project is agreed (i.e. the allocation of roles and responsibilities of the parties involved) is crucial. Ideally, contracts are awarded on the basis of standards defined by specialized industry representatives (e.g. FIDIC) or other authorities. Contracts awarded on a fix-price basis often result in unpleasant financial surprises for contractors and insurers, especially in the case of losses. A good illustration of the wide

range of contract types can be found in the IMIA Working Group Paper 96(16) Cost Overrun in Construction Projects.

It is obvious that the contractual basis and the agreed prices have a significant impact on the financial success of the parties involved. In an ideal situation, the value, the price and the cost are established with due care and leave a fair profit for all parties involved. In cases where contractual parties have engaged on a basis where prices have been lowered to unsustainable levels, the professional handling of losses and the avoidance of unjustified cost to insurers in the loss adjustment process is particularly important.

Challenge No 4:

Is it reasonable to expect that repair cost have to be “in line” with original construction cost?

In many cases, the cost of repair exceeds the original cost of construction. Is any upwards deviation of repair cost compared to original construction cost suspect of underinsurance? How much of such an increase is justified? This is a typical and tricky question in the adjustment process of claims.

For illustration: When a Wind farm with 100 turbines is constructed, will the replacement cost of 1 turbine be 1% of the Total Contract Value? Obviously, this is not the case. How do we deal with the cost of specialized equipment that needs to be brought in? Tunnel collapses and damages to access roads, to name but a few hot topics, are prominent “problems” in the insurance industry and have led to the development of several versions of special clauses. All these clauses are either extending or restricting the cover to cater for the specific circumstances of a project. A considerable selection of such clauses are available, for example to include cost for mobilization of specific equipment, extra cost for speeding up repairs or specifically addressing the situation of how to deal with highly specialized equipment (pair and set) where repair cost may substantially deviate from the original construction cost. Furthermore, fluctuations in prices for labour and material or customs fees may complicate the adjustment.

As we all have learnt from our experience, there will always be situations which were not foreseeable at the time of underwriting - for instance: what happens if one subcontractor (who won the bid on a dumping price basis) is not around anymore at the time of loss and someone else has to be appointed for the repair works? Such situations will require a fair and professional handling often times enriched with a good dose of negotiation skills. Loss adjusters have also commented that it is very common for the adjuster not to have access to information about the value of individual items as breakdown of the Sum Insured or equipment lists may not have been declared with great detail.

It is obvious that a policy wording which is tailor made to the specific requirements of the project with the necessary cover extensions (at a commensurate price) will avoid unnecessary difficulties in the loss adjustment process and will allow for a fair indemnification of cost reasonably incurred in the loss adjustment process.

Challenge No 5:

Whose role is it to keep track on such changes in the course of a project?

Who is in charge to monitor the adequacy of the Sum Insured throughout the project? Is it the Risk Manager, the Broker, the Underwriter, the Policy Administration or even the Loss Adjuster?

When a loss is reported, the claims teams will certainly check the policy conditions, but do they, or the appointed loss adjusters, have access to the original breakdowns of the sum insured? How do they interact with the Underwriters? What happens when the lead insurer has not provided updated information?

Clearly, there is no “one size fits all” solution. Various organizational options do exist and work well. All these questions should be taken care of in the specific organisational setup of your company – and deficiencies in the process need to be addressed there.

Feedback received would, however, suggest that in many cases, the parties involved in the loss adjustment process do not have easy access to essential information which would allow them to thoroughly conduct their tasks as intended. And in more than once case, we have seen that the flow of information within an insurance company has left considerable room for improvement. Maybe, you have a look at the processes adopted in your company and check whether the allocation of duties to your claims handlers and the underwriting teams is complete and the flow of information is guaranteed so that all the necessary adjustments can be made properly and in accordance with the policy?

Challenge No 6: How are the clauses to be applied?

In order to deal with the inherent changes of the “Value” of larger projects, the Sum Insured is based on an “Estimated total contract value” which is supposed to be reviewed and, where necessary, adjusted on a regular basis. In many cases, you can also find “Escalation clauses” which allow the Sum insured to be exceeded by a certain percentage, typically in the range of 10 - 20%.

This all sounds fine and clear, but let us assume there is an escalation clause as well as an average clause in your policy: how do they interact and how can they be applied correctly?

- Remember: the policy is based on an “estimated” final contract value. When is that estimate reviewed during the execution of the project - at the end, halfway through, annually?
- How do we deal with the situation when several subcontractors are affected by a loss event and it is found that all of them have declared the value of their subcontracts with a varying degree of underinsurance?
- An escalation clause (of say 20%) applied on a complex project of 100 Mio, means an “allowed” variation of 20 Mio – or do we believe the 20% should only be applied on the individual subcontracts affected?
- Let’s assume we have an average clause and an escalation clause in the policy – how will these be applied? Do deviations within the range specified in the escalation clause trigger additional premium? - or - is only the excess amount above the limit subject to additional premium?

We tend to believe that it is very difficult to combine the concept of an “estimate” which can naturally fluctuate in the course of the project, with an average clause. Furthermore, escalation clauses allowing for increases of up to 20% of project values will quickly translate into very substantial amounts of money on larger projects – often far above the average loss cost.

Challenge No 7: Are “Average clauses” still widely in use and have they been applied?

Here are some “quotes” the working group has collected in discussions with industry representatives in the course of developing this paper:

- “All our policies include an average clause”
- “We always check the adequacy of the Sum Insured at the end of the policy period”
- “A waiver of underinsurance is regularly agreed”

- “We are not aware of any case where compensation has been reduced due to underinsurance – proof of underinsurance is too complex and very unlikely successful”
- “There is no chance to check the final Sum Insured if the insured is not willing to submit it”
- “The accuracy of the Sum Insured is not considered in the loss adjusting process – it is not requested by the insurance company or the loss adjuster”
- “If we become aware that the Sum Insured is not declared correctly after a loss happened, we try to hide this”

Whilst some markets seem to be using standard wordings with an average clause, others confirm that there is a trend to exclude average clauses, especially for larger project placed “internationally”. It is evident that soft market conditions have helped to erode certain standards which were persisting for a long time. The economic environment is of course also having a major influence on the “insurance framework”. The claims pattern in project insurance is often of an attritional nature – which makes the identification of underinsurance rather difficult.

Some of our working group members confirm that average clauses are applied on local and comparatively small projects. On larger and especially on “international” placements, there is a very clear trend to exclude average clauses (or even include an explicit waiver of underinsurance). We have not been able to identify examples, where average clauses had a noticeable impact on the loss adjustment process of large and international projects.

6 Conclusion – and proposals for consideration

The above challenges have been selected to highlight that the underwriting process as well as the management of live risks are very demanding tasks which require constant monitoring and engagement with the key stakeholders involved.

The process to arrive at the “Number” called Sum Insured which forms the basis of our insurance contracts and which is crucially important for the premiums we charge for the promises we give to our clients and the exposures we put on our books, is a highly complex one. The experience and skill levels of the parties involved, their roles and incentives have a crucially important effect on the result of our trade.

Some of us do believe that “average” or “underinsurance” clauses are an effective way to mitigate the effect of insufficiently declared Sums Insured. The reality, however, is that in many markets, average clauses have been eliminated from policy wordings. And even in the cases where they are still part of the insurance contract, we have found little evidence that these clauses can actually be applied meaningfully in the claims handling process. The project management of large and complex risks is a constant challenge throughout the execution of a project – and it is very demanding to keep abreast of changes in “prices”- left alone “values” of the individual pieces which make up a project.

Clearly, there is no “one size fits all” solution to the many challenges our underwriters and other parties involved in the UW process are exposed to. For many cases, the standard policies we know may make perfect sense and can easily be applied – but for larger and more complex risks, we doubt that average and escalation clauses are helpful.

Therefore, we believe that we should not rely too much on these clauses – but ensure we have taken the necessary steps to tackle the Adequacy of the Sum Insured. The following thoughts are listed for your consideration – and application in your organisation in case you are dealing with large and more complex projects:

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- How do you make sure you have established a reasonable comfort level in your underwriting process that allows you to identify and manage the changes of the projects you insure?
 - Which elements in your underwriting process help you verify the adequacy of the Sum Insured? Do you systematically use internal and external information sources to help your underwriters to identify potential shortcomings? Compare the Sum Insured of your project with the values declared when the operational cover incepts.
 - Some characteristics of projects make them more prone to potential underinsurance. We tried to identify the most important elements and have integrated them into a “Sum-Insuro-Adequacy-Meter”. When you encounter projects where several of these elements are noticeable and thus indicate an increased risk of inadequate Sums Insured, additional checks or investigations may be required. The following criteria will positively or negatively influence the “Adequacy-meter”:
 - Size and Complexity: the larger and more complex a project, the more difficult it is to estimate the final contract value and the more effort is required to keep track on this throughout the project.
 - “Owner controlled” projects with a large number of contributing contractors and subcontractors may be more challenging than Contractor controlled projects.
 - Degree of “Proto-typicality”
 - Degree of “Political” interest (and influence). Can result in too optimistic budgeting in order to get the project supported. Cost over-run as well as difficulties in case of losses are to be expected.
 - Experience and reputation of Contractors, Developers and Risk Managers involved.
 - Do the parties involved have experience in the country in which the project is located and are they familiar with the cultural and legal environment?
 - Is the project financially viable?
 - Is the contractual basis defined and is it meeting your standards?
 - Is the Principal, the Risk management organisation of the project willing to constructively engage with the insurance representatives?
 - Is the legal situation of the project location stable? Is the local currency stable or are you working in an environment of high inflation?
 - The larger the projects, the less “useful” are general policy clauses such as average and escalation. The best way to ensure an adequately declared Sum Insured is the constant contact with the project management and regular and systematic updates on changes to the project scope. Engage in close contact with the risk management of the project and proactively address issues.
 - Request reasonably detailed breakdowns of the Sum Insured at the beginning of the project. Keep them updated and use them in the loss adjustment process.