Professional Indemnity Insurance Market Insights, 2021

State of the Professional Indemnity Insurance Market

The 2020 professional indemnity insurance market was one of the most challenging insurance markets professional services companies have faced in recent memory. As described in Aon's Q3 2020 Professional Indemnity Insurance Market Insights report, Aon saw insurers take corrective action to improve the profitability of their portfolios leading to significant premium increases ranging from 5% to 210% across a selection of Aon's Professional Services clients. The average rate increase for this group in 2020 was 30%.

So far 2021 has seen a continued focus by insurers on underwriting performance and portfolio management. A low return investment market means insurers have to focus on underwriting profitability to remain sustainable. Pricing increases continue to be sought by insurers albeit at a lesser rate than 2020. H1 2021 saw an average rate increase of 21% across the above-mentioned clients ranging from 0% to 58%.[1]

We are seeing some green shoots in the professional indemnity market with a small amount of new capacity entering off the back of more insurer-friendly premium conditions. This additional capacity is being deployed very selectively and is unlikely to have a significant impact on the majority of the professional indemnity market. There has also been a cautious increase in appetite for new business which may alleviate some of the more significant increases we saw in 2020.

Continued Professional Indemnity Market Profitability Challenges

The Australian Prudential Regulatory Authority (APRA) released its Quarterly General Insurance Statistics on 27 May 2021. This data is sourced from the regulatory returns submitted to APRA by authorised general insurance companies. It does not include data from Lloyds.

The APRA report shows a net underwriting combined ratio of 96% for professional indemnity for the year ending March 2021. Insurers generally target a combined ratio of at least 90% suggesting they will continue to seek pricing increases for the foreseeable future.

Table 1 APRA Quarterly General Insurance Statistics – Professional Indemnity

Source: www.apra.gov.au/quarterly-general-insurance-statistics

	Year-End March 2020	Year-End March 2021	Increase
Gross Written Premium	$2,531,000,000	$3,038,000,000	20%
Gross Incurred Claims	$2,298,000,000	$2,931,000,000	28%
Gross Loss Ratio	97%	103%	6%
Net Underwriting Combined Ratio*	95%	96%	1%

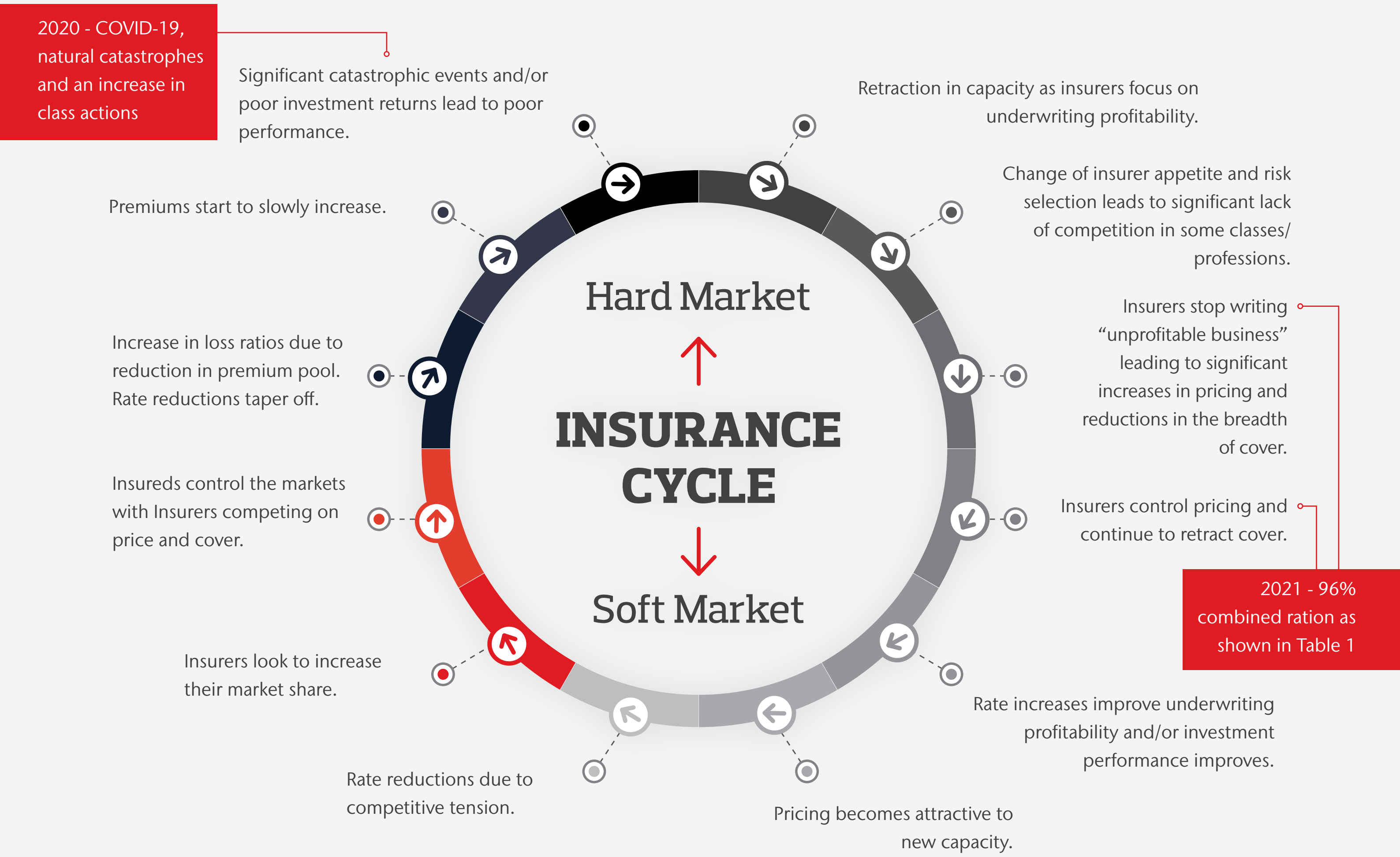
*net underwriting combined ratio = net loss ratio (claims/premiums) + underwriting expense ratio (expenses/premiums)

[1] Aon proprietary data

The Insurance Market Cycle

In mid-2020 we suggested that we may have entered what is colloquially known as a "hard insurance market". The diagram Aon has developed below shows a graphic depiction of the insurance market cycle and the factors that contribute to its stages. During a live webinar on 28 January 2021, Aon's Global Chief Broking Officer, Hugo Wegbrans advised that 2020 had been the fifth costliest catastrophe year in the last 20 years. He indicated that these "unprecedented loss levels" were one of the main drivers of the current hard market.[2]

Professional indemnity has not been immune to these losses. As you can see from Table 1, the current premium increases (20%) are yet to offset the increase in losses (28%). The APRA Quarterly statistics also show a 39% increase in reinsurance costs which suggests that professional indemnity insurers are offsetting more of their risk to the reinsurance market. This reduces the impact of the current additional claims but may increase the reinsurance costs in subsequent years.



[2] www.aon.com/unitedkingdom/insights/market-update-2021-preparing-for-the-year-ahead

Is Social Inflation Changing the Claims Environment?

The Lloyd's 2021 Market Oversight Plan has identified a deterioration in past years' professional indemnity insurance claims reserves as an area of concern[3]. Lloyd's is undertaking a workstream to review claims reserving assumptions and particularly whether past inflation is representative of future inflation. This may lead to a change in claims reserving procedures to reflect both changes to general inflation caused by COVID-19 as well as social inflation.

According to a research brief by the Geneva Association "social inflation refers to all ways in which insurers' claims costs rise over and above general economic inflation, including shifts in societal preferences over who is best placed to absorb risk".[4] The Research Brief is based on American data but suggests that Australia has many of the characteristics that they consider high risk factors for social inflation some of which include:

- Litigation funding mechanisms
- Class action regime
- Active political/regulatory environment – i.e. significant number of Royal Commissions, regulatory changes/oversight and public sentiment towards organisations and institutions.
- Legal environment

These concerns around increases in inflationary factors have contributed to insurers being reluctant to offer large insurance limits and pushing for higher deductibles. On insurance programs with multiple layers and large limits of indemnity, we are seeing insurers push to move higher up the insurance tower.

Silent Cyber

Most of 2020's Professional Indemnity market commentary continues to remain relevant for 2021. One major exception is the impact of the imposition of "silent cyber" endorsements. The issue of silent cyber was raised by the UK Prudential Regulatory Authority (PRA) after it surveyed its members and their approach to non-affirmative cyber cover in May 2018. The term silent cyber is used to describe cover for losses caused by a cyber event included in non-cyber policies, including professional indemnity. Both Lloyd's and the PRA recommended clarity under policies on whether coverage for losses caused by a cyber event was intended to be covered or not.

Lloyd's has subsequently mandated that all policies written by Lloyd's Managing Agents provide clarity as to whether they are excluding cyber coverage or providing affirmative coverage. They have developed a 4-phase implementation program with professional indemnity falling into phase 3 which covers policies incepting on or after 1 January 2021. While guidance has been provided in the form of draft endorsements there is considerable variability in the endorsement being applied by insurers with some holding firm on the recommended wordings and others willing to negotiate on the breadth of the endorsement. We have also seen instances of some insurers providing affirmative cover and others adopting the exclusionary wording. This has led to significant confusion in the early stages of phase 3 implementation. It is important to note that in Aon's experience a similar approach is now being taken by some, but not all Australian Insurers.

In light of these new endorsements, it is critical to review and understand the cyber event cover being provided under professional indemnity policies. Firms may need to review cyber insurance limits to ensure appropriate cover is maintained.

[3] www.lloyds.com/conducting-business/requirements-and-standards/market-oversight
[4] Social inflation: Navigating the evolving claims environment (www.asiainsurancereview.com/Magazine/ReadMagazineArticle?aid=44312)

Specific Industry Comments

The Aon broking team have provided industry specific commentary in the table below. This is based on Aon's experience in the professional indemnity market during the first half of 2021.

Accountants

Insurers are continuing to push for rate increases across accounting practices. Activities that insurers consider higher risk are more heavily scrutinised. This includes auditing of listed entities and financial institutions, mergers and acquisitions, and valuations.

Credit/Mutual Banks

Whilst there is still competition for credit unions, smaller banks and financial institutions, insurers are very selective. They will select those institutions they are prepared to consider with greater care and a much more detailed underwriting process than may have been the case in the past. Premiums are continuing to increase and we are still experiencing a loss of capacity. It has become even more important for clients to be able to show insurers how their risk should be differentiated, to maximise premium competition.

Construction Consultants and Design Professionals

Ongoing claims developments are driving reductions in capacity which has continued into 2021. We are seeing a greater focus from insurers on recruitment of key staff, project due diligence, cost over-runs, approach to loss mitigation, exposure to emerging markets such as renewables, cyber exposure and environmental, social and governance (ESG) plans. Design and manufacturing, renewables, any connection to the grid risk, property developers, certifiers, fire engineers, geotechnical work, structural engineering or quantity surveying are all concerns for insurers. Early engagement with insurers and high-quality submissions that detail meaningful risk management processes are essential to securing terms.

Financial Planners

The insurance market for financial planners continues to be challenging as insurers grapple with the active regulatory environment. Organisations that can demonstrate high compliance standards and risk management controls are more likely to achieve a favourable result. Any past claims activity must be clearly explained to insurers including root cause analysis and lessons learned. There is still some competition for smaller firms with 20 planners or less. Large financial planning organisations have struggled to maintain high limits due to a retraction in capacity. Pricing increases have been significant.

IT Professionals/Fintechs

IT liability continues to be a bright spot for traditional, longer-running IT firms. However, there is a limited appetite from insurers for SME start-ups and Fintech firms. Insurers are particularly cautious of payment providers and firms dealing with retail customers. Crypto and block chain are still not understood by the insurance market and require significant investment in educating insurers of the inherent risks and risk mitigation strategies.

Lawyers

We have again seen reductions in capacity and increases in premiums in 2021 as insurers continue to manage their portfolios, particularly those in the London market. We also saw the introduction of silent cyber exclusions on lawyers' "top-up" PI, which has the effect of potentially limiting "professional service" losses relating to cyber. Areas of concern for insurers continue to include mergers and acquisitions, conveyancing, corporate advisory, and plaintiff law firms.

Valuers

Cover restrictions continue to be imposed by some of the main valuers' markets around the assignment of property valuations required under changes to Section 90 of the Banking Code of Practice. The limited number of insurers that provide cover for valuers have been more open to new business in 2021 as they become more comfortable with the property market outlook.

Getting Better Outcomes from Insurers

A hard insurance market as described above requires a different approach to engaging with insurers. The 2020 experience has demonstrated that there is no room for complacency and time and effort is required to differentiate your risk from your peers.

- **Start the renewal process early**

  In the current climate, it is vital that you are prepared to start the renewal process earlier. This allows time to navigate the challenging market conditions, meet with their underwriters to facilitate a higher level of underwriting enquiry, and ensure the best possible renewal outcome. Insurers are asking for more and more information so be prepared to engage more fulsomely with insurers. The quality of your responses may impact the quality of the insurers' terms.

- **Identify your trade-offs**

  Work with your Aon broker to identify the areas of cover insurers are most likely to want to restrict. Have a plan around what you may be willing to trade.

- **Review your risk appetite and reassess your exposures**

  Professional indemnity insurance programs develop over time. Limits may have been set or increased during the soft insurance market when capacity was significantly cheaper and more readily available. When prices increase and cover retracts it can often be an opportune time to review the rationale behind limits of indemnity and reassess your limit. In some cases, minimum limits will be dictated by regulatory or contractual requirements. In other circumstances limits may have been selected based on a cost benefit analysis. Reducing the limit on a claims made policy is often a big decision as it applies to both future and past activities. To assist with this review Aon can provide Insurable Risk Profiling. Aon Global Risk Consulting will assist to determine key risks and understand their financial impact to determine the appropriate limit.

- **Cultivate relationships with multiple markets**

  Strategic meetings with alternative markets are an important hedge against last-minute surprises. Depending on the limits purchased, Aon recommends a diversified approach to insurer selection spanning both the Australian, UK, and Singapore markets where necessary.

- **Take the time to demonstrate the strength of risk management/culture**

  It is important to demonstrate to insurers the strength of your risk management frameworks and corporate culture. A proactive approach to risk management is a key differentiator against industry peers. Use case studies to bring the frameworks to life. Do not rely on insurers' proposal forms to demonstrate your commitment to risk management.

- **Do not leave insurers guessing**

  If there have been claims or risk management issues in the past, address these with insurers. What lessons were learnt? Demonstrate the changes that have been made in the business to minimise the chance of a recurrence. Your Aon broker will assist you to pre-empt the areas of concern and the types of questions the underwriters are likely to ask so that you can tailor your submission/presentations.

- **Meet with your insurers**

  Insurer meetings are becoming crucial as they are a key opportunity for you to differentiate the organisation by demonstrating good governance culture and a continued process of review and improvement. It also allows you to demonstrate the value you place on a relationship and your collaborative approach to insurance. Again, Hugo Wegbrans, Aon Global Chief Broking Officer, has said that "we want carriers to look at the individual characteristics of a client...and make sure they differentiate".[5] Clients need to contribute to this by ensuring that they allow time to meet with your insurers.

[5] www.aon.com/unitedkingdom/insights/market-update-2021-preparing-for-the-year-ahead

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