PROFESSIONAL INDEMNITY INSURANCE MARKET INSIGHTS

Q3 2019

Empower Results®

OVERVIEW

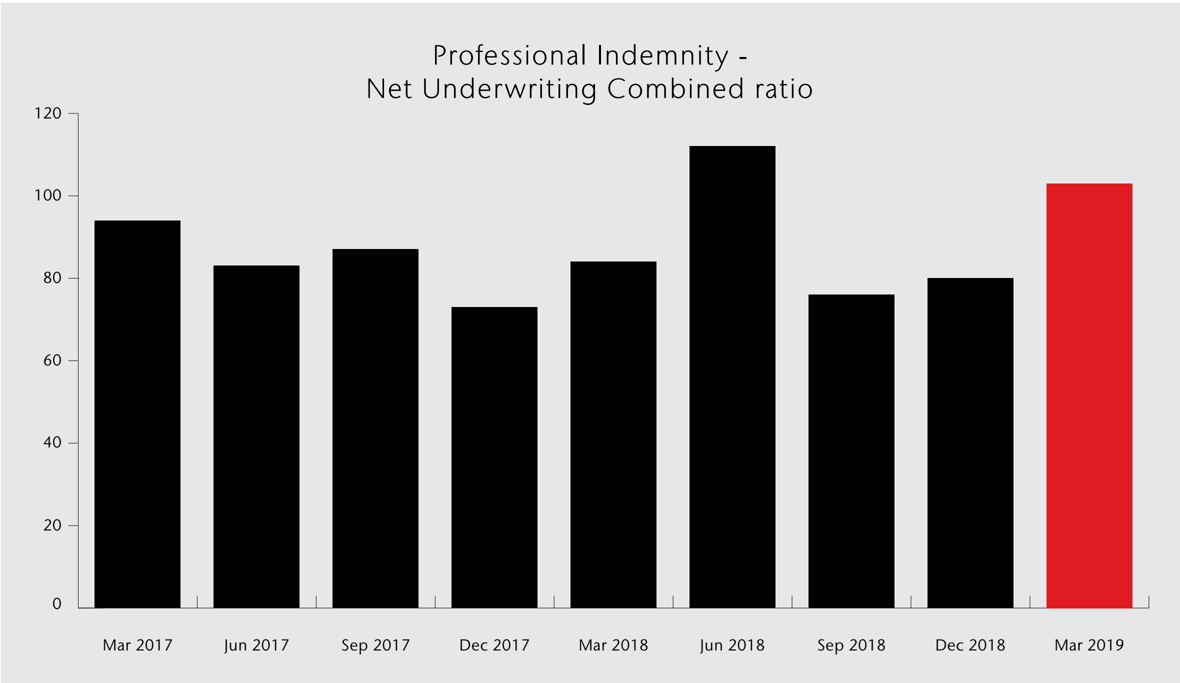
- The professional indemnity (PI) insurance market continues to deteriorate and has become severe for some industries.
- Increased claims activity and several large settlements have tipped insurer's loss ratios to unprofitable.
- Lloyd's of London (Lloyd's) continues to scrutinise poor performing syndicates as they focus on returning to profitability. This is having an impact on availability of capital and appetite to write Australian business.
- As the market hardens, underwriting agencies are becoming more relevant as they can provide quality capacity on the larger and hard to place PI placements.
- Consultants exposed to cladding have been most heavily impacted, they're experiencing significant premium increases.
- Looking ahead – the trajectory will continue to worsen for some industries – we outline tips to help you with your next renewal.

STATE OF THE MARKET

The first half of 2019 has proven challenging for many professional services firms renewing their PI insurance policies. Increased claims activity and several large settlements have pushed insurer's net underwriting combined ratios over 100%, indicating it is unprofitable. APRA's latest quarterly statistics (see Figure 1) shows that net combined ratio for March 2019 was 103%, this means that for every $1 in premium an insurer collects they are losing $1.03.

With limited investment return, insurers are experiencing increased scrutiny from overseas parent entities and Lloyd's to return their books to profitability. As a result, several Lloyd's syndicates have stopped writing Australian PI business and Australian insurers are reassessing their appetite for certain professions. Less competition has allowed other insurers to return to profitability by significantly increasing their premiums.

Figure 1:

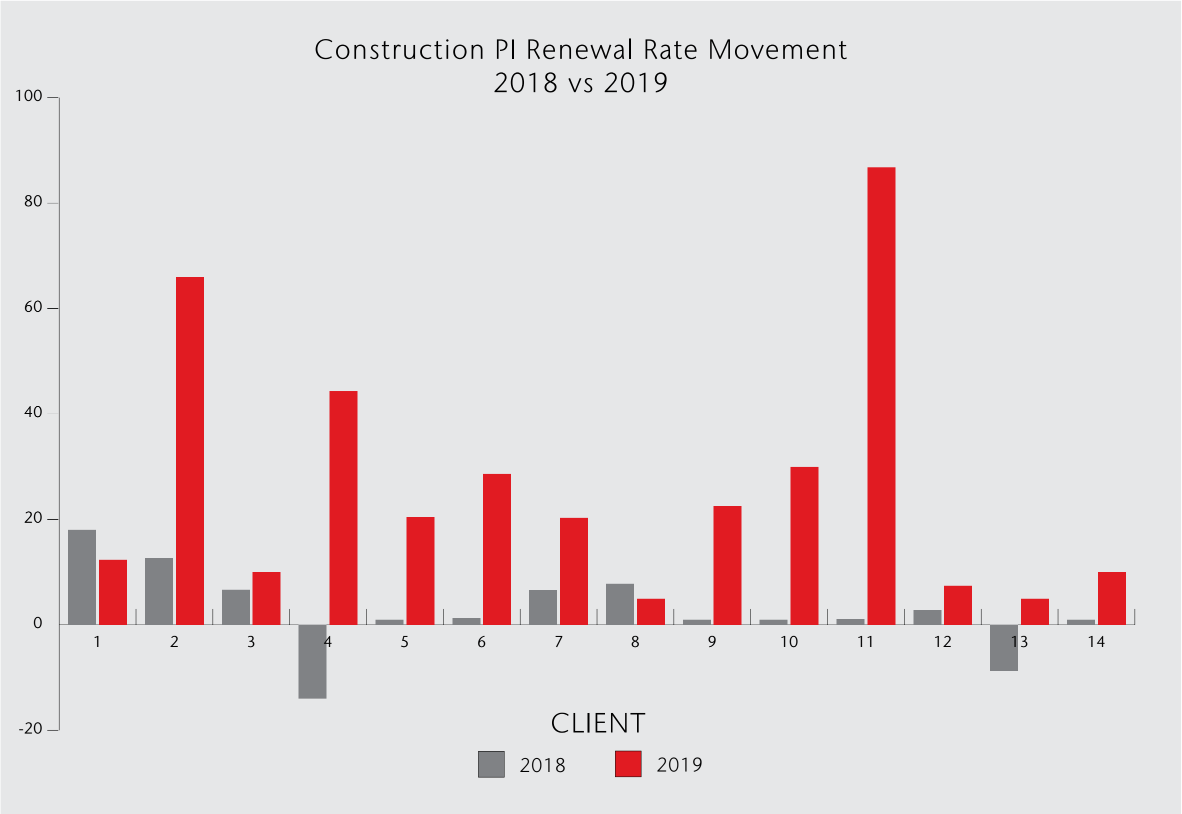


Source: APRA general insurance performance statistics - March 2019

Lawyers and construction workers are heavily impacted professions, with an average premium increase of 30% and 26% respectively based on Aon's proprietary data. Figure 2 demonstrates the change in PI renewal from 2018 to 2019 for several of our construction sector clients.

Consultants exposed to cladding such as fire engineers, building certifiers, façade manufacturers and valuers – have been impacted the most. They're experiencing three figure premium increases, if they can even obtain insurance at all[1].

Figure 2:

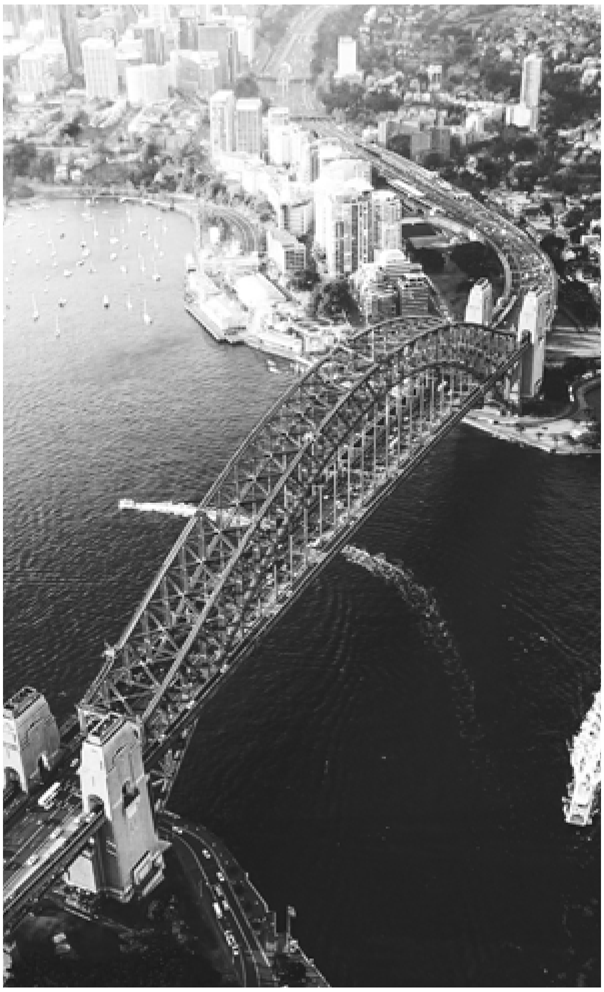


Source: Aon proprietary data

1 https://www.insurancenews.com.au/local/pi-crisis-as-insurers-retreat-from-cladding-risk

MARKET PLACES

Australia



PI insurers in Australia are reporting to be running loss ratios in the low 90s or above. The losses are heavily driven by the construction sector with a number of claims also developing in the legal, accounting and technology space. The larger insureds are generating a disproportional quantum of sizable claims, resulting in a clear initiative by several insurers to shift towards mid-tier clients.

In July, Allianz Global Corporate & Specialty announced they would be exiting long tail business in Australia and New Zealand citing the highly litigious local environment and inability to gain required scale as the main rationale for their decision. The head offices of other global insurers with an Australian presence are also refocusing their portfolios. Head offices are often setting minimum rates per attachment and restricting the capacity per account that can be deployed.

In the local market, we have seen the emergence and increased relevance of underwriting agencies as the market hardens. Several experienced underwriters have left corporate insurers to set up their own agencies backed by a range of local and overseas insurers. These agencies can provide quality capacity on the larger and hard to place PI placements. Unlike traditional underwriting agencies they are not competing on price but rather trying to add value in a contracting market.

What does this mean?

- There is limited appetite and capacity for the larger insureds. Based on our experience, deductibles (excesses) are the main focus for these insureds with levels from $1 million to as high as $40-50 million depending on their risk and claims history.
- Insureds with traditional, long standing insurers can expect material premium increases as these insurers try to return their portfolios to profitability.
- The ultimate decision maker within an insurer is now often overseas. Insurer relationships and multi-class or packaged placements are still important but may hold less weight than in previous years.
- Insureds can expect far greater scrutiny from insurers and a longer lead-in time to obtain quotes.
- Excess layer minimum rates may increase disproportionally to the primary rate as head office review their portfolios.
- Insureds should consider underwriting agencies as part of their renewal strategy.

London

The Lloyd's 2018 Decile 10 review has had a material impact on the availability of capital and appetite for Australian business[2]. The review identified international PI (which includes Australia) as the second worst performing sub-class. As a result, nine Lloyd's syndicates have exited this class of insurance, notably Aspen, Chaucer, Brit and Pioneer. Syndicates still open for business are being extremely cautious in their underwriting approach and deployment on capital with a focus on returning to profitability.

All Lloyd's syndicates are allocated a yearly premium pool known as "stamp capacity" to which they can write to. Once a syndicate reaches their stamp capacity for the year they will cease writing business. As premium rates increase, syndicates will have fewer policies to write to reach their stamp capacity. Some syndicates are switching to their company stamps to overcome this dilemma. However, this is a less than ideal solution for Australian insureds because most company stamps are not APRA approved and therefore viewed as a direct foreign insurer requiring sign off for use.

2 https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/51779149

What does this mean?

- There is very little interest from the syndicates for new PI placements.
- It is a challenge to replace existing Lloyd's lines where the syndicate is no longer writing Australian PI.
- Insureds need to present themselves as a quality risk for an underwriter to even consider reviewing them as a business they might want to insure.
- Policies with open or paid claims will experience significant premium, deductible and/or coverage changes at renewal.
- Insureds undertaking activities deemed "high risk" – such as consultants exposed to cladding – will find it challenging to obtain terms.
- Long policy periods including run-off and project PI are hard to procure due to the stamp capacity they utilise, and the length of time and capacity tied up. Several accounts have been repatriated to Australia where multi-year run-off was required.
- There is the risk that many syndicates will reach their stamp capacity heading into quarter four reducing market competition even further. This may leave existing insureds without an offer to renew their insurance.

INDUSTRY SPECIFIC INSURER FOCUS POINTS

Valuers

Changes to Section 90 of the Banking Code of Practice (the Code) with respect to the assignment of property valuations effective 1 July 2019 is a significant concern to some insurers. Despite lobbying and consultation from the insurance industry, ASIC is yet to agree or implement defined risk management processes to be followed when assigning valuations under the Code. There are currently dividing views amongst insurers on the ability to underwrite around the additional exposure the change in the banking code will add to valuers. Two PI insurers have taken hard line positions, excluding valuers on their policies from 1 July until a position with ASIC is agreed.

Building products

Cladding remains an area of concern for insurers with no clear solution in sight. The recent Victorian LaCrosse building court judgement[3] has heightened the focus on consultants including fire engineers, building certifiers, engineers and the like. There are a range of cladding exclusions being applied to PI policies which are at odds with the accredited building surveyor's insurance requirements. Brokers should negotiate a broad write back to any cladding exclusion, but it is extremely difficult to obtain a policy with no exclusion at all. The QLD and NSW building associations have recently come out with statements softening their accreditation requirements, however made it clear this is a short-term fix. Without government intervention we will see a dramatic decrease in the number of accredited certifiers. This may result in many small to mid-tier consultants being forced to shut their doors because the premium or deductible increases being applied by insurers will not be sustainable.

There is considerable pressure on the insurance industry to provide a solution to the cladding situation. The challenge is clear, there is simply not enough premium pool available to rectify all the impacted buildings and subsequent claims. PI insurance is designed to cover the unknown. It is not designed to be a funding mechanism for known issues. Industry and government are working to develop an appropriate funding mechanism to deal with the issue at hand.

The Victorian Government recently announced a $600 million funding package to address the flammable cladding crisis in Victoria[4].

While today's focus is cladding and plastic piping, in the 80s it was asbestos and next year it may be a different product again. Broad, non-compliant building product exclusions are starting to emerge on policies. Whilst the justification for a cladding exclusion may be warranted, insureds should resist any blanket non-compliant products exclusion.

Professional Indemnity Market Summary

↑ PREMIUMS	↑ DEDUCTIBLES	↑ CLAIMS
↓ CAPACITY	↓ COVERAGE	↓ APPETITE

Lawyers and accountants

Shareholder class actions and mergers and acquisitions are slowly morphing into PI claims for lawyers and accountants. Litigation funders are starting to name these parties in proceedings to access their insurance policies and, where necessary, top up the lack of company securities directors & officers insurance. The individual claim quantum is increasing and at odds to the historic finely priced rates in the sector. The PI premium pool is not great enough to withstand the increased claims severity. Insurers are extremely selective and will assess public listed company audit work in detail for accountants and lawyers advising on M&A deals.

IT companies

Silent cyber is quickly becoming a buzz term within the insurance industry. Whilst cyber insurance has emerged to deal with the new world exposures of cyber breaches, there are plenty of traditional insurance policies that will pick up elements of cyber exposure. For IT consultants there is a material cross over between PI and cyber policies. As the breadth of cover available under a cyber policy continues to expand so does the responsibility of the IT consultant providing outsourced services to an insured. Traditional IT PI insurers are experiencing an increase in the number of consequential cyber related claims, and as a result, reassessing their appetite in this sector.

On the positive, there are a couple of insurers looking to build a portfolio of business in this space. We have seen the emergence of combined IT and cyber liability policy forms. For insureds in this sector we recommend that you engage with your broker to explore if any of these new offerings could be of benefit to your business.

Construction projects

The construction sector is fraught with under-priced projects and PI policies often being called upon to cover the shortfall. There is an increasing number of claims against consultants from the head Design & Construct contractor where the project itself is complete, fully functional and the principal content. The problem lies in the project not being fully priced at tender phase or conceptual designs used in setting assumptions. Insurers are placing greater emphasis on the parties with whom insureds engage, their litigious nature and pre-tender due diligence.

The rapid pace at which renewable projects are being launched, the use of new technology and requirement to guarantee performance outputs limits the number of insurers prepared to consider wind and solar projects. There are a large number of new foreign entrants to the market with creditable overseas experience. The challenge for the sector is the lack of experienced on the ground project managers with knowledge in Australian legislation, community consultation, ground composition and grid connectivity.

The availability of capacity on single project multi-year PI placements is limited. Three historic primary Insurers Zurich, Allianz and Vero have ceased writing the class. This is placing upward pressure on premiums and deductibles and is having an adverse impact on annual PI programs. A typical 10-year project will start at a 10% rate on limit (sum insured) and can be as high as 50% on large riskier placements. Project policies covering the contractor and all consultants with cross liability provisions are no longer available in the PI market. As a result, consultants' annual PI policies are being heavily relied upon. There is a greater push from consultants to limit their PI requirements to $10 million or less, thus pushing a lot of the risk back up to the head contractor.

Other professions

PI insurers still maintain a strong appetite for many other professions and smaller firms without the exposures and claims experience noted in the previous paragraphs, for example, management consultants. For these professions, premium increases tend to be in the order of single digit to lower double digit and policy coverage remains unchanged.

Tips for a successful renewal

- Start planning your renewal early, at least four months prior to expiry.
- Understand your market, insurer pain points and how you can differentiate your company.
- Understand your company's risk tolerance / contractual ability to utilise non-APRA approved foreign insurers.
- Larger insureds should consider alternative risk transfer mechanisms. A higher deductible is going to attract greater interest from the market.
- Have a comprehensive summary of your claims history, amounts paid and why a similar claim won't occur again.
- Provide a comprehensive breakdown of your revenue so insurers aren't left guessing.
- Meet your insurer BUT ensure the right people from your company are in the room.
- DON'T turn up to meet insurers with your company promotional material, ISR presentation or latest investor presentation. Prepare material that the underwriter can put on their file to justify quoting your account.

CONTACT

Mary-Catherine Thomas

National Professional Indemnity Practice Leader
61 2 9253 8453
mary-catherine.thomas@aon.com

About Aon

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