CURRENT STATE OF THE PROFESSIONAL INDEMNITY MARKET
by Peter Holt, Michael Payne Syndicate

The Professional Indemnity market gives the appearance of the perpetual yo-yo and its volatile nature causes great concern to all parties involved. The buyer cannot budget, the broker cannot be confident with advice and the insurer suffers wildly fluctuating loss ratios. I will endeavour to explain some of the issues which cause these conditions and try to indicate the likely market state for the forseeable future.

Much of my comment is based on the records and statistics of the Michael Payne syndicate. We have underwritten a broad based Professional Indemnity account by both class and country (other than the United States) since 1974. I suspect, therefore, that the syndicate's statistical base is likely to be indicative of market conditions throughout that period, although your personal experience looked at directly may obviously differ. The syndicate has displayed a greater degree of consistency than many other insurers throughout that period. This underpins the continuity of our client base which is so important in achieving a meaningful statistical base.

To give a more rounded view of current market conditions I will approach the subject in three sections being first, the recent past, second, the present and finally with the aid of a well worn crystal ball, the future.

The Recent Past

To review the performance of the Professional Indemnity market in the recent past, I have taken a ten year period from 1982 to 1991. This indicates the market cycle over that decade and enables us to take a view on potential future trends. It is also important to appreciate the cause of such trends and not merely its symptons. Therefore, I will try to make clear the base forces which drive the market and control its destiny.

The comparative loss ratios over the ten year period under review show poor loss ratios from 1982-1985, much improved loss ratios in 1986-1988 and then a declining trend from 1989 onwards. The first four years produced serious underwriting losses which led to a hard market, the market started to harden in 1986 and reached its peak i.e. lowest loss ratios in 1988. These three years being the only ones producing any profit on a pure underwriting basis i.e. premiums minus claims. The latest three years show the return to poor loss ratios marred in particular by a potentially disastrous 1990 year of account.

When viewed graphically the comparative loss ratios show a wave type curve showing clearly the ups and downs of the decade under review. The cause of these fluctuations, I believe, is controlled by four major factors and these factors have a direct impact on underwriting conditions.

The primary cause is the availability of market capacity, this refers to both the number of insurers transacting Professional Indemnity business and the respective size of their participation. Insurers are prone to a lack of continuity and some are known to be very active and competitive in underwriting terms for a few years and then quickly withdraw from the market, normally after suffering substantial losses. However, when insurers have decided to remain underwriting the class they are then faced with three other factors which again have a direct impact on underwriting strategy.

First, reinsurance availability and the cost of reinsurance. A lack of reinsurance capacity and increasing costs restricts some markets from writing the business at all. Restrictive conditions are imposed on others which normally reduces the breadth of cover offered by insurers. The increased cost of any reinsurance program is passed on by direct insurers to the insurance buyers hence pushing up the direct premiums.

Second, investment conditions have been a factor in the market cycle. Quite simply high investment returns reduces dependence on good underwriting results and can, if improperly managed, lead to poor and underwriting practices.

Finally and perhaps the most direct factor affecting the market cycle, is the claims record of the particular professions and trades being insured. A poor claims record has a direct impact on the extent of rating increases to be charged.

Conversely a good claims record leads to more stable and consistent premium levels.

Thus the four factors of interest are:-

i) market capacity;

ii) reinsurance availability and cost;

iii) investment conditions;

iv) claims record.

The important question is therefore what is the current status of these four factors in the present underwriting cycle?

Present Market Conditions

Currently market capacity is reducing. The number of Lloyd's syndicates transacting business is reducing. Insurance Companies such as the Prudential and Guardian Royal Exchange have withdrawn from the market. Many of the remaining syndicates and companies are reverting to their core accounts. This is particularly true of the Lloyd's marine market where substantial Professional Indemnity capacity is no longer available. The result of this action is that market capacity reduced in 1992 and this reduction has accelerated into 1993.

For the markets remaining there are problems to be faced. Reinsurance availability has diminished and the cost of the available reinsurance has escalated dramatically since the beginning of 1993. Even reinsureds with relatively good claims records are suffering rate increases in excess of 30%. Alongside higher rates, reinsurers are looking for higher retentions by original insurers. Further restricted is the breadth of cover available in the reinsurance market. Unlimited reinstatements of cover were readily available only a couple of years ago; nowadays, unlimited reinstatements are either unavailable or only possible to purchase at astronomical rates. Reinsurers in certain instances are applying exclusions of cover which has a damaging effect on the amount of available capacity. So, early in 1993 we have seen reinsurance availabilty shrink and at substantially higher costs.

Investment conditions are becoming more difficult and in view of the rapid reduction in interest rates during the latter part of 1992, it is likely that current returns will diminish compared with those of recent years. The reduction in investment return forces the market to make reasonable profit on its pure underwriting account. Again in early 1993 we are seeing the effects of this with many insurers increasing rates.

The final causative factor of the market condition is the current claims record. It is becoming increasingly clear that following the recession of the past few years the market is seeing a greater incidence of claims than at any other time in history. Disputes which ten years ago would have been settled amicably are now being pushed towards litigation. In addition to the mere cost of compensating such claims, legal costs are also escalating even in many instances where the original claim can only be at best described as spurious.

There are currently outstanding several issues the size and nature of which have not been seen by the market previously.

First, claims against Chartered Surveyors by funders now alleging over valuations are reaching staggering proportions. Claims are arising from both residential and commercial valuations where the funder now has a security worth in many instances substantially less than the money first lent. There are in many examples good defences available but even if the claims are successfully defended or negotiated the cost to the Professional Indemnity market will be substantial.

Secondly, potential claims by Lloyd's Names against their members agents is of concern to the market. The mere size of recent losses in Lloyd's means that the quantum of any such dispute will be large, possibly billions of pounds. Such numbers have previously been regarded as unrealistic in Professional Indemnity terms.

Finally, the dramatic collapse of many financial operations and the failure of various takeover and merger deals is also placing a strain on the resources of the Professional Indemnity market. To name but a few, BCCI, Mirror Group Newspapers and Barlow Clowes are likely to result in litigation against various accountants, solicitors and financial institutions.

It is now apparent that the harder market of the mid-eighties had given way to a soft market in the late eighties and early nineties against a backdrop of increasing claims. The result of this is that the more current years of account are showing a decline in loss ratios and in some years unacceptable underwriting losses. The market has started to react to this.

The Future

It is apparent therefore, that the conditions to promote a harder market are now prevalent. I believe, however, that the reaction of the market will be less dramatic than that of the mid-eighties and a more professional approach will prevail. Withdrawal of some aspects of coverage is inevitable as the soft market has extended wordings on a non-sustainable basis. It is important that the premium increases should be on a more selective basis than in the previous hard market, hitting harder those clients or classes of business with the more adverse claims record.

Most underwriters now have a considerable database and can identify specific problem areas more accurately than ever in the past. The records can be viewed by each class of business and then split by each country in which the Underwriter writes business. Correct usage of this information will lead to a sensible hardening of the market in a justifiable manner.

The Underwriters will concentrate on adopting a more restrictive and selective underwriting approach. Such an approach may result in for example the following potential restrictions:

(1) Higher rates and self-insurance which is self-explanatory and is probably the Underwriter's most direct and effective tool.

(2) Wordings and fringe policy benefits are likely to come under pressure. Some examples of the areas which may be affected are as follows:

i) Directors and Officers liability - often added as an extension to a PI policy but will become less available on this basis as a specialist class requires specialist underwriting.

ii) Dishonesty of Principals - becoming an increasingly difficult area of cover. An unacceptable frequency of dishonesty-related matters is giving the market concern that lack of apparent control is making this risk uninsurable.

iii) Pollution - already under review by many Underwriters who have concern over who will pay for future clean-up costs when the proposed directives are up and running. The existing rates for Professional Indemnity can not pay for a serious pollution problem. Exclusions will undoubtedly eventuate with the alternative to buy back a restricted extension clause at appropriate additional premiums.

iv) Any One Claim - this is one of the few forms of unlimited cover still available. However, potential any one claim issues have been identified in several classes: Accountants, Solicitors, Surveyors, Financial Advisors, Stockbrokers and is rapidly becoming unsustainable.

The speed of this process may well be accelerated by the actions of reinsurers who are reducing the breadth of cover available under reinsurance contracts.

The above examples show some ways in which the market is likely to react. Other fringe benefits such as Inadvertent Non Disclosure, Fees Recovery Clauses and Instalment Premiums are already being diluted if not deleted by the current hardening market.

I have previously indicated that Underwriters will also become more selective as to which proposers they may wish to insure. The method of selection will I am sure vary between insurers but I believe most Underwriters will take the following issues into account.

The British Standard 5750 is becoming more prevalent certainly in the construction industry and will be regarded by Underwriters as basic underwriting information. Although the standard will not be the answer to all our problems it will certainly enhance the general checking and documentation procedures. In the long term, if not avoiding Professional Idemnity claims an advantage will be gained in the ability to investigate and settle claims. I think the day is reasonably foreseeable when the proposal form will enquire:

"Is the proposer certified to BS 5750? If not, please explain".

Following on from this approach, Underwriters are beginning to see some benefit in the independent appraisal of risk and this approach is gaining momentum. A relatively new proposal termed PRIME has currently been aimed at the class of Surveyors. PRIME stands for Professional Risk Investigation and Management Exercise. It is designed to assess the quality of a practice and to convey this assessment to Underwriters. PRIME is intended to be a continuous program working with practices to generate improvements in risk profile. This initiative is being supported by some solid long standing markets and is perceived by many as the way forward. In my opinion the approach will spread to other classes and such exercises will become necessary for clients to create realistic and beneficial terms.

The other area of selection will be to reward with premium credits Assured's having the ability to negotiate restrictive and more acceptable contract conditions.

Clear contract conditions reduce confusion over responsibilities and assist beneficial claims negotiation.

It is also vitally important that Assureds endeavour to stand by hard won court decisions and not give away any such benefits under contract. A classic example of this being the multitude of collateral warranties being signed and the consequent acceptance of liability for economic loss.

Another positive area of review could be the inclusion of limitations under contract whether by time, value or exclusion. It is appreciated that in these times of recession tough negotiating of contracts can be commercially unacceptable. However, if the Assured's wish to halt the advance in the cost of insurance then efforts in these directions will be required and any such efforts will prove beneficial to Assureds in forthcoming years.

1993 is the beginning of a hardening market. I do not believe that the reduction in direct market capacity will be great enough to allow the dramatic volatility of the mid-eighties although increases are inevitable.

It would be wise of all parties involved to encourage more restrictive contract conditions which will be to the advantage of Assureds whether covered by an insurance policy or not.

Finally, I would also like to encourage either continuing a more direct meetings by Insureds with Underwriters so that the difficulties and problems can be mutually understood. Insureds generally receive a better market reaction when they have put forward their viewpoints personally and such meetings certainly appear to give the Professional Indemnity policy an added value.

INSURANCE BROKERS' NEGLIGENCE
by Jonathan Mance Q.C.

1. Germany has a developed insurance market with brokers, insurers and the largest reinsurance company in the world. Yet insurance brokers' liability is in Germany an exotic topic. The majority of professional negligence claims there are against lawyers. Brokers and accountants feature only exceptionally. The latter may credit this in part to a statutory limitation of DM500,000 (about £200,000). But brokers benefit by no such legal advantage. I start therefore by asking what