Market Analysis

Professional Indemnity Insurance

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BIBA representation

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1 Indemnity market overview

Purpose of product

1.1 Professional indemnity (PI) insurance came in to prominence in the 1970s following the leading case of Hedley Byrne v Heller & Partners 1964 concerning the matter of negligent misstatements in which the House of Lords acknowledged that a duty of care is owed not only to the client but also if there is a "special relationship" to third parties who have relied upon the advice.

1.2 This case concerns economic loss which the law of negligence treats differently from negligence concerning property.

1.3 The consequence of this decision, combined with the consumer protection attitudes that were beginning to grow in the 1970s, led to professional firms becoming more concerned about negligence claims and this in turn led to the Government requiring the Law Society to oblige its members to insure against claims of negligence. The Law Society imposed mandatory insurance upon its members in 1976.

Relevant legislation/regulation and rationale

1.4 The Institutes of Chartered Accountants in England & Wales, Scotland and Ireland adopted a compulsory (as distinct from mandatory) insurance scheme in the early 1980s and this was followed in about 1986 by the Royal Institution of Chartered Surveyors and then the Architects Registration Council (for the RIBA).

Two purposes

1.5 PI insurance serves two purposes. The first is to protect the "public" (more often businesses) and ensure there is the means to compensate when negligence is proven or a claim is otherwise settled

1.6 The second is to protect the business (usually the professional firm). The rationale for protecting the business is to preserve its ability to function and maintain cash flow whilst under the threat of litigation. To do otherwise would jeopardise the best interests of the firm's other clients by reducing the capability of the business to continue.

How the market operates

1.7 There are currently some 40 UK registered insurers who are acknowledged specialists and leaders in the PI class. Very often the same insurers are also specialist in Directors and officers insurance (D&O). There is a close relationship between these two insurances which is becoming more prominent as professional firms incorporate or become LLPs.

1.8 The full effects of the "credit crunch" are yet to manifest themselves in the insurance sector but there can be no doubt that when the underlying value of insurers' assets are dealt the inevitable blow the cost of insurance will have to increase.

1.9 History has shown that, rather than lose market share by increasing prices, insurers will first use other means to reduce their risk, including :-

1.9.1 increase the level of self insured excess
1.9.2 make limits of indemnity include costs and expenses of defending the claim
1.9.3 include cost and expenses in the self insured excess
1.9.4 reduce the level and scope of cover

Types of indemnity

- Negligent act error or omission
- Civil Liability
- Legal Liability

1.10 The first PI policies insured negligent acts errors or omissions.

1.11 In the 1980s as negligence litigation developed and flourished, the term Civil liability was invented and presented by Insurers, as an enhancement of cover over negligent acts errors or omissions.

1.12 Recently, some insurers have opted to adopt the expression Legal Liability, proclaiming that it has a wider meaning than Civil Liability. Taking into account the exclusion of criminal and many other forms of liability, expressed in the typical policy wording, there is some doubt as whether this is anything more than a marketing ploy.

1.13 The exclusions in PI policies, generally, are voluminous and could be the subject of a specific study.

1.14 Every PI policy is on a "claims made" basis. This means that when a policy lapses there is no further cover; period.

1.15 The implication of this is that run-off cover has to be maintained by professional firms for a minimum period of six years (see Limitation Act) and this has always been a burden to policy holders and a problem for some to achieve and maintain without income to pay for it.

1.16 The Conditions in a PI policy include the duty to notify claims and circumstances that might give rise to a claim. There is a constant debate surrounding this area, especially with regard to what actually constitutes a notifiable circumstance. This too could be the subject of a special report.

1.17 Claims are refused in part or in whole where insures allege a breach of the claims notification condition/s.

Limits of indemnity

1.18 Each professional body has its own regulations for minimum standards of cover and limit of indemnity.

1.19 Generally, the lowest level is £500,000, each and every claim, each year

1.20 The most common limit of indemnity in the lower strata of the professions is up to £2m, each and every claim, each year.

1.21 The mid-range firms will buy between 5m and £10m, each and every claim, each year

1.22 The second tier firms will buy between £25m and £75m each and every claim, each year

1.23 The top firms will buy as much as they can get depending on how inexpensive are the top levels (layers) of cover. Cover has been available up to circa £250m each and every claim, each year

1.24 Larger firms and companies also use Captive insurance as part of their risk transfer programme.

Customer profile

1.25 The precise numbers of professionals in practice and the numbers of firms and businesses giving professional services and buying PI insurance is information we do not have.

1.26 However, the following figures are a guide.

- Solicitors 110,000 practitioners
- Chartered Accountants 100,000 practitioners
- Chartered Surveyors 80,000 practitioners
- Registered Architects 28,000 practitioners
- Consulting Engineers 30,000 practitioners
- Medical malpractice not included - separate market.

The business entity profile of the professions is broadly similar in each discipline.

- 5% Major international firms
- 20% Second tier leading firms
- 30% SME firms and businesses
- 20% Public authority
- 25% Sole practitioners / sole proprietors

Size of market

1.27 This information would require special investigation from leading insurers and brokers.

1.28 In broad terms the market value of PI business is estimated to be circa £900m, in the UK.

1.29 PI insurance is underwritten in layers and market volume by £value is often measured in the Primary levels of up to £5m limit of indemnity.

Performance

1.30 The PI market has remained highly competitive for nearly fifteen years. Some would say there is an over capacity that has driven down prices to a dangerously low level.

1.31 Premium costs are now at an all time low there having been a "soft " market for almost fifteen years. The continual flow of money to invest in the insurance industry has fuelled, in some cases, reckless competition and the consequences include an increasing level of disputed claims. Insurers will sometimes, and too often, take issue with the minute interpretation of a word or phrase in a policy in an attempt to avoid paying the claim.

2 Analysis

Strengths and weaknesses/market failure?

2.1 There is no evidence, at the time of writing that the market is likely to substantially shrink or indeed fail. However, the potential for a collapse is there if the credit crunch impact is more severe than the market has contemplated.

2.2 Rating Agencies will have some impact upon buyers' perception of security and if the banks begin to collapse there must be a prospect of some insurers failing, as well.

2.3 The inherent strengths and weaknesses of the market are measured in security; continuity; pricing; payment of claims; claims management service.

2.4 They differ as between classes of PI business. The most prominent and well recorded is the solicitors' profession because of its mandatory status and consolidated market, but this is not a good model by which to judge the other professions because it is a very different model. However, the pricing at the annual October 1st renewal (of all UK solicitors) is taken as an indicator of overall market PI pricing. Whether this holds to be true this year remains to be seen.

2.5 The way the market operates means that brokers are often unable to give their client firm renewal terms until a few days, or hours, before expiry. This is despite the "contract certainty rules that have been introduced.

2.6 Competition between brokers for new business and the influence they can exert on their preferred insurers to reduce price at the last minute serves to make a highly dynamic pricing structure but at the same time is disconcerting to the client whose opinion of the insurance market is not enhanced and makes it difficult for the buyer to look at the contract detail and implications in the time available.

2.7 Claims handling and payment remains the "poor relation" in an industry that focuses its efforts in sales and investment.

2.8 The uncertainty of the litigation and dispute resolution process continues to fuel claims management costs and the "assembly line" outsourced claims-handling facilities now favoured by many insurers does not enhance the integrity of the PI product. There are complaints about claims handling and the causes of these are partly concerned with outsourced suppliers ' vested interest" in keeping their client's (the insurers') costs down.

2.9 The issue is not so much one of price, which takes care of itself in a competitive market, but the integrity of the insurer, upon whom the client is relying, to *professionally* manage a future claim. Professional men and women who buy the insurance are expecting professionalism in their insurer but this is not always displayed at the time of sale or, at the commencement of a claim, when, for example, "reservation of rights letters are sent at the earliest opportunity.

2.10 Comparatively few claims get to court; probably fewer than 5% but estimate is anecdotal.

2.11 A detailed analysis of the strengths and weaknesses of each is a large piece of work and it would be advisable to pre-define what is required of the analysis before embarking upon it.

Historical trends

2.12 The insurance industry describes itself as a cyclical market with prices rising and falling in, traditionally, about a 5 year cycle. The cycle has evidently changed its form in the last twenty years and so a new definition of the term is needed before it can be relied upon to mean "things return as they once were". There is no evidence that this is now the case.

2.13 The principal trend in PI insurance is the fact that claims tend to be reported within three years of the negligent act and can take up to seven years to settle.

2.14 PI claims will increase substantially as the economy slows, we already seeing signs of this. You could say that the PI market is contra-cyclical to the broader economy.

3 Potential issues in the future

3.1 The last swingeing increase in PI market premiums, generally, was in the mid 1980s when premia rose up to 300% in just a few weeks. Many architects went out of business and so too did other professionals operating in small units or alone.

3.2 A recession in the UK could bring about a recurrence but there is more capacity now than in the 1980s by a factor of about six times. However, without the sustained reinsurance protections, which are independent upon the sustainability of interbank lending and trading, there seems nothing to prevent capacity drying up quickly.

3.3 If that happens then insurers will compete vigorously for the "better risks"

3.4 It is already evident that some insurers are no longer accepting surveyors engaged in valuation and investment work; solicitors engaged in conveyancing or who have less than 10 partners; financial advisers and mortgage brokers.

3.5 The industry has an overall fear of a new pandemic loss similar to the pension review losses of the 1990s. In that case the Government's action to determine compensation without proof of liability led to insurers pulling out of the class because they could not price a risk based upon Government dictate as to the terms of and definition of a claim. Removing legal liability from being the trigger of a PI policy changes the face of the contract and indeed the entire viability of the PI insurance proposition.

3.6 The make up of the modern PI market is very different with little or no co-insurance for anything other than the major placements. Additionally most Lloyd's syndicates derive the capacity from a single source and of the 40 registered insurers at least 50% would be considered recent entrants. Accordingly the market is more vulnerable to a dramatic correction than in previous cycles.

3.7 Claims. Insurers, and to a lesser extent brokers out-sourcing claims is one of the most significant developments of recent years Moreover the trend for insurers to recruit lawyers as opposed to claims underwriters is worrying, there is a growing tendency for direct reporting and you can expect a more rigid application of policy terms.