ace new zealand

association of consulting and engineering

ceas

professional indemnity insurance market challenges

introduction

The insurance industry is cyclical in nature. The cycles last approximately two to 10 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 more significant number of policies and higher limits are available; and

Increased competition amongst insurers.

Before 2017, the Professional Indemnity (PI) insurance market was in a soft cycle for at least eight years, then 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. To appreciate the health of the PI insurance market and the shift to a harder market, it is essential to consider what is happening in the broader pool of insurance.

PI insurance sits within a pool of financial and professional insurance lines that include, for example, Directors and Officers Liability insurance and Cyber Liability. In New Zealand, the financial and professional insurance lines are a concern for the insurance sector because the risk profile is increasing. Some examples of where the risks are coming from are:

Concerns regarding the volume of potential claims arising from the building sector (from cladding, etc.);

Claims from the civil infrastructure sector (given the size and scale of projects);

Reforms arising from the government review of the banking, finance and insurance sectors;

Substantial losses arising from solicitors and the subsequent correction of historically low premium rates;

Heightened exposures for Directors following the collapse of Mainzeal;

Emerging cryptocurrency and cyber risks; and

Consequential cybersecurity claims hitting the IT industry.

This all means that insurers are placing far greater scrutiny on their underwriting assessment, rates, terms and conditions. Finance and professional lines of insurance are highly exposed to the risk of claims resulting in Insurers reducing capacity or withdrawing from certain lines of insurance altogether.

In New Zealand, gross claims incurred in 2017 was $2.7 billion. This value was 71.6% of total premiums earned in the New Zealand market. An insurance agency needs to earn approximately $1 for every 65 cents of claims incurred to breakeven. This means that in the New Zealand insurance market, the average insurer lost 7 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 most significant loss year ever experienced by insurers due in large to the Atlantic hurricanes, Californian wildfires and the Mexican earthquake.

COVID-19

The impact of COVID-19 on the insurance market has yet to manifest itself. However, many international insurers are already reporting significant losses due to COVID-19. Therefore, it might be expected that the global uncertainty of the medium and longer-term effects of the virus could act to harden the market even further, reinforcing the need for better management of risks within all businesses.

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 essential 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 typically 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 differs significantly from 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 New Zealand is a relatively small PI insurance market, larger businesses, in particular, have traditionally sourced cover from overseas 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.

By industry, design and construction are the most densely 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 most significant 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[1].

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

Syndicates were mandated to provide written business plans on how they intend to remediate and return each class to profit. Several Lloyd's underwriting syndicates decided to exit the PI insurance market[2].

1 Lockton Brokers Report on the PI Market, May 2019
2 Lockton Brokers Report: How to Navigate the PI Market

New Zealand businesses are exposed to Lloyd's syndicates directly (as mentioned), or via some of the underwriting agencies present locally in New Zealand backed by Lloyd's capacity. Aon reports[3] having experienced some New Zealand 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 announced that it would stop providing PI insurance in New Zealand from 1st September 2019.

Zurich Insurance has also said that while it will not withdraw from providing PI insurance in New Zealand, it does not intend to underwrite engineering risks going forward.

While nearly all New Zealand businesses have been impacted to some extent, the most affected by the contraction and hardening of the financial lines insurance market are[4]:

any risk related to the construction sector, including architects and engineers;

surveyors, certifiers, fire safety and façade engineers;

financial institutions;

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 New Zealand, the local risks that insurers are particularly concerned about in our market are; claims exposure due to non-conforming construction materials and contractual terms.

3 Aon Professional Indemnity Insurance Market Insights Q4 2018
4 Aon Professional Indemnity Insurance Market Insights Q3 2019

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.

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 typically 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 concerning 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.

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, 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 being 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. To address these losses and rebalance the risk insurers are:

Withdrawing policy extensions that increase the risk exposure of consultants;

Increasing policy premiums - 20% increases are possible and disproportionately more for those accounts with losses or increased risk;

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?

To maintain an 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 building 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 to allow for risk assessment workshops with all parties involved. These should be held during the tender process.

4

Reduce multiple layers of insurance by exploring the options to insure projects to achieve a fair outcome for all the parties.

5

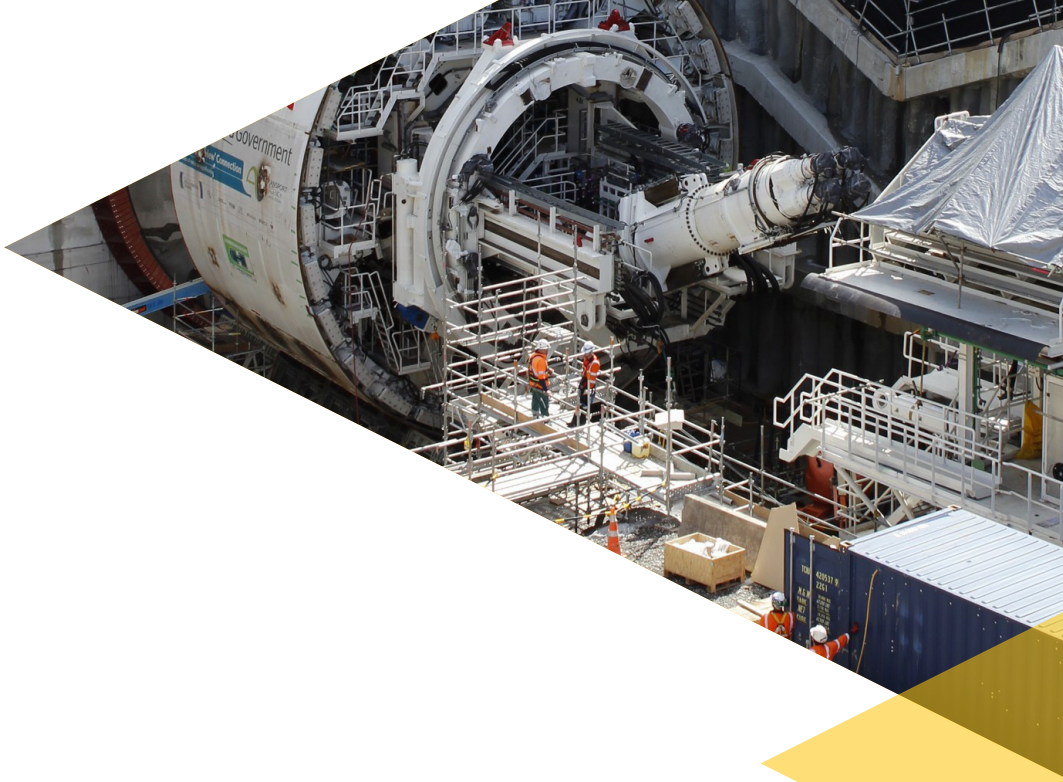
Actively manage project risk by establishing standard contract terms that drive collaborative behaviour, innovation, allocate risk to the party best able to manage it and have a focus on early problem identification and solutions.

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 to unlock to whole-of-life efficiency and best for project outcomes.

7

Increase the understanding of client advisors about the consultant's role and legal obligations as a professional exercising a duty of care, and the connection between this duty and the availability of insurance cover.



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