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The Professional Indemnity Specialists

REPORT ON THE PROFESSIONAL INDEMNITY INSURANCE MARKET FOR IFAs FOR 2009 – Written by Neil Pointon, Chief Executive, PYV Ltd.

Ever since the proposed FIMBRA PI Scheme in 1989, Professional Indemnity (PI) insurance has been a hot topic for IFAs and it seems likely that the recent economic meltdown may reignite this issue once more. PI is a mandatory requirement under both the regulation of the Financial Services Authority (FSA) and European Legislation making this an unavoidable issue.

Over the years, there have been many challenges which have created problems in the smooth placing of PI for IFAs. Not least of these was the Securities and Investment Board (SIB) sponsored Pension Transfer Review. Although this related to pension transfer business transacted between 1988 and 1994, today it still produces a number of new potential claims. In more recent times, concerns involving Split Capital Investment Trusts/Zero Dividend Preference Shares, SCARPS/Precipice Bonds and Endowments had continued to present IFAs in an unfavourable light in the eyes of PI Underwriters. These problems culminated five years ago in helping to create the hardest PI market for IFAs since the Financial Services Act 1986 was passed.

In early 2004, at the height of this hard market, it was not uncommon for IFAs to be unable to obtain any cover at all and for those that did, to pay a high premium with high excesses and conditions which restricted cover including onerous exclusions. Some firms that were unable to obtain cover were given some relief by the FSA in the form of waivers, however, with the Insurance Mediation Directive (IMD) due to come into force in January 2005, it was likely that that the FSA's power to allow waivers would cease and, therefore, the spectre of IFAs being driven out of business due to the state of the Professional Indemnity Market loomed large. Fortunately, in late summer 2004, market conditions began to improve with underwriting capacity beginning to flow back into this sector and by the time the IMD came into force there was enough capacity at affordable premiums to go round. This was due partly to increased capacity in the professional liability market as a whole as well as underwriters becoming more satisfied that IFAs' past problems were now behind them to a greater or lesser degree. The FSA, working together with trade bodies and professional associations such as AIFA/AMI and the PFS, should be congratulated for resisting calls for further product reviews and improving the professional image of the IFA population.

Since then, the PI market has continued to improve and soften with many of the harsher premiums and excesses being substantially reduced and most of the additional exclusions deleted. In 2008, it was still possible for some IFAs with certain business characteristics to obtain a better deal than the policy they arranged the previous year, however, after such a long period of sustained softening, the questions must be: Where are we in the insurance cycle? Has the PI market reached rock bottom and will it now begin to harden again? In order to consider these questions, we need to look at factors which might directly affect the IFA PI market.

The current credit crunch, whilst being a global threat, is expected to cause a tidal wave (some might say a Tsunami) of claims against those UK professional advisers with direct involvement in financial and property markets. The reasoning is obvious as when prices fall, people face losses on their investments and look for someone else to blame. Whether these allegations are converted into successful claims

against an adviser's PI policy will depend on individual circumstances, although defence and administration costs are likely to have been incurred, regardless of the outcome. Those who have kept full documentation to demonstrate the client was fully informed of the risk involved and that the advice was suitable will be best placed to defend themselves and keep their own costs down. The potential for increased claims activity is sure to force PI insurers to take another look at their exposure and revisit the terms that they are offering.

Particular areas currently catching underwriters' eyes are: Lehman Brothers' exposure, 'Madoff', various structured products and counter-parties risks, Icelandic banks, Kaupthing Singer & Friedlander Isle of Man Ltd and cash in offshore bonds.

IFA buyers of PI should also revisit the terms they are offered at each renewal to ensure that they remain in line with the latest regulatory requirements. The introduction of the Markets in Financial Instruments Directive (MiFID) on 1st November 2007 brought with it additional cover requirements for those UK firms that are authorised to either hold client money or 'passport' business into Europe. These involve a complex calculation to carry higher Limits of Indemnity which may alternatively be taken care of by the holding of additional capital adequacy.

In addition to this, all UK IFAs will be affected by the Euro's rise against Sterling as the minimum Limit of Indemnity they are required to hold was set by the Insurance Mediation Directive (IMD) in Euros - although large IFAs with an annual income in excess of £6,000,000 are also required to carry higher sterling limits by the FSA. The IMD previously required firms to carry minimum limits of 1 million Euros for any limit that is on an any one claim basis and 1.5 million Euros for any limit that has an aggregate cap, the market norm. In the recent past, this equated to purchasing sterling limits of £700,000 and £1,050,000 respectively but for cases incepting in late 2008, the exchange rate required that these sterling limits be increased to around £900,000 and £1,350,000 and this position continued to change.

Furthermore, The IMD also requires that these limits be reviewed in line with the movements of the European Index of Consumer Prices every five years. Therefore, for those renewing or taking out fresh cover as from 1st March 2009, these limits need to be increased by just over 12% and an aggregate limit of £1,600,000 is now offered as standard. **Please note, these limits need to satisfy this criteria only at the inception of the policy.** Remember, these limits are the minimum required and it may be prudent to consider purchasing even more cover.

In the Summer of 2007, the FSA issued the much talked about 'Retail Distribution Review' Paper along with Discussion Paper 07/04 - 'Review of the Prudential Rules for Personal Investment Firms'. Included in DP07/04 were some wide-ranging proposals to 'better mitigate the market failures in this sector' and they concentrated on the financial resources and PI held by Personal Investment Firms. In the FSA's latest paper 08/20, however, they appear to have boiled down these ideas to such a degree that the latest proposals under consultation are unlikely to affect PI underwriting market conditions. These proposals, if implemented, are more likely to affect the IFAs themselves as they do involve additional capital requirements and potential for the holding of further additional capital resources where an IFA's cover carries an exclusion for a class of business they have transacted. This was rare during 2008 but if a hard market was to appear, this is likely become more commonplace.

Other areas of specific concern to providers of UK IFA PI include potential exposure to equity release, income drawdown and mortgage fraud claims, pension-switching and the potential for any future regulatory reviews. The effect of European Financial Advisers taking up additional capacity following the introduction of MiFID on 1st November 2007, however, has yet to materialise.

We should also look at the bigger picture. The hurricanes and catastrophes in 2005 put a large dent in worldwide insurance capacity with hurricane Katrina alone expected by some to cost a total over 86 billion dollars. You may think this should have nothing to do with the rates an IFA pays for his PI, however, if insurance capacity diminishes as a whole or alternatively the available capacity flows from PI to another field which underwriters believe will produce greater returns, then this could cause conditions to harden. As it turned out, the reverse happened last time with new fresh capital being drawn in chasing after the expected (and achieved) healthy returns from a hard market specific to US property catastrophe rates. This, however, would not necessarily be the case again if we were to see a return to the same level of hurricane activity as 2005 in the future. In 2008, hurricanes Gustav and Ike caused some major (insured) damage. If the current global insurance capacity were to be exhausted by new large catastrophes who is to say whether new fresh capacity will come in, especially bearing in mind the worldwide tightening of available money associated with the credit crunch.

All these factors may lead to another type of crunch – a capacity crunch! Whilst it is understandable that any firm which has been receiving better terms at their recent renewals would wish that this trend continues, it is also important to be aware if premiums fall below a level which is sustainable when balanced against actual claims experience, there will inevitably be a rebound reaction which will favour no-one. Stability is needed for buyers and providers alike. This would enable IFAs' to budget effectively for future years' costs, not only those relating to premium but also those in respect of reserves to cover against self-insured excesses for future claims.

With so much uncertainty and so many variables to consider, it is important to seek a deal with partners who will be there for you in the long run. That is why it is important to use a specialist broker who knows the market inside out and has access to all relevant underwriters to provide options for the long term. They should also be able to provide you with up-to-date knowledge regarding PI matters concerning your industry. Check to see whether your broker has access to IFA specific PI facilities and a tailored proposal form and wording. As the FSA do not prescribe an actual model policy wording, your broker needs to be able to handle any questions regarding any of the terms, conditions, limitations or exclusions contained in your policy. For example, those connected or related to insolvency, appointed representatives, regulatory action or the excess. Consideration should also be given as to whether you have access to a broker's own claims department that has the experience in handling IFA claims and is there to work exclusively on your behalf. After all, protection in the event of a claim is ultimately what you buy the cover for.

In conclusion, in recent years it has been a highly competitive market, favourable to IFAs and Mortgage Intermediaries. The insurance market cycle will always go up and down and it would be better for all concerned if these movements were less severe especially when rates in the past have been more than four times what they are today. It may be that with the current fast changing economic environment, PI

conditions are set to become more challenging, making your choice of PI provider even more important.

PYV's Claims Director, Robert Bass, has set out below information regarding some current hot topics from the claims arena which I am sure you will find of interest.

Endowments: continue to be a time consuming activity for IFAs. FOS anticipated in 2005 they would receive 67,000 endowment complaints and as a further wave of re-projection is due it will precipitate more complaints. "Claims promoting firms" ("Ambulance Chasers") are becoming persistent although we are advised that a case they put through the FOS is statistically less likely to succeed than one from the investor direct. In June 2004 FSA changed its time-barring rules and by the end of 2009 it is hoped that the majority of endowments will be time-barred. Hopefully the end is nigh….

Pension review: the primary pension review is over, however, the FSCS has been very active in reviewing old cases and re-approaching Insurers of defunct firms. In some cases payouts are being made to FSCS which, although not directly relevant to firms still in business and their Insurers, will increase the loss ratios on older years and could affect underwriting going forward as their costs increase.

PPI Policies: a number of high-profile fines (and ensuing business reviews) were imposed by the regulator in both 2007 and 2008 and there seems to be the likelihood of many more in the offing as the FSA have openly and repeatedly expressed their concerns over PPI sales. The likelihood of a review along the lines of the pension review appears remote, but some individual advisers have been required to review their book of business and to make redress payments where necessary.

The main issues are that many policyholders may not appreciate the cover is optional or have sufficient understanding of the limitations of the cover. An adviser needs to be very careful to explain and document all exclusions and draw attention to all pertinent facts in order to defend a complaint. Certain legal firms are endeavouring to make reputations for themselves as "crusaders" in this field.

Mortgage advice: There are a number of potential pitfalls for the adviser. Most would result in modest claims but the long-term aggregation cost can be damaging to the business. These include:

- **Early redemption charges:** the costs must be clearly explained, considered and documented to avoid disputes at a later date.
- **Delays in processing applications:** these should be avoided wherever possible. If delays are unavoidable the client should be kept fully informed. The loss of a property due to delays in mortgage processing could result in a claim for lost or additional fees incurred or even a revised valuation of the property.
- **Economic factors:** though outside the control of an adviser these will inevitably have an effect. Following the house price collapse, close attention is being paid to mortgages and their affordability. The downturn has exposed examples of inadequate advice. Borrowers who struggle financially may decide to blame their adviser, and the adviser may find themselves having to justify his recommendations.

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In this turbulent environment, advisers are urged to keep their wits about them. PI polices contain strict notification conditions and it is paramount to comply with them or risk losing the protection the policy affords. If in doubt, consult your broker.

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