LOCKTON

UNCOMMONLY INDEPENDENT

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Professional Indemnity

2021 Market Overview

For the last two years, the insurance market both in the UK and globally has been hardening at a rate not seen since 2001/2. Current market trends show insurer capacity withdrawing from the market, competition reducing, premium rates increasing, policy coverage narrowing, and insurers employing a highly selective approach to the risks they choose to cover. However, these difficult conditions will not last forever, and many suspect that we have already reached or are nearing the peak of our current phase of the market cycle.

Background to the hardening market

The existing hardening market conditions have resulted from a combination of factors including: insurers and their reinsurers experiencing increased and sustained catastrophe losses in recent years, double-digit annual claims inflation across many lines of business, and historically low investment returns on premium income due to extreme volatility in the wider economy. With premium levels prior to 2018 at a historical low due to a long period of a soft and highly competitive market, there was inadequate risk funding to allow insurers to both pay losses and remain profitable. We are now experiencing a major correction of the market, with a severe increase in premiums and reduction in insurer appetite.

In this review, we reflect on recent renewals to provide an overview of market conditions, highlighting specific factors that influenced the environment. We analyse high-level data and provide commentary on our findings. We conclude by providing insight on what we expect to happen in the forthcoming renewal period, offering guidance on how to successfully navigate the current insurance market.

Overview

A key indicator of a "hard market" is when insurers start to restrict policy terms and conditions. Due to the SRA's requirement for law firms to be covered by the Minimum Terms and Conditions (MTCs) this is prevented from happening. However, in many cases insurers have looked to impose changes to the self-insured retention (SIR) structures. Accepting much higher levels of SIR has been a means by which firms can mitigate the requirement for excessive premium increases.

Insurers (and their reinsurers) now require far greater levels of underwriting information, for example in relation to:

- Non-standard coverage requests
- COVID-19 risk control
- Emerging risk exposures
- Business continuity planning

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Challenging trading environment

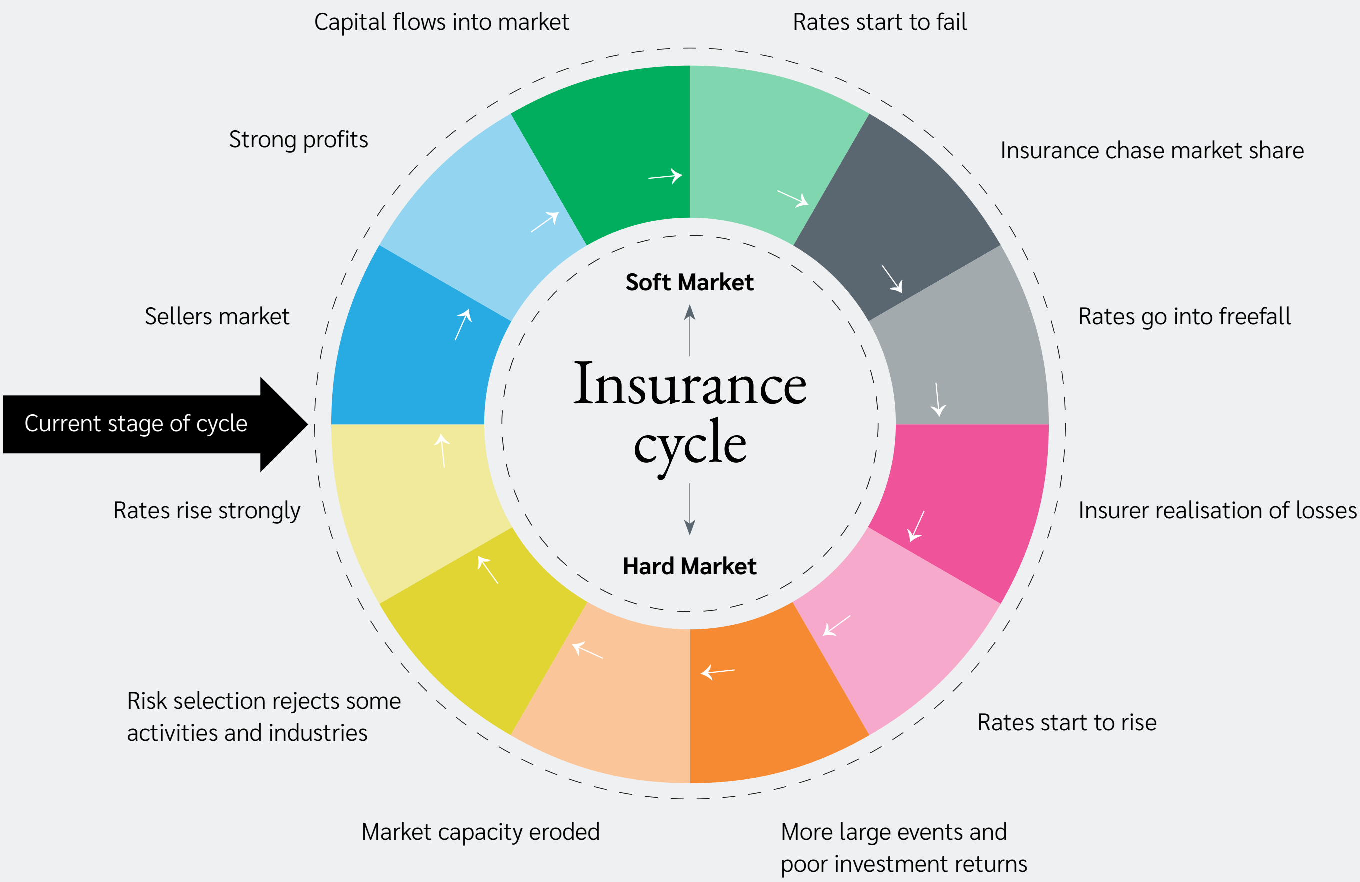
All renewals are taking substantially longer to conclude. Underwriting controls, senior sign-off, increased reinsurance referrals and the need to access new capacity are all driving a longer process.

Most insurers are reviewing capacity they deploy, leading to:

- Reduced primary and excess layer policy limits
- Total capacity being deployed in smaller tranches spread throughout programmes
- Increased numbers of insurers needed to complete large limit placements

As in previous hard markets, firms that can evidence investment in effective risk management programmes, articulate strong corporate governance protocols, and robust business continuity planning have the best chances of securing the optimal renewal outcomes.

The insurance market is cyclical; harder markets typically do not last for more than two to three years. We are hopeful that 2022 will see new capacity entering the market and consequently an easing of the pressure for insurers to increase rates much further.



COVID-19

While the full effects of the COVID-19 pandemic remain unknown, business interruption losses in the property market are likely to be substantial. The verdict on the Financial Conduct Authority's test case is widely perceived to have supported policyholders and is expected to equate to approximately £1.2 billion in additional claims (FCA, 2021).

There has also been an upsurge in litigation brought against firms and their professional indemnity policies, where they may have acted in error or provided negligent advice to other businesses, extending to the employment practices markets in relation to employment law, redundancies and wrongful dismissal throughout the pandemic.

Almost all lines of business are expected to be negatively impacted by Covid-19 in some way with "few classes expected to emerge unscathed" (Insurance Times, 2020). For example, the insurance market is experiencing increasing numbers of cyber, crime and business interruption claims in the liability markets.

Silent cyber

There has been a great deal of debate recently on the issue of so called "silent cyber". Silent cyber refers to the potentially inadvertent inclusion of cyber risk cover in certain policies, on the basis that such cover is not specifically excluded. This is problematic for all insurers, as in some cases they have found themselves liable for risks that they did not intend to cover and have not charged for in their calculation of the premium. In response to this growing problem, the Prudential Regulation Authority and Lloyd's have required all insurers to revise their policy wordings to make it clear whether this risk is included or specifically excluded for cover.

From the beginning of January 2021, all professional indemnity insurers at Lloyd's were required to specifically include or exclude cover for this risk. The Lloyd's Market Association (LMA) and the International Underwriting Association (IUA) of London have produced model endorsements for their members to adopt.

Lockton has worked with the IUA to draft one of these model endorsements. A further endorsement has since been published by the LMA. This has been a complex process for the market. Slightly different approaches are adopted in the endorsements published by the IUA and LMA, and the endorsements require careful analysis to consider their effect. It is complicated further by the fact that a number of professions, not just legal, have policies that are governed by Minimum Terms and Conditions (MTCs).

For solicitors, an extension of time has been agreed between Lloyd's and the SRA until 1 October 2021 to consider the implications of varying cover and to consult with stakeholders, including the Legal Services Board. Until the outcome of that consultation is settled, insurers cannot, within the Minimum Terms and Conditions cover (i.e. the first £3,000,000) include the model endorsements in solicitors' PII policies.

Solicitors are one of the few professions that hold client money, and accordingly, the financial consequences that arise from a cyber-incident can be severe. Consequently, the SRA will need to consider the best way to proceed given the importance that the SRA places on the protection of the public.

Solicitors and their insurers will be monitoring the position closely over the next few months and as part of the SRA's consultation, which opened at the end of April 2021, will be able to express their views. We understand that a model draft clause prepared by the SRA is already in circulation among participating insurers.

Strategies to help navigate the current insurance market

Clear priorities: Ensure that your priorities drive the renewal process. In challenging negotiations, it may be necessary to compromise in order to secure what matters most

Timeline management: Robust management of the renewal timeline will ensure that time does not become a feature in negotiations. Many elements of negotiations are taking longer

Flexibility: Approach renewal with an expectation of changes being required, and be prepared to consider alternative options if needed. This will require flexibility in terms of programme structure, insurers utilised, market access points and, in some cases, coverage priorities

Communication: Agree a clear communication plan as part of the renewal process. This should include both formal 'milestone' dates, and regular informal discussions with insurers and your broker

Relationship management: Strong and effective tri-partite relationships are proven to assist in achieving the best outcomes in difficult renewal negotiations. Evaluate your current relationship profiles and develop plans to enhance these as necessary

Information: Work with your broker to review how your risk is presented to insurers and have a clear strategy to collect the information insurers require, supported by clear analytics

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Topical Subject – Captive Insurance

In the midst of the extremely hard market several large law firms have been considering the pros and cons of establishing a captive insurance company.

The purpose of a captive insurance company is to reduce the cost of risk to an organisation, the underlying premise being that:

1. It is more cost effective to retain risk than to transfer risk to the insurance market; and

2. It is more cost effective to use a formal risk retention vehicle than to 'self-insure' or simply to retain risk within the organisation.

It is worth noting that any decision to form a captive insurance company is typically taken at the very end of the decision making process and only once it has been determined that this is the optimum strategy. The main decision factors typically include:

RISK TOLERANCE/APPETITE	Understanding your capacity for risk and appetite to accept risk is a critical first step in any risk financing decision. It will impact the suitability of all subsequent options. This can change over time so should be kept under regular review.
LONGEVITY	Informal 'pay as you go' approaches and balance sheet funds can be wound up quickly. Captives are long term strategies with potentially complex exit requirements.
COST	Key cost components to consider are: • Impact of insurance premium taxes which are payable on captive premiums but not on self-insured claims • Annual fees of captive insurance companies (e.g. management fees, actuarial fees, audit fees etc.) • Opportunity cost of capital, i.e. capital deployed in a captive will become unavailable for other investments by the business
TYPES OF INSURANCE	Risks with low frequency/high severity loss profiles are generally more suited to risk transfer than low severity/high frequency risk. Financing volatile risks presents challenges whatever method of risk financing is selected.
SCALE	The fixed costs associated with a captive means that a sufficient scale is required to make this approach cost effective. As a very broad guideline, we would not expect a captive to represent the optimum economic solution where premium spend is less than £1m.

To our knowledge, very few firms have seen a benefit of establishing a Captive for many of the reasons outlined above but also because there are often inter-generational fairness issues that have been a barrier to establishing this type of vehicle.

We can support you in making informed decisions around your risk financing strategy. This includes:

Financial Risk Tolerance analysis

Risk appetite assessment

Loss projections

Captive management company selection

Captive viability reports

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