Architects and Engineers Professional Liablity Insurance State of the Market

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Introduction

Purchasers of a/e professional liability insurance are understandably perplexed by the cyclical nature of this market segment. The cost of coverage goes up and goes down again without any apparent reason. When competition heats up negative pressure is exerted on pricing. In addition to price reductions, coverage tends to expand and previously undesirable classes of business become easier to insure. Purchasers, as well as insurers prefer an environment that supports stability. However that goal seems as elusive today as it has over the past twenty-five years.

Since the early seventies, we have experienced underwriting cycles marked by short hard markets (two to three years) where insurers pretty much have their way. The hard market is followed by a prolonged soft market where it's the insured's time to shine. There are many reasons for the cyclical nature of the insurance market. At the high point of the market cycle, higher rates produce a relatively strong underwriting profit. The lure of attractive underwriting returns, combined with the need to expand business, attracts insurers to the market segment. As competition heats up, pressure to maintain an existing book of business, or to get one off the ground, puts downward pressure on pricing resulting in a gradual deterioration of rates. In addition to reducing rates, insurers will compete by expanding coverage. During the last fifteen years, architects and engineers have benefited from significantly enhanced coverage in the areas of pollution, asbestos, and design/build. Because of increased competition, certain practice areas, which were otherwise difficult to place, become easier to insure. When rates produce an unacceptable return, insurers seek better use of capital and exit the market segment. Reduced competition leads to an environment that supports higher rates, reductions in coverage, increased selectivity, and a new market cycle begins.

The previous hard market began in 1984 and ended in 1986. However, rates declined steadily until the fourth quarter of 2001, which resulted in dismal underwriting returns. In an effort to return to profitability, rates have increased, coverages narrowed, and some insurers withdrew from the a/e market segment. Those insurers that remained in the market imposed more selective underwriting criteria. Consequently, the years of 2002 and 2003 produced improved returns that were continuing through the first three quarters of 2004. The question remains, "Are we in for another prolonged soft market, or has the market found a way to stabilize itself?"

Current Underwriting Environment

Rates are at a three-year high, insurers are cutting back on the classes of business they are willing to entertain, and new coverage restrictions are creeping in. However, there are indicators that point to a looming soft market. Primarily, the market has undergone a transformation as key players have changed. The following table illustrates those insurers writing a/e professional liability insurance in 2000 and those that are current market participants. Only two of the significant current writers were in the market in the year 2000.

Writing in 2000 through 2004	Writing in 2000 but not in 2004	Writing in 2004 but not in 2000
AIG/Lexington	DPIC	XL
CNA	ECS	Quanta
Lloyd's	Evanston	Liberty
Zurich	Great American	Houston Casualty
Evanston*	Gulf	Everest
Gulf*	Kemper	National Casualty
	Reliance	St. Paul
	SAFECO	ACE
	Tudor	
	Westchester	
	Alpine	

The firms marked with an asterisk have indicated that they shall soon be exiting this class of business or have a limited appetite. Therefore, of the seventeen insurers writing business in 2000, only four are actively pursuing a/e business today; I will refer to these insurers as the "legacy writers". To put this into perspective, the total market in 2000 represented an estimated 800,000,000 dollars in premium volume. The insurers that wrote in 2000 and are still writing today account for less than 400,000,000 dollars of the total premium.

As one might imagine, there is a behavioral difference between the legacy writers and the new market competitors. On one hand, the legacy writers have more experience and are using that experience to project the future, so they are more conservative. Legacy writers also need to regain the trust and support of their investors and reinsurers. On the other hand, the new players need to stake a place in the market and are not encumbered by previous underwriting losses. The legacy writers are competing with the new players for the huge amount of business now in play, which is due to the large number of insurers that have exited the market. Legacy writers are finding it difficult to protect their existing book of business because the new players tend to be more price competitive. However, some insurance buyers are willing to pay a higher premium for the sake of stability, enhanced service, and the broader coverage that the legacy writers provide.

It is yet to be determined whether the legacy writers are being too conservative, or are the new players undercharging. It will take some time until this is known. If the market continues in its current direction we will re-enter the soft portion of the market cycle. If legacy writers maintain underwriting discipline, it is possible that they too will elect to withdraw from the a/e market segment.

Pricing for 2005

During its annual meeting this past September, the a/e ProNet organization interviewed ten insurers that are actively writing this class of business. Each insurer was queried as to what they plan on doing with rates in 2005. The prevailing response was that no rate changes are expected for next year. However a couple of insurers are looking to "fine tune" current rating structures, and one insurer was indicated a moderate 5% rate increase. Time will tell whether insurers will be successful in holding the line on rates. The entry of the new players as indicated above would put pressure on existing insurers that could result in more price competition.

Coverage Changes and Emerging Challenges

Insurers are profitable as long as the total premium exceeds total loss and expense payments. The premium side is simply a matter of rates. However, the amount of claim payments depend on many things, including risk selection and breadth of coverage. Therefore when things seem to be going bad, insurers tend to raise rates and to narrow coverage. Ironically, during a soft market, insurers tend to offer broader coverage terms in order to attract more business or to retain existing business. One would think that when rates are low, insurers would not be willing to increase their exposure to claim related losses. Conversely, as the market hardens, insurers not only take rate increases but also take advantage of market conditions to narrow coverage terms. This behavior pattern contributes to the swings in insurer profitability and consequently, pricing. During the nineties, competitive pressures caused insurers to expand coverage. As a result, most insurers eliminated pollution, asbestos, delay and design/build exclusions. Additional coverage features were also added such as mediation deductible credits, and coverage for otherwise excluded fines or penalties in connection with FHA, OSHA or ADA. During the last soft market, insurers competed heavily on policy form, which resulted in a much improved product for the insured.

Hard market conditions can result in reductions in coverage that will include responses to emerging claim trends and reduction in competition. We are already seeing that the new players are offering coverage that is typically more restrictive than the legacy writers. Emerging claim trends that are now being addressed include exposures to terrorism and mold.

Terrorism

The current thinking at the underwriting level is that insurers should not have exposure to losses arising out of acts of terrorism. It is perceived that such losses are most likely to be catastrophic and that there is no way to properly underwrite in a manner that would protect the insurers. The general (but not uniform) response to the WTC disaster was to exclude any sort of claim arising out of an act of terrorism. The response was the Terrorism Risk Insurance Act (TRIA) enacted by congress and signed into law by President Bush on November 26, 2002. The law establishes a temporary federal reinsurance program where any covered losses caused by “certified” acts of terrorism would be partially reimbursed by the United States under a formula established by federal law. Under this formula, the United States pays 90% of covered terrorism losses that exceed the statutorily established deductible paid by the insurance company providing the coverage. This law expires at the end of 2005, and it is unclear if it will be extended.

Architects and Engineers clearly have a need for this coverage. One can imagine scenarios where an affected structure is allegedly not be up to code because of improper fire separations or insufficient smoke evacuation and containment. Should congress not extend the current TRIA law, it is expected that many insurers will exclude coverage for terrorist acts creating a difficult uninsured exposure for the design community.

Mold

Mold continues to emerge as a problem area and insurers are approaching the coverage of mold related claims in various ways. Some insurers are willing to provide coverage for mold related losses but are watching developments closely. At least one insurer has drafted and filed its mold exclusion so that it will be ready to move quickly if it decides to later restrict coverage. Other insurers are expressing a great deal of concern and are applying an absolute mold exclusion. There is, however, a middle ground where some insurers are willing to provide a sub-limit of liability with reduced coverage available for mold related claims.

At this point in time it appears that mold claims are not as unpredictable or explosive as once feared. Therefore, the position on mold will likely be effected by market conditions. In other words, if we move into a soft market, it is likely that those insurers taking a hard line on coverage for mold claims will agree to remove the exclusion on a case by case basis or offer at least limited coverage by offering a sub-limit of liability.

Residential

Insurers currently believe that residential housing, particularly condominium and townhouse projects, are problematic. For that reason, it is becoming increasingly difficult to insure design firms that practice in this area. This can be a very frustrating problem in that much of the work available to small design firms today are these kinds of projects. Most insurers will accept a firm where condo/townhouse projects represent a small amount of total annual revenues. Tolerance for residential projects varies by insurer and the nature of services provided. Some insurers accept no more than 5% as an acceptable percentage. While there are insurers that will provide coverage for a firm that has a high percentage of condominium/townhouse design work, the insurer options are limited and the cost is relatively high.

Project Coverage

Project coverage is desired by owners that wish to have some control over all of the professional liability coverage applicable to a single project. A project policy is one that is written for a specific term of years and can cover all of the design team members. Since all members of the design team are covered under a single policy, it is believed that any dispute involving design errors would be less contentious because only one insurer would be involved. The perceived benefits are that an owner can make certain that a specific limit of liability is available. Additionally, project coverage would eliminate the need to monitor the various design team members to assure compliance with minimum insurance requirements. Another perceived advantage is that insurers would guarantee project coverage for the policy term, and owners would not need to be concerned about coverage availability with each subsequent renewal.

The market for project insurance has become very limited. The recent a/e ProNet survey revealed that only two insurers are willing to entertain project coverage and that the limitation are such that very few projects will fit within the limited underwriting criteria. The reason for this is that project coverage has been very unprofitable for insurers during the past ten years. Project coverage has been unprofitable for the following reasons.

Adverse Risk Selection

Project coverage has often been utilized on the most claim prone projects types. These are typically projects that pose both a high incidence of claim activity as well as claims that are often large.

Generally Under Priced

Due to very soft market conditions during most of the nineties, increased competition for large premiums leads to a market that is particularly under priced for large projects.

Aggregation of Exposures

Typically an insurer looks for a spread of risks. For example, a property underwriter would not wish to insure an entire block of homes due to an increased risk of catastrophic exposure arising from fire, flood, tornado, etc. In a project policy, the same insurer is covering all member of the design team and is, therefore, responsible for any design related problem.

There is little doubt that project coverage can be written profitably, but the over-use and aggressive pricing of project coverage on very large projects has led to a perception that this class of business is very difficult to underwrite profitably. Therefore, insurers are approaching any new project policy with a large degree of caution.

Coverage Enhancements

During the nineties, insurers introduced a number of coverage enhancements some of which have been referred to above. It is unclear if insurers will continue to offer this expanded coverage or otherwise retreat to a more conservative approach. This can go either way and much will depend on how soft the market becomes. As of now, it seems that the legacy writers will continue to offer expanded coverage and services. However, if they continue to lose market share to the new players that do not offer expanded services or broadened coverage, the legacy writers must strip down their services or coverage or they must withdraw from the market due to competitive pressures.

Conclusion

The coming year will be a struggle between the legacy writers and new players. The legacy writers will likely be higher priced. Insureds looking for more stability and higher levels of service will be less likely to change for the sake of a lower premium. Other purchasers, particularly those that have been paying a larger portion of earnings on insurance, will likely take their chances on unproved insurers. At some point, equilibrium needs to occur, because either the legacy writers are charging too much or the new players are under priced. This will work itself out but we will need to wait and see which insurers remain standing when the dust settles.

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