Professional Indemnity Insurance Market Insights **Q4 2018**

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Overview

- The Professional Indemnity (PI) market has deteriorated significantly over the last quarter with no signs of it easing in the short term.
- The cooling Australian property market, the commencement of the royal commission into aged care and the findings from the banking, superannuation and insurance review are all concerns for insurers.
- Lloyd's have commissioned a review of their worst performing classes following an underwriting loss in 2017, which includes PI.
- The macro environment, industry specific issues and claims losses are all impacting PI market pricing, coverage and deductibles.
- Looking ahead to 2019 – clients can expect PI rates to increase at least 5-10% and much higher for the riskier industries and insureds with claims.

State of the market

Insureds have been the beneficiaries of 10-15 years of rate reduction driven by historic abundance of capacity in the market. For many professions 2017 rates were half that of 2004. Over this period the average time to settle a claim has stretched from 5 to 9 years prolonging insurers ability to gain full visibility over the performance of their portfolio for any one year. Increased claims activity along with margin erosion has resulted in many insurers experiencing losses on their PI portfolio.

At a macro level, easing of the Australian property market, commencement of the royal commission into the aged care sector and resultant reforms from the banking, finance and insurance review are all concerns for insurers. Over-laid with contagion issues such as cladding and plastic piping in the construction sector; advice on self-managed super funds by accountants; emerging crypto currency risks; and consequential cyber security claims hitting the IT industry, insurers are placing far greater scrutiny on their underwriting assessment, rates, terms and conditions. The London market is in the middle of one of the largest shake ups in its history with Lloyd's implementation of the 'Decile 10' remediation review of which International PI is one of the worst performing classes.

Lloyd's Review

In 2017 Lloyd's reported an underwriting loss of £3.4 billion with international PI contributing £435 million. Off the back of deteriorating market results, Lloyd's have commissioned what they are referring to as the 'Decile 10' review. All syndicates have been mandated to identify their three worst performing classes and provide written business plans on how they intend to remediate and return each class to profit. International PI is the second worst performer. 62% of syndicates have loss making PI portfolios.

As part of the review Lloyd's have instructed some syndicates to put their portfolios into run-off and several others have elected to withdraw from the PI market and focus on other classes. For those remaining in PI remediation will take the form of a combination of increased rates, reduced capacity, higher deductibles and tighter terms and conditions. Lloyd's will implement a quarterly review to ensure progress is being made on the approved plans and if change cannot be seen they have confirmed they will undertake "active intervention".

Clients in Australia are exposed to Lloyd's syndicates either through direct placements into London or via the many underwriting agencies present locally backed by Lloyd's capacity. London insurance companies are not immune from the poor performance with the Prudential Regulation Authority in London considering a similar review. Australian based insurers whilst more open for business are reviewing their portfolios carefully with a general move away from the large diverse insureds to the middle market. We have experienced various Australian insurers withdraw from specific professions namely lawyers, engineers and construction companies reducing the overall capacity and competition on those classes.

We anticipate further scrutiny on specific professions and a greater push on rates as insurers go through their treaty renewals with the reinsurance market in January. Clients will feel the impacts of this on their 2019 renewal.

Industry Specific Factors

In today's environment there are many factors contributing to claims and/or sentiment in the PI market impacting on renewal pricing, terms and conditions. The following seven factors are by no means an exhaustive list but provides insight on the macro factors affecting the sector:

1. Australian property market

The downturn in residential housing, risk of increased interest rates and the uncertainty surrounding the long-term treatment of investment properties creates an increased risk exposure for real estate agents, valuers and builders. An individual's home is generally their most significant asset. People are happy when property values are on the rise. When they fall we typically see the blame being passed to those professions involved in the buy, sell or build of the property.

2. Construction material

Cladding has been an underwriting focus for insurers over the past 12 months. The risk is not diminishing with claims in the market against building certifiers, architects, fire safety engineers, façade engineers, design and construction companies. As insureds review their portfolio of previous projects many are triggering the loss mitigation extension of their PI policy in an attempt to rectify the works before any claim is made. IMF Bentham, Slater and Gordon and Adley Burstyner are all considering class actions to pursue compensation for property owners of residential and commercial buildings.

Insurers are now also focused on projects that utilise polyethylene pipes as oppose to metal. The concern is when mixed with copper they oxidise and over time start to burst. Similar to cladding, insurers are now applying plastic pipe exclusions unless the insured can demonstrate they have reviewed prior projects and have not utilised such material.

3. Royal commission

The recent announcement of the royal commission into Aged Care Quality and Safety has sparked similar concern with insurers to the banking, superannuation and insurance review. Being an industry wide review the level of insurance cover available to insureds to respond to the requests for information and attend the inquiry will vary with many policies providing no cover at all. Insurers have already started to apply royal commission exclusions to insureds' PI policies despite notices yet to be issued. Insurers are concerned with the unknown consequential claims that may come from the findings of both royal commissions. If you are in a sector impacted by the royal commission, it is important any exclusion applied to the policy is equally offset with a mirroring claim notification to ensure no gap in cover from one policy year to the next. The breadth of exclusions in the market vary with fewer and fewer insurers prepared to write policies with no exclusion at all. Careful review of the exclusionary language is of vital importance.

4. Imbalanced contractual terms

PI policies traditionally contain an exclusion for any liabilities agreed under contract that go beyond common law. Today most insurers offer a range of extensions to cover indemnities, novation, warranty and guarantees. A construction claim is typically contractual hence the importance of aligning the PI policy as close as possible. Unreasonable liquidated damages, express warranties and guarantees and resultant consequential loss is often excluded from PI policies, yet such terms appear to be enforced by principals more frequently. There is a seemingly growing imbalance in contracts with a strong bias towards the principal. Before signing contracts be sure to consult your insurance broker to ascertain the level of insurance protection you have in respect to the contract in question.

5. Self-managed super (accountants)

Profession creep is a concern with accountants preparing accounts and advising on the establishment of self-managed super funds. The risk profile between an accountant and financial advisor differs as does the claims profile. It is important insureds remain diligent in separating out investment advice from traditional accounting services via clear engagement, scope of service letters and reporting disclaimers.

6. Cryptocurrency

Cryptocurrency is currently unregulated, prone to fraud and generally perceived as a speculative, insecure investment. Very few insurers are prepared to offer terms to clients exposed to cryptocurrency regardless of services – trading, investment advice, transaction platforms or mining. Clients specialising in this space should focus on contractually limiting their liability with the knowledge there is very little insurance protection available.

7. Cyber-attacks – IT consultants contribution

IT liability has traditionally been viewed as a well performing class. Focus is now being placed on IT consultants responsible for hosting, system integration, creation of Internet of Things (IoT), security monitoring or access to company systems. Claims are starting to emerge from clients and/or cyber insurers seeking recovery from the IT consultant if it is deemed their work contributed to or left the company vulnerable to a cyber-attack.

Looking ahead

Over the last year underwriters have seen a slight rate increase on their total book. This is set to continue into the second half of 2018. Most insurers are forecasting that their PI rates will increase by a further 5-10% and disproportionately more for those accounts with losses. The situation is changing monthly with a number of large loss reserves being posted. Experience to date is that PI losses have been both large in number and quantum which has made some portfolios now unsustainable. This has been despite insurance being established on the premise of a portfolio approach where a single loss can be absorbed by the insurer's portfolio. These market conditions have driven some insurers to withdraw from writing PI insurance altogether, while others have made the strategic decision to reduce their exposure to PI risks.

Despite all these challenges, there continues to be capacity available in London for Australian PI risks. Insurers are simply much more selective in how they deploy their capacity. The merger of several dominant players - combined with four markets withdrawing from writing Australian PI - has had an impact on the competitive tension. In contrast to the Australian marketplace, London insurers are focussed on policy coverage, contractual liability, multiple reinstatements of the sum insured and multi-year run-off are all becoming harder to obtain.

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