# PROFESSIONAL INDEMNITY MARKET UPDATE – JULY 2019

The UK construction PI market has deteriorated significantly over the last 12 months and it continues to decline. Underwriting construction PI, especially in relation to 'Design & Construct' firms, has been unprofitable for many Insurer's for several years.

An over-supply of capacity and the subsequent competition led to a sustained period of benign market conditions in recent years. That capacity has now rapidly diminished as the last 2 years has seen various Insurers pull out of the UK PI market, with several others having ceased to underwrite Construction PI entirely. A recent Lloyd's crackdown targeted loss-making syndicates, culminating in Lloyd's restricting how much PI business syndicates are permitted to underwrite (no syndicate has been allowed to increase the amount of PI premium they underwrite in 2019).

As a result, those Insurers still active in the construction sector are typically looking to limit their exposures by reducing capacity, increasing premium rates and excess levels and enforcing coverage restrictions.

### What has caused the deterioration in the Construction PI market?

**Claims Activity**: There has been a noticeable increase in construction PI claims activity in the UK and globally in recent years, particularly relating to large infrastructure projects and renewable technologies (especially in the 'Waste to Energy' sector). The scope for costly disputes continues to grow as major construction projects become ever more expensive and complex, and an increasingly globalised landscape often adds further complexity to projects and any ensuing claims. Lengthy disputes (synonymous with PI) coupled with claims inflation increase Insurer's costs - just 'being at the scene' is often enough for construction insureds to get drawn into project disputes.

**Financial viability and supply chain resilience**: Carillion's demise fueled pre-existing concerns amongst Insurers about financial viability and supply chain resilience. PI Insurers are wary of an economic climate where margins are so thin, and the political climate remains so uncertain. Vicarious liability is a growing concern, as Insurers' ability to make recoveries from the parties at fault seems ever more challenging. Vicarious exposures are increasingly significant given the popularity of 'design and build' procurement and supply chains are frequently long and complex. In a landscape ripe for solvencies, Insurers can end up effectively insuring unknown entities over whom they have no control.

**Tough contracting environment**: Hugely competitive procurement processes have resulted in a race to the bottom in terms of margins and the prevalence of fixed cost contracts drives relentless 'value engineering'. Onerous contractual obligations are often forced all the way down supply chains, transferring more risk away from employers than is perhaps reasonable. PI Insurers could be forgiven for being nervous about the potential consequences.

**Concerns about 'cladding'/fire safety:**

The Grenfell Tower tragedy highlighted issues surrounding cladding and fire safety in general and numerous claims notifications have already been made. In spite of recent legislative changes, PI Insurers are understandably nervous about such claims and the perceived inadequacy of building regulations, given the legacy exposures still faced.

**How has the PI Market reacted?**

PI Insurers are becoming increasingly selective about the risks they underwrite in the construction sector. Stricter underwriting discipline and resolve is evident as Insurers are no longer chasing premium income but are now comfortable in declining risks they might previously have underwritten.

**More information required:**

Insurers are demanding more in-depth information in the run-up to renewals, adding to the time it takes to provide formal terms and place a policy.

**Capacity restrictions**:

Insurers are restricting the capacity they accept on many construction PI placements. Subscription placements (where more than one underwriter participates on a risk), common place in the Lloyd's market, are increasingly necessary for even the smaller risks and 'differential placement' is being more widely used to get difficult risks over the line. Capacity reductions mean that placing high limits of indemnity can be extremely challenging and if capacity is available, it now tends to come at considerably higher cost. Some Insurers have stopped underwriting 'excess layer' PI, deeming it unsustainably cheap. Claims experience suggests that excess layers, especially at low attachment points, are now 'working' layers and far from immune to claims.

**Limit of indemnity restrictions:**

It is important to bear in mind that the extent of policy coverage will differ and markedly so between contractors and professional consultants.

Generally speaking, Insurers are still providing 'Any One Claim' cover for consultants, especially when they are required to carry such cover by their

respective institutes. The same is not the case for contractors, where aggregate limits of indemnity are increasingly becoming the norm. Insurer's appetite to provide reinstatements of aggregate limits is also generally diminishing, especially for unlimited reinstatements. When Insurers are prepared to provide reinstatements, particularly multiple reinstatements, they are increasingly likely to insist that an Insured buys a far higher limit of cover so that there is more cover above them to be eroded before any reinstatement is triggered.

**Policy coverage restrictions**:

Insurers are frequently looking to limit their exposure by restricting the scope of policy coverage and some extensions of cover are certainly proving harder to obtain. 'Cladding' and fire safety restrictions have simply become standard, typically limiting cover to a single aggregate amount, imposing a higher self-insured excess, limiting cover to a rectification-only basis (so excluding consequential and economic losses) and weakening insuring clauses to a negligence-basis only (if that is not already the basis of cover).

Cyber liability exclusions have also started creeping in to guard against silent cyber exposure which Insurers feel should be picked up by a stand-alone cyber liability policy.

**Attention on self-insured excesses**:

There is heightened focus on levels of self-insured excess, with seemingly widespread concerns that excess levels have escaped appropriate increases over the years. For contractors particularly, self-insured excesses are frequently made applicable to defence costs (if they weren't already) and defence costs are included within the overall limit of indemnity.

**What can be done to mitigate the impact on your PI placement?**

Commence your renewal process early:

Early engagement with the renewal process is critical. Meeting your Insurers can pay dividends, enhancing relationships and allowing underwriters to see beyond the paperwork and get a feel for the culture of a business. You should work with your broker to pre-empt the inevitable PI market concerns, formulating risk-focused narratives where necessary to compliment the more standard renewal documentation.

Given Insurer concerns about the economic climate, highlighting comparatively healthy profit margins is appropriate. Such margins would no doubt be viewed as a positive by Insurers who will be concerned about the prospect of Insured's cutting corners on projects to boost their margins.

## Highlight risk management processes:

Providing evidence of entrenched and effective internal processes and risk management systems is expected and vital.

## Highlight supply chain management processes:

Emphasising robust supply chain management should serve to mitigate Insurer concerns about supply chain frailties. Provide evidence to Insurers of your positive relationships with an established supply chain. Engage on back-to-back terms with sub-contractors and aim to pass down liability evenly, ideally ensuring that their liability is not limited to a lower level than your own.

Highlighting appropriate and extensive due diligence on your supply chain will be viewed positively. Indeed, emphasising due diligence undertaken on projects you are tendering for and due diligence undertaken on prospective employers (to identify possible funding issues) may also prove beneficial.

## Highlight contractual risk management processes:

Evidencing effective contractual risk management to Insurers is crucial and of course the benefits of appropriate contractual protections will not be limited to facilitating cheaper PI premiums. Highlighting effective use of liability caps (for example) should be looked upon favourably and will demonstrate a good risk management ethos even if ultimately such caps don't stand up. This might also assist in driving additional value, especially on excess layers. Being able to demonstrate the use of 'Net Contribution Clauses' (which aim to restrict your liability to the proportion of loss for which you are responsible) could derive additional value but may meet with resistance from some Clients.

## Consider how much PI cover you need:

When agreeing to maintain PI cover contractually, don't agree to buy unnecessarily large amounts of cover and ensure that your obligation to maintain such cover is dependent on it being available at *commercially reasonable rates* (and that the cover only needs to be on *commercially reasonable terms*). Where obtaining sufficient cover (or cover on an appropriate basis) is problematic, you need to provide sufficient information to enable your broker to tailor a bespoke programme accordingly. Innovative placement structures can sometimes provide the cover required, even if at first it does not seem available or it is prohibitively expensive.

## Conclusion

As with many insurances, the PI market is cyclical, so softer more flexible conditions will return. A ‘hard’ market has historically only lasted two, perhaps three renewal cycles, but typically some sources suggest that several years of sustained premium rate increases might well be necessary to mitigate recent loss experience and restore profitability.

However, we have been here before and once premiums have increased and profitability returned, we expect new capacity to flow back into the sector providing an inevitable increase in competition. Whilst the current climate is undeniably challenging for all parties, heightened focus on risk management processes will serve any firm well, both in hard and soft market conditions.

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