CLIENT BRIEFING

Professional Indemnity Insurance Market Update

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CONSULT AUSTRALIA

INTRODUCTION

The insurance industry is cyclical in nature. The cycles last from approximately two to ten years and are comprised of a hard market and a soft market.

A soft market is typically characterised by:

- Lower insurance premiums;
- Broader coverage;
- Reduced underwriting criteria;
- Increased capacity, meaning a greater number of policies and higher limits are available; and
- Increased competition amongst insurers.

The Professional Indemnity (PI) insurance market has been in a soft cycle for at least the 8 years prior to 2017, from then however, the market began to harden and this trend has continued since. The market is continuing to deteriorate, this is manifesting through increases in policy excesses and premiums; reduction in policy limits; tightening of policy conditions; and increased focus on risk selection. In order to appreciate the health of the PI insurance market and the shift to a harder market, it is important to consider what is happening in the broader pool of insurance.

PI insurance sits within a pool of financial and professional insurance lines that includes for example, Directors and Officers (D&O) insurance, and Cyber Liability. In Australia the financial and professional insurance lines are a concern for the insurance sector because the risk profile is increasing. This risk is coming from, for example:

- the commencement of the royal commission into the aged care sector;
- reforms arising from the Royal Commission into banking, finance and insurance;
- substantial losses arising from solicitors and the subsequent correction of historically low premium rates;
- advice on self-managed super funds by accountants;
- emerging crypto currency risks; and
- consequential cyber security claims hitting the IT industry.

In addition, concerns regarding the volume of potential claims arising from the building sector (cladding etc) and claims in the civil infrastructure sector (given the size and scale of projects) means that insurers are placing far greater scrutiny on their underwriting assessment, rates, terms and conditions.

As a result of the finance and professional lines of insurance being highly exposed to the risk of claims, insurers are reducing capacity or withdrawing from certain lines of insurance altogether.

In Australia, gross claims incurred was $1.25 billion at the end of 2017. This value was 86% of total premiums earned in the Australian market. An insurance agency needs to earn approximately $1 for every 70 cents of claims incurred to breakeven.[1] This means that in the Australian PI insurance market the average insurer lost 16 cents for every dollar earned. As a result of this declining profitability, the market has tightened in the years following 2017.

It should also be noted that globally 2017 was the largest loss year ever experienced by insurers as a result of Atlantic hurricanes, Californian wildfires and the Mexican earthquake.

WHAT IS PI INSURANCE?

PI insurance is for individuals and businesses that provide professional advice or services as part of their work. It is an important protection for a business against claims of negligence, malpractice or professional misconduct. It costs time and money to defend against a claim of negligence, malpractice, professional misconduct, or breach of duty (hence sometimes known as 'Error and Omissions' insurance). A PI insurance policy is a safeguard by providing cover against such claims, including legal defence costs.

PI insurance policies are annual policies and need to be renewed each year. PI insurance is underwritten on a 'claims made' basis, meaning that the insurer who is on risk when the claim (or potentially circumstance giving rise to a claim) was *notified*, is the insurer who will respond to cover the losses (not the insurer at the time the work was done). This is in contrast to public liability insurance, which is typically underwritten on an 'occurrence' basis, where an insurer is on risk for a particular policy year and covers insured losses arising from incidents that occur during that period. The 'claims made' basis on which PI is underwritten makes it imperative for professionals to notify their insurer as soon as they become aware of a potential claim, otherwise there is a risk of no cover.

PI MARKET CONTRACTION

It is important to note that by geography, PI insurance is the most heavily written in the UK, accounting for 33% of the non-US market. Canada accounts for 19%, Australia 17% and other non-US territories make up the remainder.

Given that Australia is a relatively small PI insurance market, larger businesses in particular will source cover from overseas in order to gain value from the larger marketplace, in particular the Lloyds of London insurance market. Interestingly, PI insurance has been unprofitable for many insurers for several years yet has continued to grow.

[1] AON Professional Indemnity Insurance Market Insights Q3 2018

By industry, design and construction is the most heavily written PI insurance, accounting for 24% of the non-US market. Lawyers PI insurance accounts for 21%, accountants' 11%, technology 4%, and miscellaneous 40%. The largest losses were concentrated in lawyers' PI insurance followed by design and construction PI insurance. Lloyd's incurred £272m in paid claims in 2017, compared with a premium income of just £170m across non-US architects' and engineers' PI insurance.[2]

According to documents from the Lloyd's Performance Management Directive as a result of a review labelled the 'Decile 10', 62% of Lloyd's syndicates that write non-US PI insurance have made an aggregate loss over the last six years, making it the second least profitable class at Lloyd's.

Syndicates have been mandated to provide written business plans on how they intend to remediate and return each class to profit. Several Lloyd's underwriting syndicates have already made the decision to exit the PI insurance market – including Aspen, Canopius, Brit, Novae (legacy business) and Channel.[3]

Australian businesses are exposed to Lloyd's syndicates either directly (as mentioned) or via the many underwriting agencies present locally in Australia backed by Lloyd's capacity. Aon reports[4] having experienced various Australian insurers withdraw from specific professions namely lawyers, engineers and construction companies reducing the overall capacity and competition on those classes.

Notably, Allianz Global Corporate and Speciality has announced that it will stop providing PI insurance in Australia from 1st September 2019.

Zurich Insurance has also said that while it will not withdraw from providing PI insurance in Australia, it does not intend to grow its existing portfolio in light of challenging market conditions.

While nearly all Australian businesses have been impacted to some extent, the most affected by the contraction and hardening of the financial lines insurance market are[5]:

- any risk related to the construction sector, including architects and engineers;
- surveyors, certifiers, fire safety and façade engineers following the highly-publicised building issues that have emerged (e.g. Lacrosse Tower fire, Opal Tower and Mascot Tower in Sydney), such events are further exacerbating the problems faced by a traditionally hard-to-insure sector;
- financial institutions – where broad Royal Commission exclusions have (or are) being applied to most policies at renewal;

[2] Lockton Brokers Report on the PI Market, May 2019
[3] Lockton Brokers Report: How to Navigate the PI Market
[4] Aon Professional Indemnity Insurance Market Insights Q4 2018
[5] Aon Professional Indemnity Insurance Market Insights Q3 2019

- solicitors – resulting from substantial PI losses and the subsequent correction of historically low premium rates.

ISSUES IMPACTING THE BUILT ENVIRONMENT SECTOR

Against this backdrop of a hardening PI insurance market due to the losses being felt both globally and in Australia, the local risks that insurers are particularly concerned about in our market are; claims exposure due to non-conforming construction materials and contractual terms.

1. Claims exposure due to non-conforming construction materials

Building 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 the insured review their portfolio of previous projects many are triggering the loss mitigation extension of their PI insurance policy in an attempt to rectify the works before any claim is made.

Class actions to pursue compensation for property owners of residential and commercial buildings are being established.

Insurers are also becoming 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.

2. Contractual terms

PI insurance typically provides cover for a consultant's common law liability (i.e. negligence).

Exclusions under PI insurance policies generally apply in respect of any 'assumed' liability. This means that liabilities assumed under contract will generally only be covered to the extent that such liabilities would have existed regardless of any contract in place (i.e. under common law or statute).

So typically, contractual terms like liquidated damages, express warranties, guarantees, indemnities and resultant consequential loss are excluded (usually expressly so in the policy wording).

In a softer insurance market, some insurers may offer contractual liability extensions to their standard PI insurance cover. They do not form part of the usual standard policy but may be provided as optional extensions within their standard products, or by an amendment to their standard policy by endorsement/special conditions. Examples can include:

- Limitation of Liability

The right to indemnity of the insured will not be prejudiced by the insured agreeing to waive or limit the liability of other parties to whom they have a written contract to perform professional services.

- Principal's Indemnity

  The insurer will indemnify the principal with respect to vicarious liability arising out professional services undertaken by or on behalf of the insured.

- Contractual Liability / Hold Harmless

  The insurer will indemnify the insured in respect to claims under an indemnity / hold harmless term of a contract to the extent the contractual liability arises out of the performance of professional services.

- Proportionate Liability

  The insurer will not preclude cover or reduce their liability simply by reason of the insured having contracted out of the proportionate liability legislation.

- Implied Warranties & Conditions

  The insurer will indemnify the insured against civil liability the insured incurs in respect to a claim alleging breach of warranty or condition as to merchantable quality, due skill and care or fitness for purpose implied in a contract which results from the insured's performance of professional services.

In a limited number of cases, some insurers may even go so far as offering the following extensions:

- Elevated Duty of Care

  The insurer will indemnify the insured against civil liability the insured incurs in respect to a claim alleging a breach of any expressed or implied term of a contract which imposes on the insured an obligation to exercise more than reasonable care to the extent such civil liability results from an error or omission of the insured in the performance of professional services.

- Joint Venture Partner's Liability

  The insurer will indemnify the insured against civil liability the insured incurs in respect of a claim arising out of the performance of professional services by a joint venture partner where the insured assumed such liability under contract with any joint venture partner.

A claim made against a consultant is typically contractual in nature, these policy extensions have become available because of an increase in demand for such cover by consultants in response to terms included by a principal or contractor in their terms of engagement, albeit at a significantly increased premium.

Terms such as those listed above have traditionally been considered unreasonable because they extend the consultant's risk beyond the common law and thus outside the terms of a standard PI insurance policy. However, such terms have become significantly more commonplace and so in limited circumstances extensions to a standard policy have become available.

This has led to a significant increase in the number of claims made as principals and contractors are enforcing the terms more frequently than anticipated. This increase in claims made has contributed to the losses incurred by the insurance industry and is a significant contributing factor to the hardening in the PI insurance market. In order to address these losses and rebalance the risk insurers are:

- Withdrawing policy extensions that increase the risk exposure of consultants;
- Increasing policy premiums - 5-10% increases are likely and disproportionately more for those accounts with losses;
- Increasing policy deductibles (excess);
- Increasing scrutiny of the type of work being undertaken by consultants and their previous claims history.

WHAT ACTION IS REQUIRED TO ADDRESS THESE ISSUES?

In order to maintain adequate supply of PI insurance for the consulting sector, action is required to de-risk the sector and reduce the likelihood of claims.

The insurance industry operates on the principle that it insures the 'unforeseen risk'. Insurers assess and price various risks to work out how much they would need to pay out if an insured suffered a loss for something covered by the policy. This helps the insurer determine the amount (premium) to charge for insurance.

To be able to put a financial value on a risk, insurers calculate the risk probability. Given the size of the losses and unprofitability of PI insurance, it is clear that the risk ratio needs to be significantly re-evaluated. The hardening in the market is evidence that this re-evaluation has begun.

In the built environment sector, principals and contractors have been shifting the risks associated with construction and infrastructure projects by relying on the insurance policies held by consultants to address any claims. This needs to be addressed urgently to ensure that PI insurance remains available at an affordable premium and provides a reasonable amount of cover to those businesses that need it.

Recommendations for the built environment sector:

1. *Ensure that projects are appropriately scoped before being released into the market for pricing and seek target cost pricing with pain/gain model as an incentive.*

2. *Adopt digital solutions that bring the parties together to drive efficiency and reduce risk.*

3. *Ensure that tender timelines are not truncated in order to allow for risk assessment workshops with all parties involved to be held during tender process.*

4. *Reduce multiple layers of insurance by exploring the options to insure projects to achieve a fair outcome for all the parties, one example could be the adoption of a "tower model", so that project risk is treated separately from contractor performance or consultant standard of care.*

5. *Actively manage project risk by establishing standard contract terms that drive collaborative behaviour, innovation, allocate risk to the party best able to manage it and have a focus on early problem identification and solutions.*

6. *Reform the 'value for money' proposition used by governments to a 'whole of life' standard, to ensure that capital cost at the outset is not the overriding factor in order to unlock to whole of life efficiency and best for project outcomes.*

7. *Adopt a Model Client Policy approach, meaning that government must set the standard for good procurement practice across Australia, in line with the principles of governments' 'model litigant' policy.*