PI REPORT

LONDON MARKET PROFESSIONAL INDEMNITY REPORT JULY 2021

LONDON PI MARKET CONFIDENT IN THE FACE OF CHALLENGE

CLYDE&CO

CONTENTS

LONDON PI MARKET CONFIDENT IN THE FACE OF CHALLENGE

WILL RATES CONTINUE TO RISE FAST ENOUGH AND HIGH ENOUGH TO MATCH THE GROWTH IN ASSET VALUES AND DEMAND AND THE DRIVE FOR PROFITABILITY?

Will the long tail of COVID-19 impacts suck the momentum out of a market that is getting to grips with the 'new normal'? Will buyers and their insurers find a way to manage the scourge of cyber crime that is such a blight on business? Does Brexit have a sting in the tail for London market players?

The Clyde & Co Global Professional Liability team has a long history of working with participants in the London market. Against the backdrop of what can best be described as 'challenging' times, we felt it would be useful to take the market's temperature and try to reach a landing on some of these important questions. We also wanted to take stock of sentiment in the PI insurance buying community so that we can plan to overcome the hurdles ahead in terms of wordings, cover, regulatory intervention and the likely impact on deals in this space.

We surveyed a targeted mixture of insurance professionals – spanning underwriting, broking and claims – as well as a smaller, selected group of insurance buyers for their take on developments in the PI market.

The findings have both surprised and heartened us.

Appetite is strong despite a trinity of challenges for the PI market – recession, increased cyber threat from remote working and the continued uptick in regulatory oversight.

Experienced market players back themselves to take advantage of rising rates, but are allocating capacity with care, even as they brace themselves against the inevitable influx of fresh capital which so far seems to be writing with longevity in mind.

Neither buyers nor carriers have any doubt that claims are set to rise, but there is no real consensus on what the trigger will be and how the impact will be felt across books of business. There is agreement, however, that London is well placed to preserve its position as a preeminent international hub for PI risks.

We hope that our findings are of interest and I would particularly like to thank the market leaders who participated in the survey, and some of whom are quoted in this report, who were so generous with their time during what has been a particularly busy run-up to the 1 July renewal. I would also like to thank Clyde & Co partners Anthony Brown and Jane Williams who provided assistance in the preparation and production of this report.

Please contact me or your usual partner should you require further insight.

Simon Konsta
Partner, Clyde & Co LLP

+ KEY FINDINGS

48% of insurers* will write the same level of PI business in the next 12 months

46% will write more

95% of insurers expect more claims in the next 2 years

67% expect them to be more severe

100% of buyers and 99% of insurers expect rates to rise this year

75% of insurers think prices will continue to increase through 2022 but only 6% expect hardening beyond that

40% of insurers expect that insurance buyers will not be able to maintain existing aggregate PI policy limits at the next renewal

71% of buyers do not anticipate difficulty in securing cover

39% of insurers expect more PI business to be written through MGAs, binders and delegated authority over the next two years

*Insurers refers to the insurance market, including brokers

83% of insurers expect market change in the form of new entrants, exits and consolidation

84% of the London market is unconcerned by increasing international competition

52% believe the PI market fails to invest in talent

44% of insurers say that it needs to invest more in D&I

COVID IS CHANGING RISK PROFILES:

68% of insurers see an increased threat associated with weakened supervision

58% expect greater privacy, cyber and ransomware exposures

58% foresee financing and insolvency consequences due to the economic impact of the recession

THE IMPACT OF COVID-19

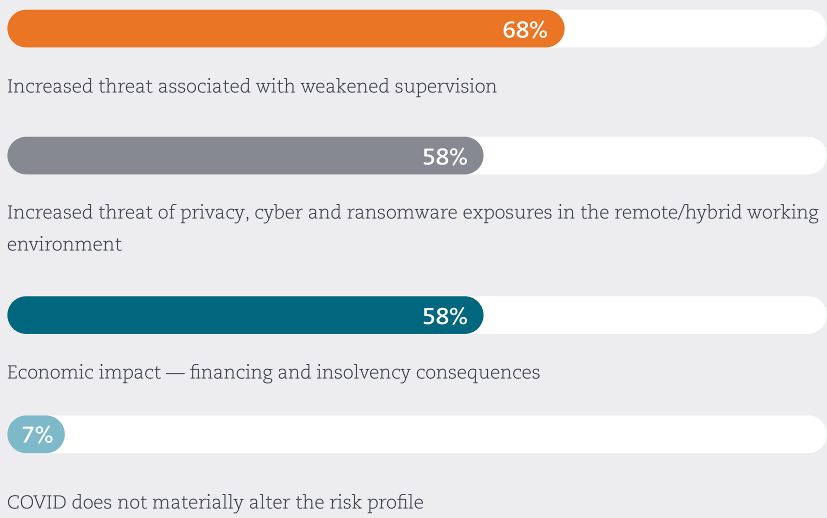
THE TRUE IMPACT OF COVID-19 AS A DRIVER OF CHANGE IN THE PI SECTOR OVER THE PAST 18 MONTHS, ALONGSIDE THE ON-GOING PROCESS OF MARKET REMEDIATION, REMAINS HARD TO JUDGE.

Pandemic-related claims have yet to materialise on the scale that may have been expected. Given the time-lag associated with losses resulting from economic or supervisory issues for example, it may be some time before they do.

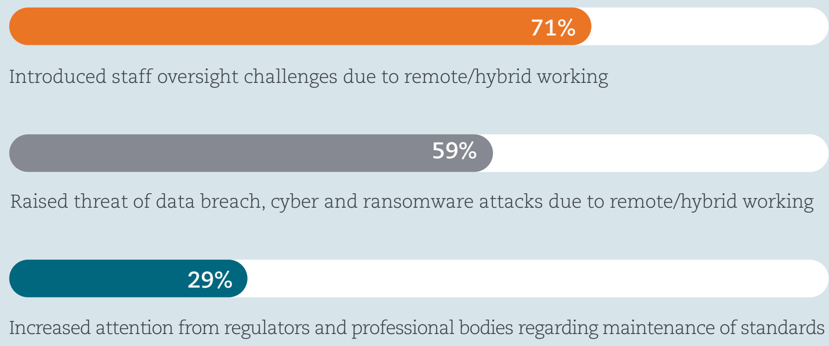
However, insurance industry respondents acknowledge that there are key areas where COVID might change buyers' risk profiles, ranking the increased threat associated with weakened supervision first. Increased privacy, cyber and ransomware exposures in the remote and hybrid working environment comes in joint second together with the financing and insolvency consequences of the economic impact of the recession.

Insurance buyers are also keenly aware of the impact of COVID-19 on their risk exposure, in particular with regard to the shift to remote or hybrid working. As a result, 71% of buyers report they have experienced staff oversight challenges; 59% report a raised threat of data breach, cyber and ransomware attacks; and 29% have seen or anticipate increased attention from regulators and professional bodies regarding maintenance of standards.

Insurance industry: How will COVID-19 change risk profiles?



Buyers: How has COVID-19 altered your risk exposure?



COVID-19's "long tail" set to influence the next five years

Looking ahead, our research shows that the insurance industry and buyers are united in the view that the fallout from the pandemic will dominate the market over the next five years. COVID-19 appears to have brought about something of a trinity of challenges for the PI market – recession, increased cyber threat from remote working and a continued uptick in regulatory oversight.

From an insurance industry perspective, the fallout from COVID-19 in terms of economic and recessionary pressures and insolvencies is the biggest factor that will shape the PI market over the next five years, cited by 77%. In contrast, for buyers it ranks only fourth of the risks keeping them up at night, behind regulatory oversight, cyber and fraud & crime.

Increased oversight not a bad thing

While insureds dread the impact of increased regulation, underwriters' caution is more tempered. While in the short term increased regulation and enforcement will create significant difficulties for professionals that will drive claims and costs, their impact should be positive in the longer term – for example changes to ESW1 cladding regulations will improve fire risk in buildings in the future.

"WE HAVEN'T HAD MARKET CONDITIONS LIKE WE HAVE SEEN IN THE LAST 12 MONTHS SINCE THE FALLOUT FROM THE GLOBAL FINANCIAL CRISIS. BUT THIS TIME AROUND IT IS A VERY DIFFERENT SET OF CIRCUMSTANCES AND THE MILLION-DOLLAR QUESTION EVERYBODY IS ASKING EACH OTHER IS HOW LONG IS THIS GOING TO LAST?"

Simon Moi,
Head of Professional & Financial Risks - Asia,
Markel International

Concerns over the next three to five years

Top five concerns for the insurance industry over the next three to five years:

1. Recessionary pressures/ insolvencies post COVID-19
2. Cyber and ransomware
3. Growing regulatory oversight
4. Social inflation
5. ESG requirements

Top five concerns for buyers over the next three to five years:

1. Growing regulatory oversight
2. Cyber and ransomware
3. Fraud & crime
4. Recessionary pressures/ insolvencies post COVID-19
5. Claims due to remote working

"REGULATORY INTERVENTION IS INTENDED TO PROTECT CONSUMERS – FOR EXAMPLE BY SETTING STANDARDS FOR BUILDING CONSTRUCTION. INSURERS' INVOLVEMENT SHOULD REINFORCE REGULATORY COMPLIANCE AND SO ULTIMATELY IMPROVE RISK."

Andrew Townsend, Underwriting Manager, Professional Indemnity, Liberty Specialty Markets

CLAIMS OUTLOOK SET TO DETERIORATE

Our findings show that the claims environment has already started to shift. In the past 12 months, a quarter (24%) of buyers have seen more PI claims brought against their organisation, while 35% say the size of claims has increased.

Looking ahead, there is strong consensus between buyers and insurers in their expectation of increased claims activity. Over the next two years, 95% of insurers expect to see more PI claims and 68% expect them to be more severe. Over the same period, 41% of buyers expect more losses and a similar number expect the size of these losses to increase.

Bubble about to burst?
Our survey revealed a very real concern that there is evidence of a growing asset bubble. Indicators of this include steadily rising house prices as a result of the extended stamp duty holiday introduced by the government, a substantial amount of prime new office space about to hit the London market and stock markets making substantial gains driving opportunistic flotations, mergers and acquisitions.

At some point this bubble is likely to burst. Commodity and skills shortages in construction may threaten the completion of significant contracts. Inflation and the withdrawal of stimulus may change the equation in the residential property market and impact stock markets, leaving significant levels of exposure for a range of professionals.

Where economies stumble, an increase in claims will follow against residential conveyancers, surveyors, property valuers, investment advisers, and accountants and law firms which risk being caught on the wrong side of a variety of deal types and investments driven by 'frothy' valuations and 'buyer remorse'. The profile will vary by jurisdiction, but the broad pattern of volatility will have similar if not identical impacts internationally.

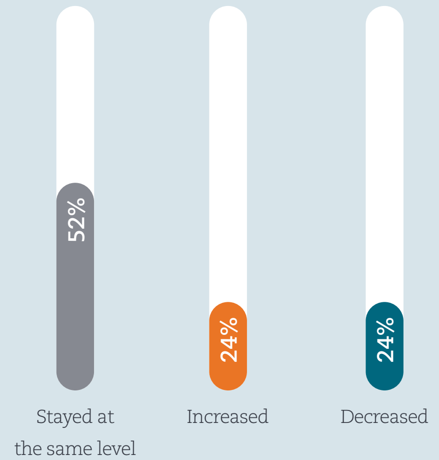
95%

of insurers expect more claims in next 2 years

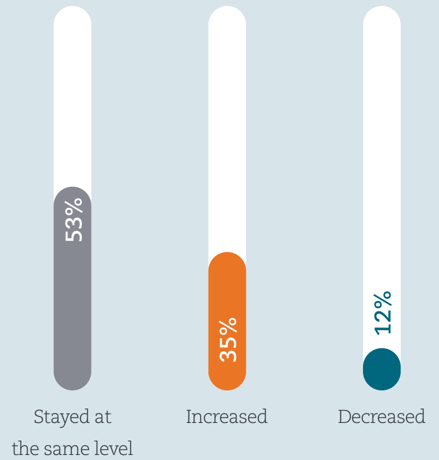
67%

expect them to be more severe

Buyers: In the past 12 months, how has the number of PI claims brought against your organisation changed?

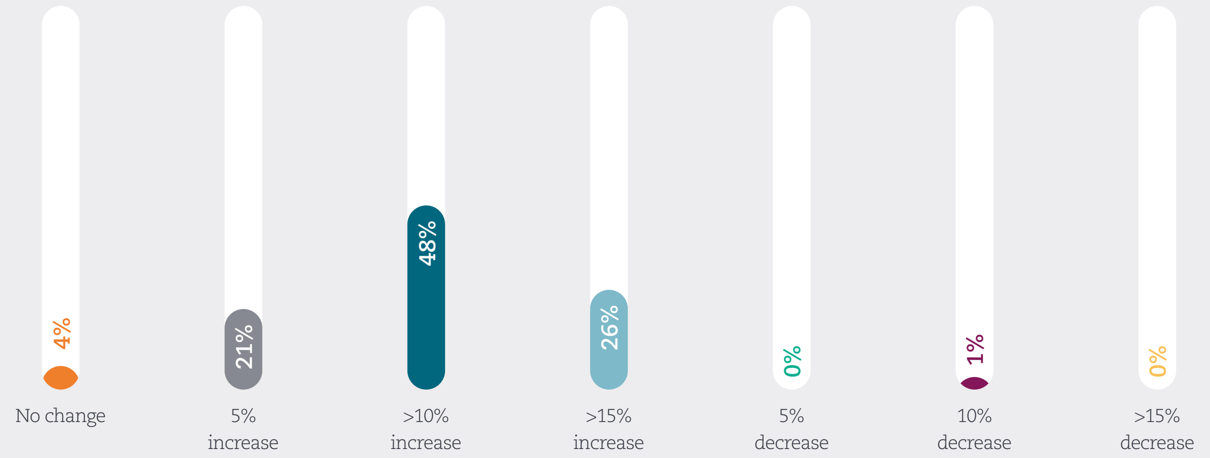


Buyers: In the past 12 months, how has the size of PI claims brought against your organisation changed?

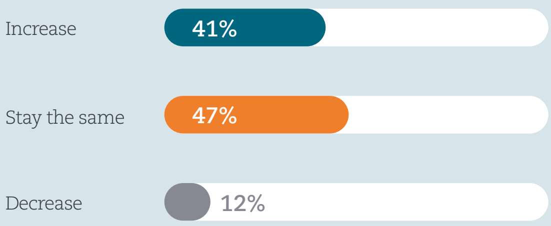


Claims outlook set to deteriorate

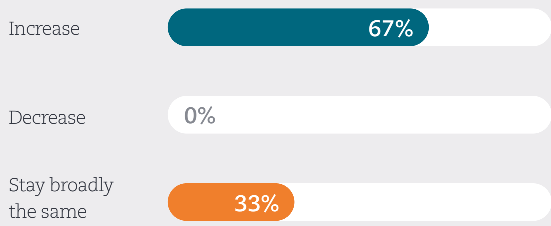
Insurance industry: In the next 24 months, how do you expect the number of PI claims to change?



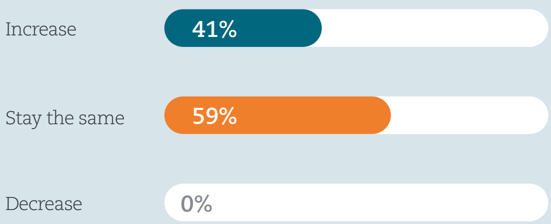
Buyers: In the next 24 months, how do you expect the number of PI claims to change?



Insurance industry: In the next 24 months how do you expect the size of PI claims to change?



Buyers: In the next 24 months, how do you expect the size of PI claims to change?

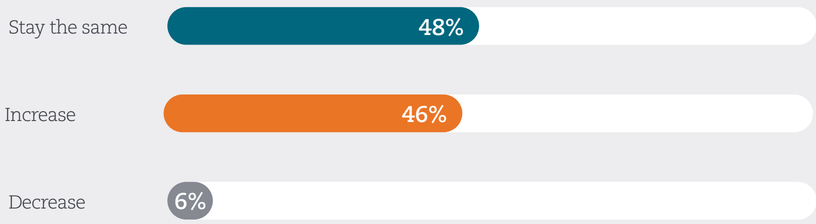


Frequency and value of claims expected to rise

PI underwriters are focused on understanding how this range of simultaneous exposures is likely to manifest and what the impact might be. Whatever that re-set looks like, however, it is inevitable that claim size will be linked to raised asset, project and transaction values.

APPETITE REMAINS SOLID

Insurance industry: How will your appetite for PI business evolve in the next 12 months?



Despite the challenging market, appetite for writing PI business remains robust. Over the coming year around half of the market expects to continue underwriting at the same level, while the other half expects to write more.

With prices continuing to harden after an extended soft market, underwriters are sensing an opportunity to write more restrictive cover for higher rates – a situation that may be a career-first for many given the market has seen rates stand still since 2002.

Caution is the watchword
However, their approach is tempered by caution. Over the last couple of years, insurers' lines have been shrinking and their willingness to put out large lines for individual clients has decreased notably across the board, in part to minimise their per risk exposure but still write the same level of premium.

Concerningly, some professionals could be in for a rude shock if it becomes apparent that tower sizes are inadequate to meet the anticipated rise in claims exposure.

Renewal not straightforward
Further evidence of the unsettling impact of COVID-19 on the market has been the renewal experience as at 1 July 2021. With only a month to go, many brokers were still working hard to complete placements that in previous years would have been straightforward.

The market was only marginally positive (52% vs 40%) that buyers would be able to maintain existing policy aggregates, with a surprisingly high proportion (8%) of floating voters. In addition, conflicting views on how and where best to allocate capacity were clearly reflected in our findings.

Inexperience is an issue
Part of the difficulty in managing the new hard market conditions is inexperience.

48%

of insurers will write the same level of PI business and

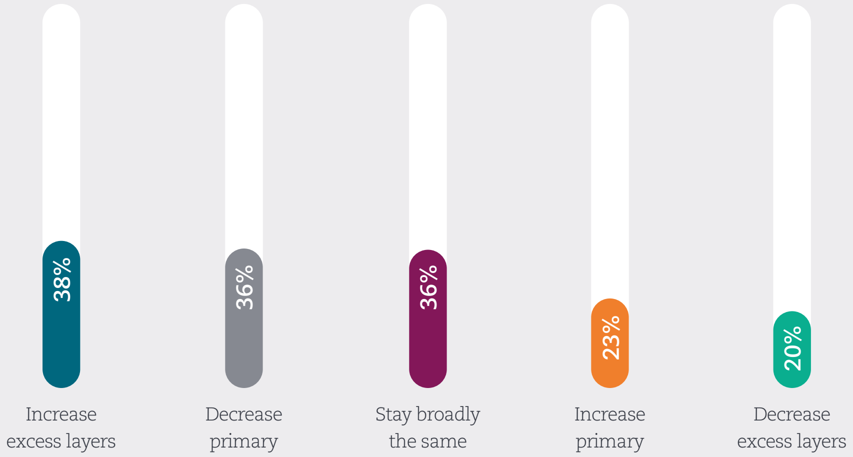
46%

will write more in the next 12 months

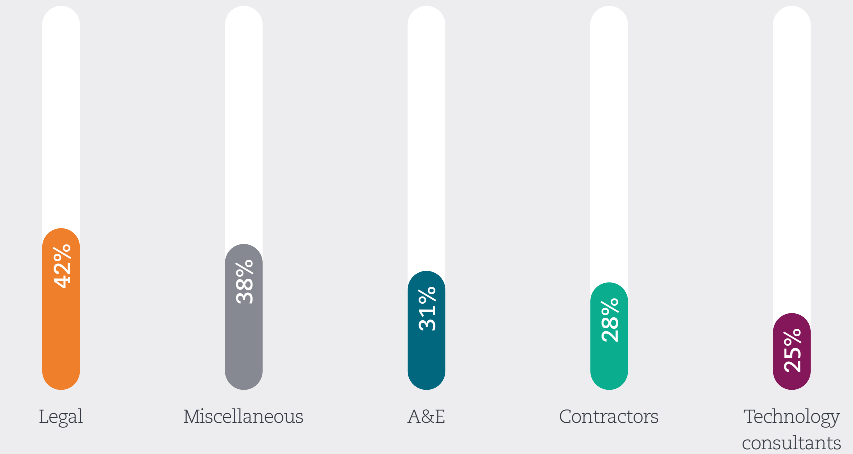
"INEXPERIENCE IS AN ADDITIONAL NEW DYNAMIC IN THIS ENVIRONMENT. MANY IN THE BROKING COMMUNITY DON'T HAVE THE EXPERIENCE OR EXPERTISE TO SUCCESSFULLY NAVIGATE THE HARD MARKET. LOTS OF UNDERWRITERS HAVEN'T EXPERIENCED IT EITHER."

Brian Boehmer, Partner, UK Professions, Lockton

Insurance industry: In the next 12 months how do you expect the level of capacity to change?



Insurance industry: For which groups of professionals do you expect to write more PI business in the next 12 months?



Selectivity is key

The top five categories of professions in scope for writing more business are legal, miscellaneous, architects & engineers, contractors and technology consultants. In contrast, there is much less appetite to grow the book for accountants, management consultants, insurance brokers and financial advisers. But there is clearly a degree of selectivity, even among preferred professions.

For example, those writing legal business will be wary of clients with large residential conveyancing departments. Instead, they will be focusing on lawyers that have practice areas which are perceived as lower risk. Similarly, given the ongoing issues around cladding in the construction sector, insurers are writing policies offering much tighter cover and containing broad exclusions particularly in the area of fire safety.

"LET'S TAKE CONSTRUCTION - INDIVIDUAL PROJECTS WITH CONSTRUCTION VALUES OF OVER A BILLION DOLLARS WERE UNUSUAL A FEW YEARS AGO. NOW MULTI-BILLION PACKAGES ARE THE NORM. OVERALL, THE CHALLENGE IS THAT TOWER SIZES ARE NOT TRACKING UNDERLYING ASSET VALUES. IN FACT IN RELATIVE TERMS THEY ARE COMING DOWN. PRICING MAY HAVE BEEN REMEDIATED IN THE PRIMARY LAYERS BUT NOT ON THE EXCESS LAYERS. AND AS VALUES, VOLATILITY AND UNCERTAINTY ARE RISING, PROFESSIONALS ARE CUTTING LIMITS AND ARE THEREBY TAKING ON MORE UNINSURED RISK."

Jana Ratnajothy, Head of Professional Liability, Convex

PRICING IS ONLY GOING ONE WAY

OUR RESEARCH SHOWS A THIRD OF INSURERS EXPECT RATE RISES THIS YEAR IN EXCESS OF 10%.

100%

of buyers and

99%

of insurers expect rate rises

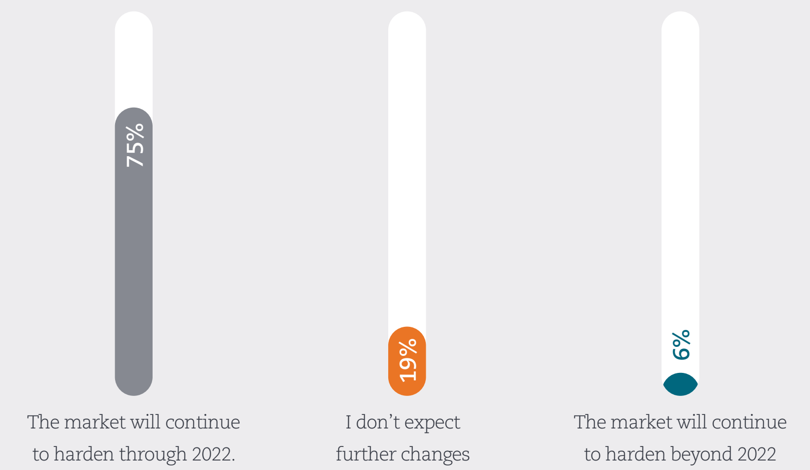
A resounding 100% of buyers surveyed and 99% of insurers expect rates to rise this year. Further hardening is expected but only in the medium term – 75% of insurers think prices will continue to increase through 2022 but only 6% expect hardening beyond that.

Difference of views on rate rises

However, there does seem to be some variation in outlook around the extent of price rises. Around a third of insurers expect rate rises this year in excess of 10%, and a similar number think they will top out above 15%.

Buyers are slightly more pessimistic with more than half expecting rises of above 15%, but nearly a quarter anticipating that rate increases will exceed 25%.

Insurance industry: How do you think the PI market will change over the next two years?



Pricing is only going one way

Insurance industry: How much do you expect PI rates to increase in 2021?

Buyers: How much do you expect rates to increase in 2021?

"DESPITE THIS BEING THE BEST TRADING ENVIRONMENT FOR 20 YEARS IT IS STILL ALMOST IMPOSSIBLE TO DELIVER DOUBLE DIGIT PROFIT."

Simon Mantell, Head of Professional Indemnity at QBE Insurance

Sector variation

Market participants felt there will probably be some variation by sector in terms of price increases. In the construction sector for example, the market is still waiting for cladding losses to hit balance sheets. In other areas, such as the IFA market, rates started to harden at an earlier point than the rest of the market so we will likely see those flatten off sooner.

Findings suggest a range of views on how hard and for how long rates will rise. At one end there is a sense that what we're seeing now is simply an inevitable correction of the market and, once rates have returned to a level that generates reasonable profit, competition will start to bite again.

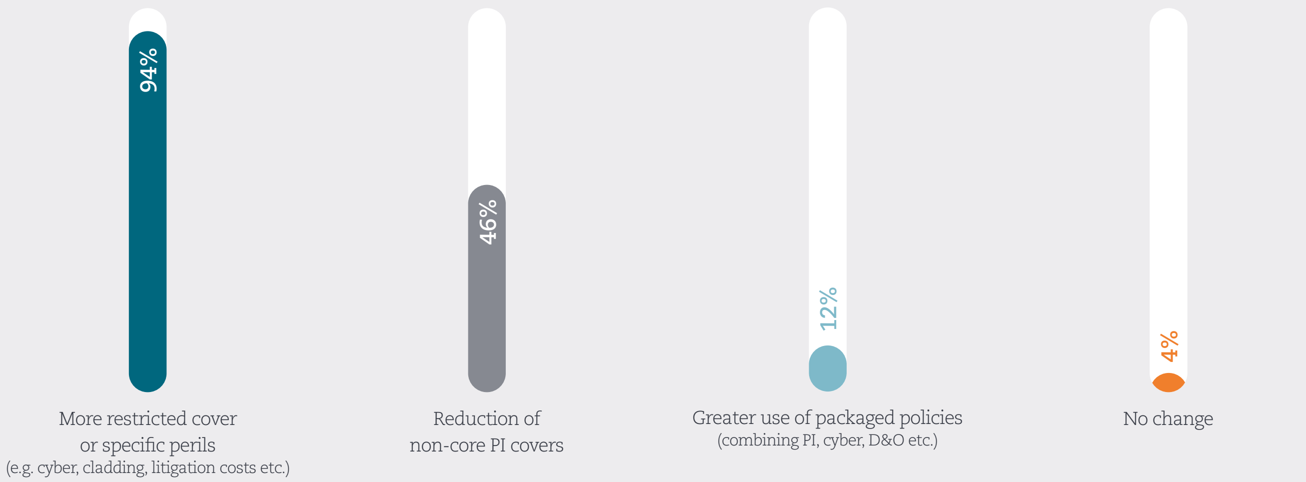
Others express concern that pricing may reach the point where it is unaffordable while at the same time the cover available continues to come down. The reality is that prices will need to increase year-on-year to offset anticipated inflation and the development of claims. Market data suggests that PI claims deteriorate between 5% and 7% year-on-year so premiums need to rise by the same amount before insurers can start to make a profit.

COVERAGE WILL BE CONSTRAINED

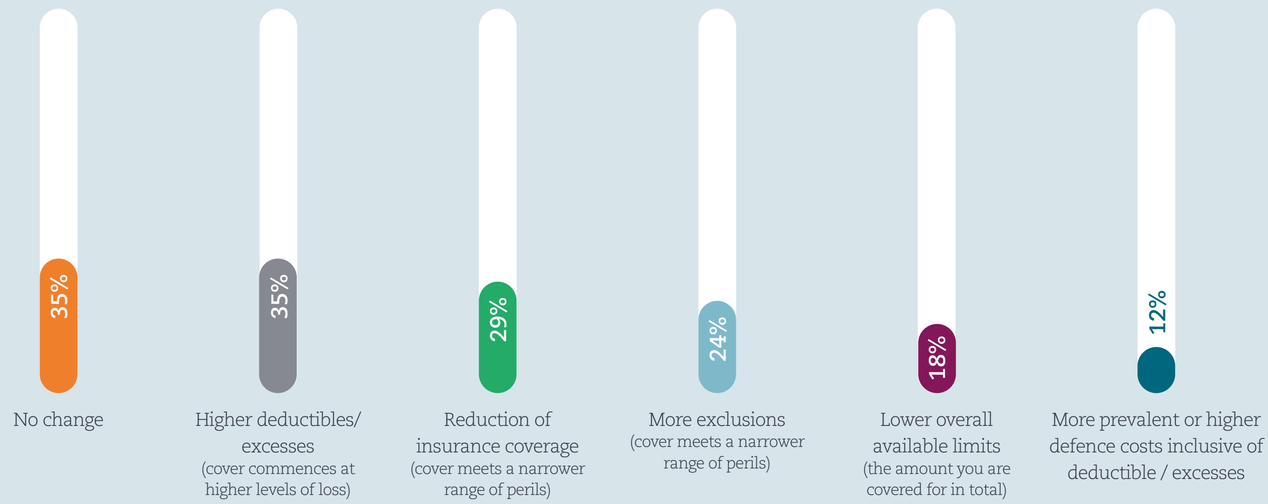
Coverage has already started to become constrained and will continue to be more so. Insurers believe that buyers should expect change to their PI programmes with 94% expecting to offer more restricted cover for specific perils in the coming year and 46% to see a reduction of non-core PI covers.

Buyers are seeing changes in the terms of their PI cover with 35% reporting higher deductibles and excesses and 29% a reduction in coverage. 24% are seeing more exclusions.

Insurance industry: How do you expect PI programmes will change in 2021?



Buyers: What changes are you seeing in the terms of your PI cover?



LOOKING AHEAD, SOME 40% OF INSURERS EXPECT THAT INSURANCE BUYERS WILL NOT BE ABLE TO MAINTAIN EXISTING AGGREGATE PI POLICY LIMITS AT THE NEXT RENEWAL.

Although 71% of buyers do not anticipate difficulty in securing cover. In an environment of claims severity, inflation and growth in transactional and project values, uncertainties concerning the ability to maintain aggregate PI policy limits ought to be of significant concern to both buyers and the insurance market.

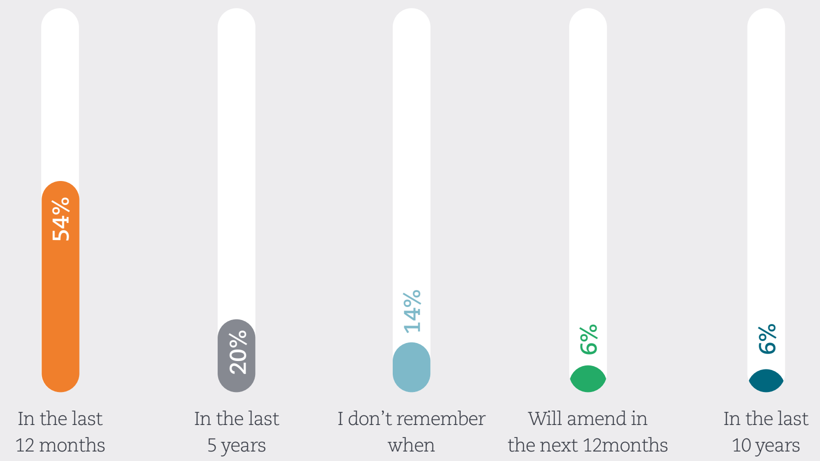
In addition, it may be a factor in buyers looking to other methods of risk transfer – our findings reveal 29% of buyers are considering captives and 24% co-insurance.

The challenge for the insurance market is whether it can deliver solutions to meet the needs of professional services firms, particularly the larger ones with international operations.

Wordings will continue to be tightened

It is likely that some of the language that was introduced in the soft market will be tightened up and 54% of insurers stated that they substantively revisited their PI insurance wordings in the last 12 months. In part, this will have been a knock-on effect from the FCA business interruption test case which has caused a number of insurers to look at their full suite of products and try to ensure that there is consistency across the different distribution channels. There is some variation by profession – architects, engineers and contractors have already seen the introduction of significant exclusions with regard to fire safety, something that is going to continue until the on-going cladding issue is resolved. It is noteworthy that 12% of the market has not addressed wordings in the last five-plus years, with 14% simply unable to remember when they last revisited wordings.

Insurance industry: When did you last amend your wordings?



Regulatory intervention

There is a general anxiety about regulatory intervention across the professions. Law firms and finance professionals are seeing this happening more and more. In the case of the latter, for pensions advisers or IFAs, for example, this can come with an enormous expense attached. If the FCA decides to conduct a major review of operations or a Section 166 investigation (FSMA skilled person review), the cost can run into millions of pounds. As a result, cover for these areas is becoming more restricted.

Cyber is the biggest concern

However, the area where we expect to see the biggest changes in cover is cyber. Since January 2021, Lloyd's syndicates have been required to clarify their position on 'silent' cyber in PI policies. A lot of insurers are taking the opportunity to apply broad cyber exclusions to a large number of policies. As a result, many buyers will need to consider whether a separate cyber insurance policy is required to ensure that appropriate cover is maintained.

"PROFESSIONAL SERVICES FIRMS ARE INCREASING ADOPTERS OF TECHNOLOGY AND USE OF DATA IN AN OPERATIONAL AND SERVICE DELIVERY CAPACITY. INFRASTRUCTURAL RESILIENCE IS KEY. THE RISKS OF DISRUPTION AND CLAIMS ASSOCIATED WITH A CYBER BREACH ARE VERY REAL."

Simon Konsta, Partner,
Clyde & Co

CHANGING MARKET DYNAMICS

83%

expect new entrants, exits & consolidation

As the risk environment has shifted, so too market dynamics are changing. Now that the prolonged soft market is at an end, hardening prices are catching the attention of those scenting an opportunity for profit. We have already seen London market businesses look to build out their PI offering via acquisition, while start-ups unencumbered by legacy costs, or looking to differentiate their offering through innovative technologies, are entering the market.

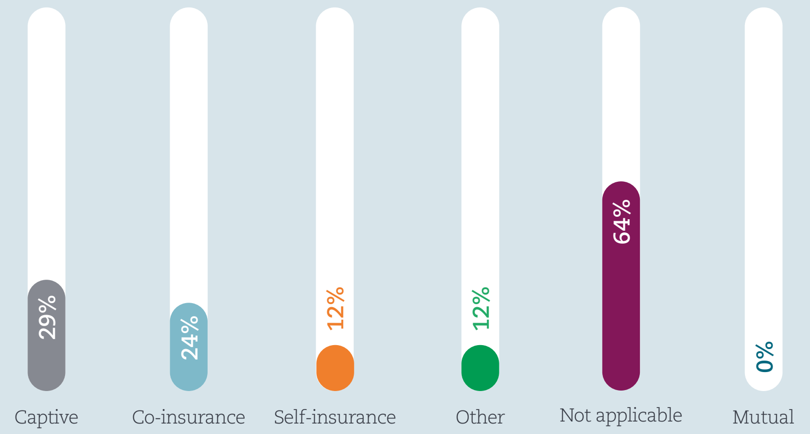
Alternative distribution channels

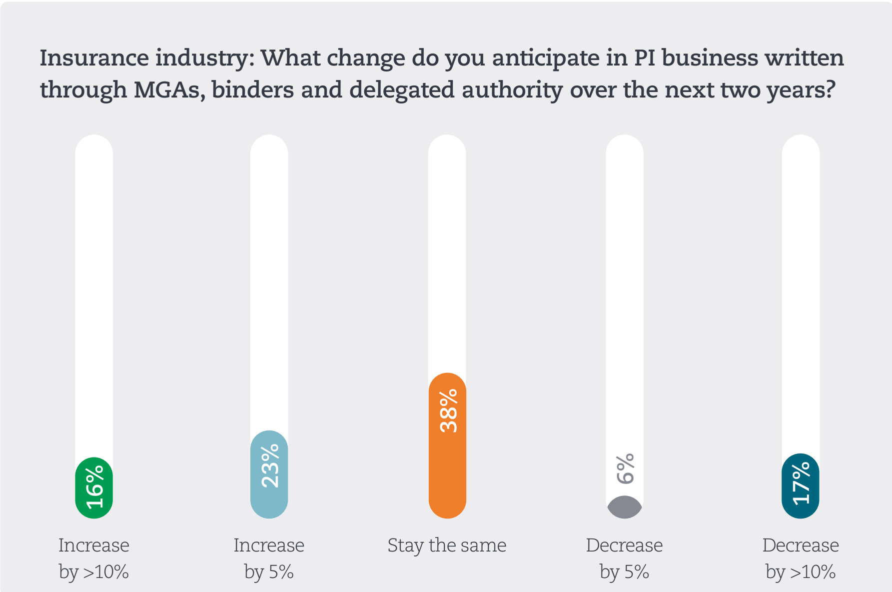
Our findings underline the fact that market disruption is likely to continue, with 83% of insurance market respondents anticipating market change in the form of new entrants, exits and consolidation. A further 39% expect more PI business to be written through MGAs, binders and delegated authority over the next two years. This finding is a little surprising given that as insurers are reducing capacity, it is not unreasonable to expect that they would be inclined to underwrite less through third parties. Buyers are certainly aware of shifting market dynamics with a significant percentage considering alternative approaches to PI insurance with 29% stating they are looking at captives and 24% co-insurance with a traditional insurer.

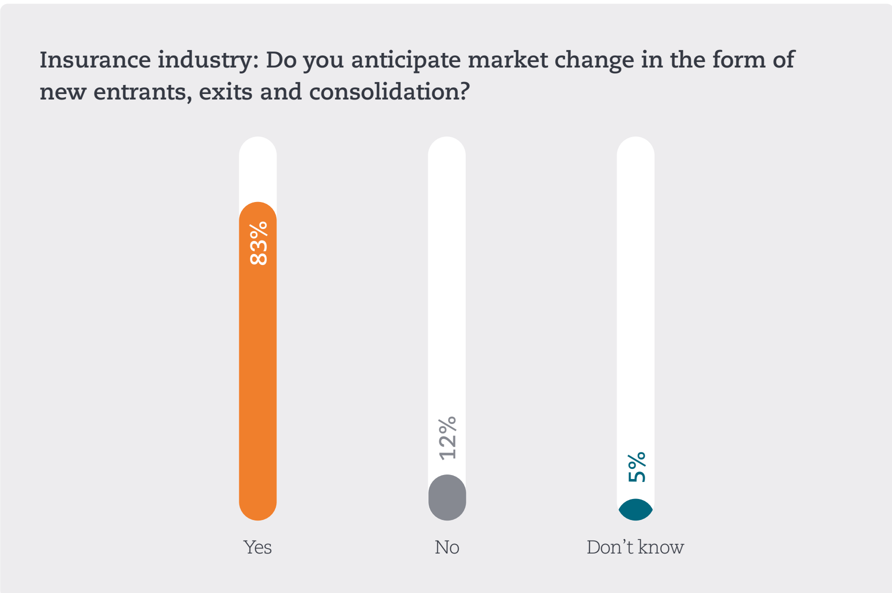
"AS THE MARKET HARDENS THOSE WITH ACCESS TO CAPITAL SEEK TO RIDE THE WAVE OF POTENTIAL UNDERWRITING PROFITS WHICH HAVE OFTEN BEEN SOMEWHAT ELUSIVE FOR A WHILE. BUYERS OF INSURANCE FACED WITH RISING COSTS MAY THEMSELVES LOOK FOR ALTERNATIVES LIKE SETTING UP A CAPTIVE."

Ivor Edwards, Partner, Clyde & Co

Buyers: Are you considering alternative approaches to PI insurance?







"BUSINESSES IN ASIA, WHICHEVER SECTOR THEY OPERATE IN, WANT TO WORK WITH INSURERS AND BROKERS WHO ARE EMPOWERED TO GIVE SAME-DAY DECISIONS, ARE BASED IN THE SAME TIME ZONE AND SPEAK THEIR LANGUAGE."

Christian Stobbs,
Managing Director - Asia,
Markel International

84%

of UK market unconcerned by increasing international competition

28%

of insurance industry respondents report no impact from Brexit

Overseas competition

Market dynamics are not just shifting domestically but internationally too. However, the London PI market is confident that it can defend its position as an international centre, with 84% of insurance market respondents unconcerned by increasing competition from other global insurance hubs.

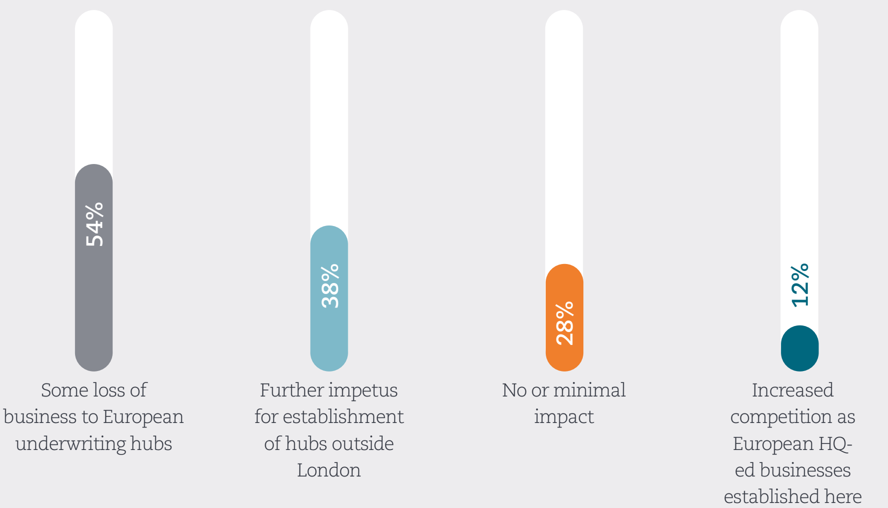
But if we take Asia as an example, 20 years ago there were maybe three or four international players operating in the PI market in Hong Kong. Now there are around 25. The region has seen a massive growth in the availability of both capital and talent in recent years, together with the growth of domestic insurers like China's Ping An and Korea's Samsung that have established themselves as global players and true competitors to established international insurers. Regulatory focus is shifting with the special exemption that allows domestic Singaporean business to be written in London coming to an end next year. Meanwhile, Asian companies increasingly want to work with Asian insurers. The direction of travel is clear – the London PI market will see increasing international competition in the coming years.

Split verdict on Brexit

Market sentiment on Brexit appears to be split. According to our findings, just over a quarter (28%) of insurance industry respondents report that Brexit will have no or minimal impact. However, 54% expect some loss of business to European underwriting hubs due to Brexit and 38% think it will generate further impetus for the establishment of hubs outside London.

The market participants were confident that the industry had done everything it could structurally to ensure that it was ready for a hard Brexit and were unanimously in agreement that they had not been losing any business as a result so far. However, there is a degree of caution; a sense that as time goes on there may be some challenges – not least from European regulators in regard to the licensing of Lloyd's businesses – that will make it harder to continue to service EU business as seamlessly as in the past.

Insurance industry:
What is the likely effect of Brexit on the London PI market?



D&I to make a difference?
If the PI market is to face down today's challenges effectively and those in the future, it needs to up its game with respect to diversity and inclusion.

Just over half (52%) of insurance industry respondents believe the market fails to invest adequately in attracting, training and retaining talent. And the findings show they are more negative than positive about whether the London PI market invests adequately in D&I. The phrase "pale, male and stale" was used more than once to describe the industry and there was frustration that insurance lags some way behind other industries in embracing D&I. Similar concerns were conveyed in relation to training, which is evidently another feature to address.

52%

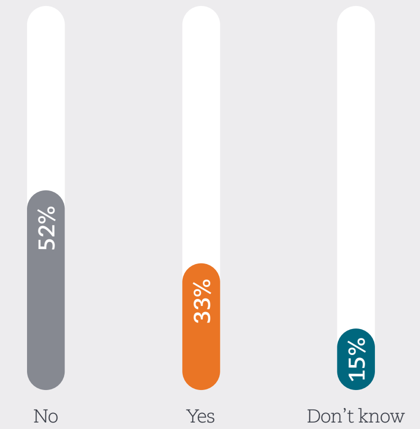
believe PI market fails to invest in talent

20%

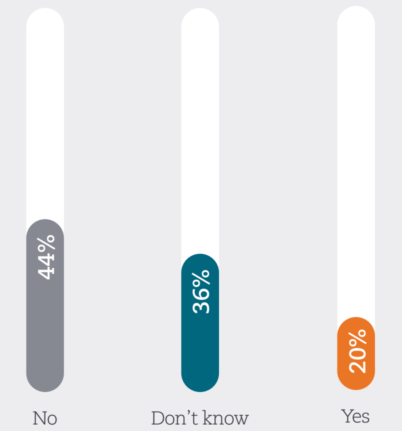
think D&I investment is adequate

"THE PI MARKET IS CHARACTERISED BY PEOPLE WITH EXCEPTIONAL SKILLS. FINDING A MEANS OF TRANSFERRING THOSE SKILLS TO AS DIVERSE AND INCLUSIVE A GROUP OF THE NEXT GENERATION OF TALENT AS POSSIBLE – AND SUPPORTING THEM THROUGH TRAINING AND MENTORING – WILL BE ESSENTIAL FOR LONDON'S ONGOING COMPETITIVENESS."
Jane Williams, Partner, Clyde & Co

Insurance industry: Does the London PI market invest adequately in attracting and retaining talent, training and career development?



Insurance industry: Does the London PI market invest adequately in diversity and inclusion?



Methodology
Clyde & Co conducted an online survey of 122 targeted London market insurance professionals and buyers during May 2021. The findings were then discussed and analysed by Clyde & Co partners and used as the basis for interviews with Graham Wynes, Lockton; Simon Mantell, QBE; Andrew Townsend, Liberty; Jana Ratnajothy, Convex; and Simon Moi and Christian Stobbs, Markel.

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