Changes in the Professional Liability Market

Design and Construction Professional Liability

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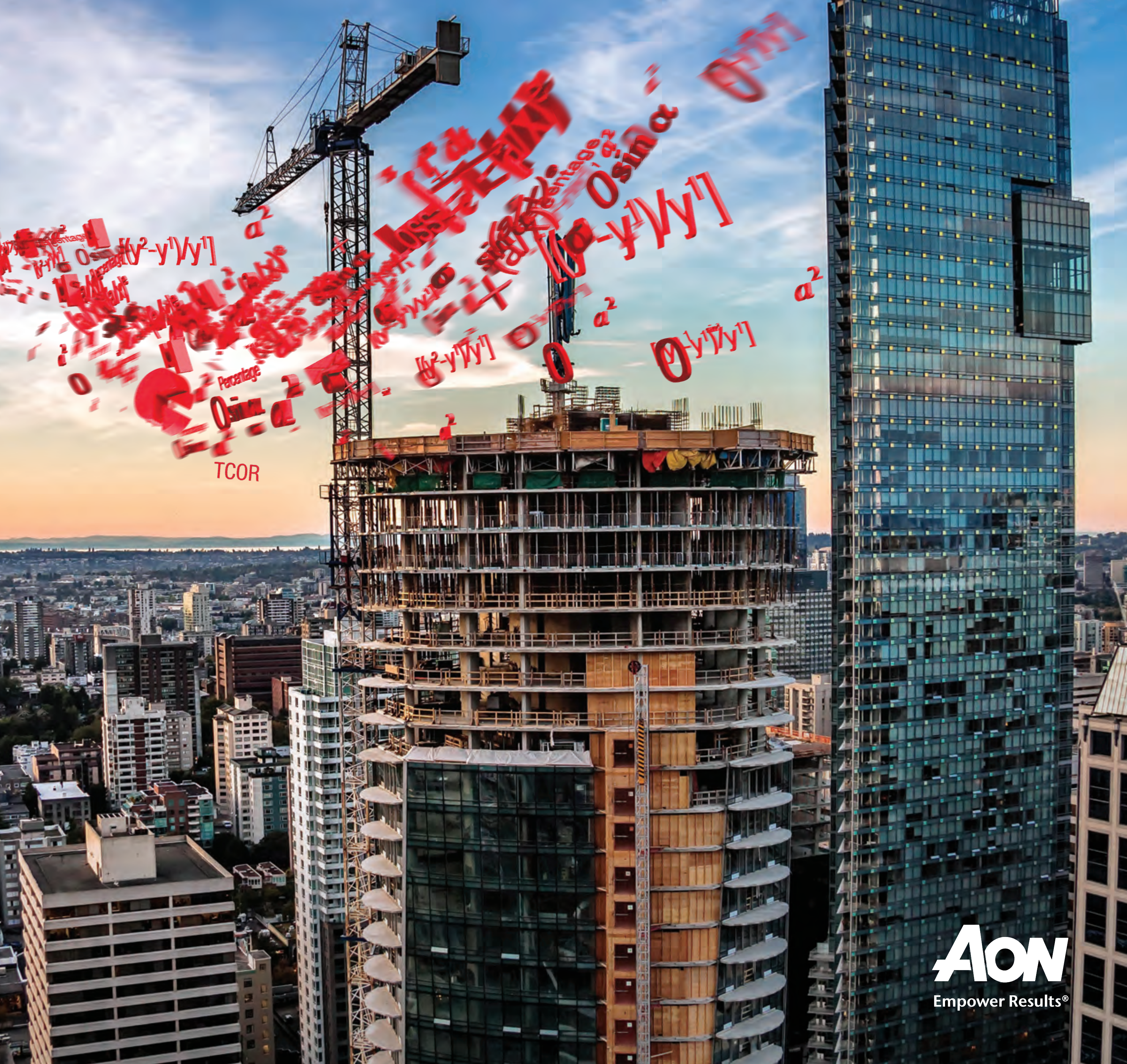

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Background

Over the past twelve months the professional liability insurance market has solidified for the first time in fifteen years. The extent and duration of the hardening market are unknown, but all current indications are that 2020 will bring no financial relief to firms seeking to renew their corporate annual programs or those seeking coverage for professional liability coverage on a project specific basis.

Insurer change in professional liability appetite and pricing for US risks began in late 2018 with the Architects and Engineers (Designers) markets. Then in mid-2019 other classes of professional liability began showing signs of stress — primarily the Lawyers and Consultants markets. The stiffening market began with the insureds being asked to take on more risk themselves by means of increased Self-Insured Retentions (SIRs). Quickly thereafter, the markets began applying significant rate increases, particularly to those clients with a poor loss history. Finally, several markets began to reduce the capacity they were willing to commit on any professional liability risk.

Designers in the construction field have indeed experienced all the ill effects associated with a hardening market over the past eighteen months. We anticipate the ability to maintain current limits of coverage, retention levels, and pricing to remain very challenging for most Designers.

Contractors journey through the hardening professional liability market however has thus far been much less severe. While several Contractors performing work in North America have been asked to take modest increases in their SIRs, pricing for professional liability has increased only 5-8% and capacity has remained relatively consistent for both annual programs and project specific opportunities (though we are starting to see some carriers evaluate capacity outlay for a single risk). While a poor claims history will indeed negatively affect a Contractors' renewal, the increased costs are not proportionate to uptick experienced by other classes of professional liability risk. Will this trend continue for Contractors? That seems unlikely, at best.

The change in the professional liability market is, like most things in life, a combination of factors. Most prevalent, however, is the significant increase of claims activity and losses. And some of the contributing aspects to the increase of claims include Designers and Contractors:

- underbidding work;
- bidding on work outside of their firm's core competency;
- submission of Guaranteed Maximum Price bids based upon minimal completed designs;
- a lack of suitably qualified/experienced professionals to work on projects; and
- the number of mega projects where even the smallest of errors often translates into a significant dollar loss.

But the single largest contributing factor to claims is the rapid development and use of the Design-Build delivery model in the US construction industry. To be sure, the insurance market has experienced frequent and severe losses associated with the Design-Build delivery model since its use began in earnest over the past decade. The root cause of these losses ranges from a basic underappreciation for the unique risks associated with the delivery model, to a lack of coordination and communication between Contractors and Designers.

Broader and more general market forces can also be blamed for the recent challenges in transferring risks by means of insurance. Over the past decade, professional liability insurers serving the construction industry simply failed to maintain rates and SIRs commensurate with the increased exposure. Projects continued to increase in size and complexity, yet the competition between carriers resulted in unreasonably and unsustainably low rates and SIRs being continually offered to the entire construction industry.

The inevitable claims are now maturing, and the collected past premiums are far short of what many insurers believe to be necessary to sustain an ongoing market. Professional liability rates are also likely rising due to peer pressure within insurance carriers. As many of the other classes of insurance (e.g. Property, Auto, Excess Casualty) have suffered significant rate and SIR increases, the probability that the professional liability lines would escape scrutiny by a multi-line insurance carrier is unlikely.

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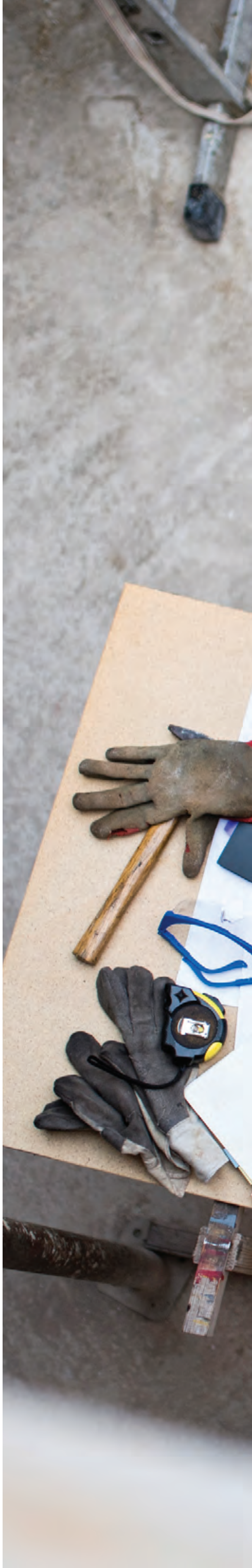

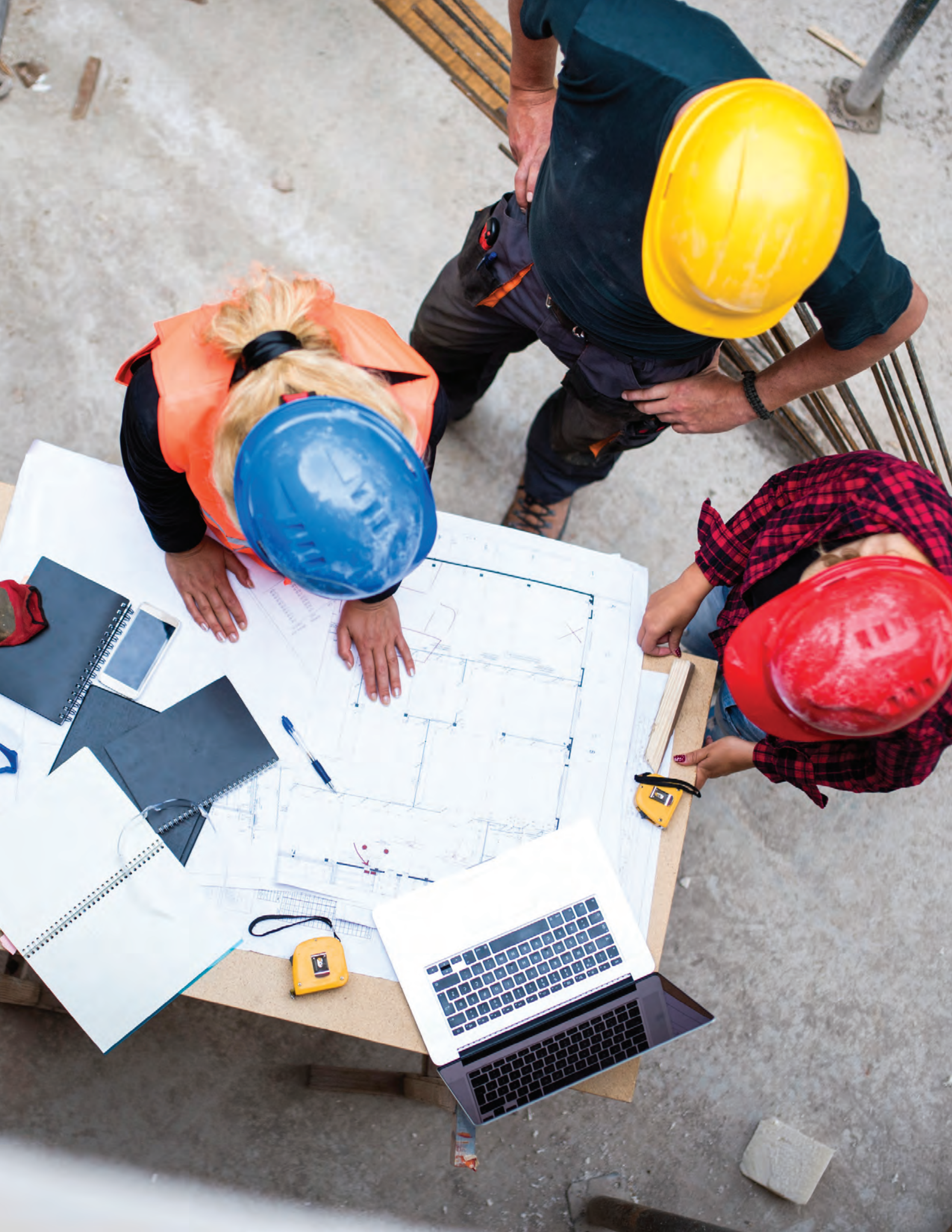

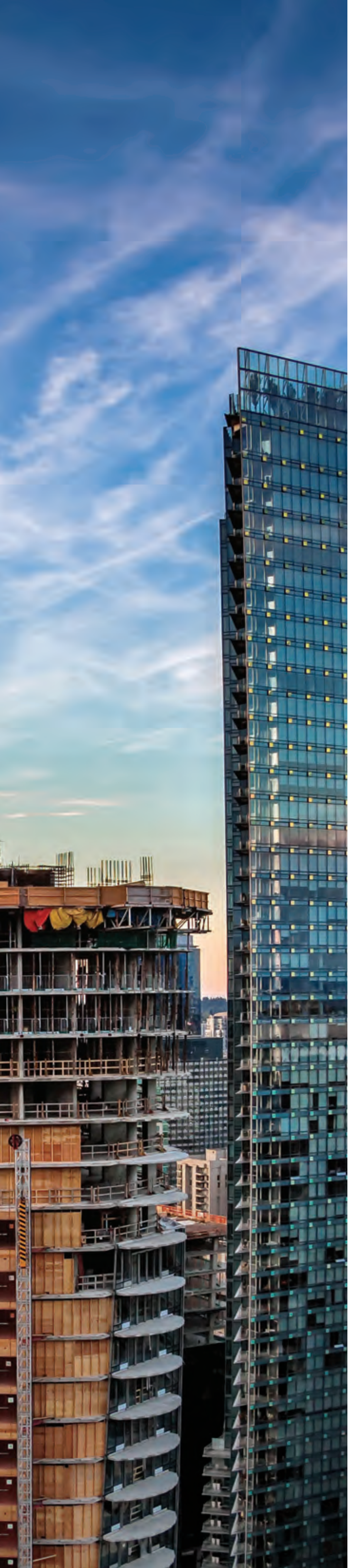

Learning from Previous Changes in Market Conditions

Although it has been some time since the construction professional liability market hardened, it is not unprecedented. Approximately fifteen years ago, the market hardened briefly and in the early 1980s the insurance market for these types of risks became nearly non existent. Valuable lessons can be gleaned from an examination of what occurred during the past downturns.

Designers

In the mid-1980s, many large United Kingdom based Architectural firms felt that they were not being well served by traditional market insurers and that the high premiums they were paying bore little relationship to the amount of loss they were creating by way of claims. After conducting an actuarial analysis, the disaffected architects determined it was financially prudent for them to form their own non-profit insurance company.

Also, during the last true hard market, the paucity of capacity resulted in larger risks forming captive insurance companies or joining risk retention groups. One of the most significant risk retention groups in the designers market was the Wren Insurance Association formed in the United Kingdom in 1987. Wren began by underwriting professional liability lines for large UK-based designer practices on a mutual basis.

Simultaneously, design firms begin to seriously focus on risk management in their practices and on empowering training for their junior professionals. Designers and insurers also negotiated revisions to the insuring agreements in their policies that more appropriately balanced their respective risks.

Valuable lessons can be gleaned from an examination of what occurred during the past downturns.

Contractors

Design-Build construction is a relatively new procurement method in North America. Not so in the United Kingdom and Australia where Design-Build has been a prominent form of contract since the early 1980s. And during the past hard markets, London professional liability markets reacted more severely within the Contractors space as opposed to rate and capacity issues for Designers. The prevalence of Design-Build likely led to this result and is a warning flag to Contractors in North America.

Prior to 1986, the European professional liability cover for Design-Build contractors provided broad first party coverage, including a robust Rectification extension — very similar to the broad coverage now enjoyed by Contractors in North America under a standard CPPI (Contractors Protective Professional Indemnity) liability policy. Ultimately, a series of severe errors and omissions resulted in Insurers paying several contentious and expensive claims. And because of the breadth of the European Contractors policy, combined with the limits of liability negotiated by the Designers, and/or lack of adequate insurance coverage held by Designers, the vast majority of the claims were paid out under the Contractors' professional policies. Sound familiar?

Today, one could argue we are beginning to experience a similar set of circumstances in the US. Contractors currently enjoy broad professional liability coverage including robust Rectification and Protective coverage — which is primarily to cover losses caused by their designers under the Design-Build procurement model. Designers have simultaneously now begun negotiating strict Limits of Liability clauses within their Design-Build contracts and many downstream designers continue to carry very little professional coverage. Thus, the financial losses suffered due to errors under the Design-Build model will ultimately be borne by the Contractors' professional liability insurance — very similar to the scenario experienced by the European and Australian markets years ago.

If history does repeat itself, the types of coverage restrictions and underwriting processes that could be seen in North America for contractors include:

- Greater scrutiny by underwriters as to allocation of risk between contractor and designer within the Design-Build contract and proportionate rate assessment between the parties;
- Strict definition of professional activities and duties excluding faulty (non-professional) workmanship;
- Strict definition of "professional services" to be covered under the policy and detailed underwriting of personnel anticipated to perform the professional activities;
- Narrowing of the Rectification coverage to apply only to direct costs of mitigating a potential Professional Liability error, and only where insurers have given their prior consent to the mitigation measures;
- An unwillingness to provide vicarious liability of a subcontractor if the subcontractor's duties are not specifically defined within the Design-Build contract;
- The introduction of an exclusion for claims arising from a Designer's costs estimates;
- Enhanced obligations on the part of the insured to cooperate in subrogation matters against subcontracted Designers;
- Sub-limits and significantly higher SIR being applied to Rectification and Protective claims.

Some of these concepts are already embedded within the CPPI policy and may mitigate against more drastic market changes. But if history is any guide, further scope erosion of CPPI coverage should be anticipated.

Best Practices in a Shrinking Professional Liability Market

Firms' and companies' preparation for the annual renewal process cannot begin early enough. More communications with insurers, not less, will produce a more palatable result. Evidencing to the markets that you are actively engaged in Risk Management training throughout the company with respect to professional liability issues is also essential. An ability to demonstrate rigorous adherence to good contractual protocol will serve you well. But what does best contractual practice really mean for both the Insured and the perceived risk from insurers' viewpoint?

We believe the issues which must be analysed, and in turn demonstrated to the insurance market, include:

- The number and type of GMP contracts;
- How joint venture partners are selected;
- Specific contractual language when a joint venture partner includes a Designer;
- How design oversight is being conducted (e.g. in-house design team, third party design review, communication protocols with the designer and sub-designers);
- Use of Integrated Project Delivery;
- Structure of project specific insurance programs;
- Creation of dedicated response teams and responsibilities when a design error is identified.

It is our intent over the next few months to analyze what truly reflects best practices of each of these topics and share those with our clients.

Considering the structure of your professional liability program may also be useful in minimizing the effects of a hardening market. Bundling other lines of coverage with a single carrier allows the insurance partner more premium and thus makes the risk more attractive. Spreading the risk between several carriers by means of quota sharing may also be a wise alternative because it spreads the risk of loss to a number of carriers and thus minimizes the response from the market to an adverse claim.

Overall, the professional liability insurance market will continue to contract in 2020. But thoughtful preparation when approaching the market and recognizing historical trends will assist in minimizing the effects that firms feel.

Snapshot of US Market Trends

Architects & Engineers

2019 Q4 Direction				2020 Outlook
Rate increases of 10% or more for insureds with claims.	↑	**Pricing/ Rates**	↑	Insurers continue to evaluate the deterioration of their A&E book, with more increases likely in 2020.
Most firms focused on maintaining their current limits in a changing market, which was challenging as insurers continued to manage their capacity.	↔	**Limits**	↓	2020 may see insureds purchasing lower limits due to increased costs and a paucity of capacity for large risks.
With the advent of larger claims, Insurers were looking for increased retentions, and many firms elected higher retentions to offset premium increases.	↑	**Deductibles/ Retentions**	↑	We believe the current trend will continue, especially with claims inflation continuing to run in excess of 3% per year.
Coverage stable as previous enhancements are seen to take effect.	↔	**Coverage**	↓	Coverage stable as previous enhancements are seen to take effect.
Reduced appetite for Primary and 1st Excess business.	↓	**Capacity/ Appetite**	↓	There have been further notable markets exiting from the A&E space, and other insurers have indicated they will be reducing their per risk limit.
Losses are increasing with more claims coming from Design-Build contractors where there has been under-design at bid stage and insufficient contingencies built in by contractors.	↑	**Losses**	↑	We see this continuing into 2020.

Snapshot of US Market Trends

Contractors

2019 Q4 Direction				2020 Outlook
To a large extent, rating is still highly dependent upon client specific factors, most notably, claims history. On clean risks, expected rate change: 0% to +5%	↔ ↑	Pricing/ Rates	↔ ↑	Expect this to continue with some carriers declining risks with multiple claims, and those with a high "design" risk content, particularly in the oil & gas arena. On project policies, we are seeing a more conservative rating approach, with limitations on the maximum policy term and capacity.
Clients continued to evaluate limits due to the perceived severity of professional liability losses.	↔ ↑	Limits	↔ ↑	The position as outlined for 2019 Q4 is likely to be unchanged.
Most clients have maintained their deductible/retention levels.	↔	Deductibles/ Retentions	↔ ↑	No material change is expected; however, carriers continue to push higher retentions on larger clients in an effort to offset risk of claims deterioration.
No material changes in annual programs.	↔	Coverage	↔	No material changes in annual programs.
While capacity continues to be readily available, the pricing for excess capacity is becoming increasingly scrutinized by insurers as claims values escalate. Lower excess layers are being priced more akin to primary coverage as carriers are viewing these excess limits as still being in the burn layer.	↔	Capacity/ Appetite	↔	Capacity is expected to remain available for most insureds, but pricing will escalate.
Claims activity in the Construction sector was fairly constant, but we continue to see an escalation in the severity of these claims.	↑	Losses	↑	We expect this trend to continue with year over year escalation in claim values and defense costs.

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