

# The Willis Index

Willis

Accountants' and Auditors' Newsletter  
The Financial Advisers PI Insurance and Risk Management Quarterly

Q3 2005

## A Cooling-Off Period?

### Willis Insurance Market Survey – The Results Q3 2005

The results of the latest insurance market survey show the market continuing to maintain competitiveness, especially in the small to medium firm sector. Average premium reductions for primary layers with limits of indemnity up to £5m are continuing to vary between 5% and 25% year on year.

Excess layers are also continuing to show savings of 25% to 30% and this is particularly true of limits between £10m and £50m, where restructuring can be highly beneficial.

We have also seen that this environment is continuing despite a number of claims in the £10m to £20m range which are affecting second tier firms.

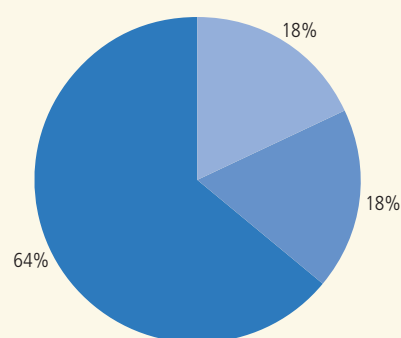
In relation to other aspects, our survey indicates that coverage and limits of indemnity are remaining largely unaltered. Firms appear to be content with banking any premium savings, with wording conditions predominantly agreed without challenge. Although claims activity is currently spread across audit, tax and trust work (with no particular trend), warnings to firms discouraging them against taking premium savings and not spending wisely on higher limits have been issued.

## Willis Prediction

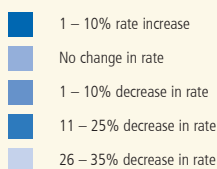
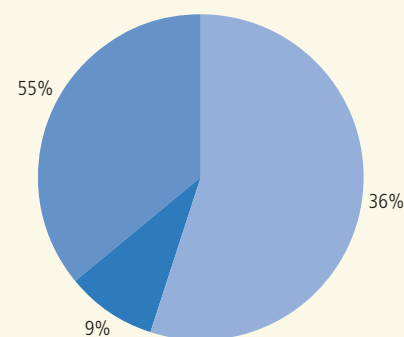
There is a strong feeling that the market cannot sustain continued reductions of the order of those seen in 2004 and 2005. Underwriters will have to be much more selective with ever increasing emphasis on risk management. Furthermore, we see the job of the broker intensifying with the need to constantly review programme structures, whilst exploiting market conditions, in the best interests of the client.

Jeremy Jones, Willis' PI broking director added "I believe that the wise buyer of Professional Indemnity Insurance should seriously consider using their savings to increase their limit of indemnity. This can be done at any time on a pro-rata cost". If you have any questions on Professional Indemnity Insurance please email them to [jonesjs@willis.com](mailto:jonesjs@willis.com)

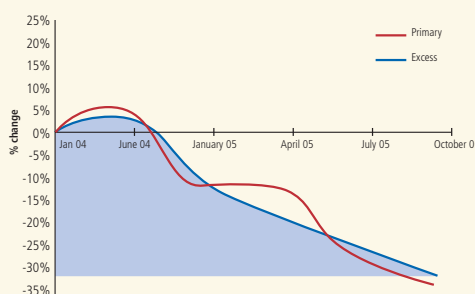
Market Survey Results, primary rate changes – last three months



Market Survey Results, predicted rate changes – next three months



Primary Layer Premium Change



\*The data is based on criteria presented by multiple risks, and does not relate to any one risk in isolation.

The Willis Index is a quarterly publication reporting on the relevant issues affecting the Professional Indemnity Insurance industry, and the impact they have upon those in the financial services sector. The main feature is the Willis benchmarking commentary on professional indemnity premiums which has been taken from an analysis of sample rate reductions received over the last three quarters.

Our quarterly analysis will provide buyers with an overview of insurance market conditions and our assessment of the outlook.

In this issue we include a technical review of coverage with a special feature highlighting changes in regulation and insurance market news.

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# A liability cap loophole – will you be making the most of it?

The DTI has taken the next step in finalising their consultation process for the Company Law Reform Bill. On the 19 July 2005, draft clauses were published relating to proportionate liability for auditors and it would seem that, at last, this offers the prospect of capping liability. In response to these proposals, Joanne Willmore investigates what this will mean in the context of Professional Indemnity Insurance.



Within the draft clauses there is provision for private and public companies to reach "Limitation Liability Agreements" ("LLA"s) with their auditors. This news will be well received, particularly as these agreements will not be subject to the Unfair Contract Terms Act 1977 and therefore the standard requirement for "reasonableness" need not be met.

It has been suggested that these new agreements will be unofficially interpreted as formal liability caps, enhancing the potential of an immediate increase in the use of these clauses which will be largely welcomed by PI Insurers (providing they are carefully drafted).

In addition Joanne commented; "The widespread use of adequate LLA's may help prevent an increase in Professional Indemnity premium rates. Interestingly, this has been the experience reported by the Australian Competition and Consumer Commission where, under a similar capping system, Australian PI premiums have reportedly been prevented from rising by up to 20%. UK firms should take heed as this level of potential saving can represent a significant amount for many firms."

It is important to note the draft clauses provide that an LLA: "Is not effective to limit the auditor's liability to less than such amount as is fair and reasonable in all the circumstances of the case having regard to:

- a) The auditor's responsibilities...
- b) The nature and purpose of the auditor's contractual obligations to the company,
- c) the professional standards expected of him..."

Any limitation will not apply if an auditor is a party to a fraud.

The Willis note of caution would involve the wording of these clauses having experienced other professions falling into the trap of "blindly " inserting liability limitations which have subsequently not been upheld by the courts. The decision of the courts has been made predominantly on the grounds of reasonableness (or lack thereof) despite the LLA's negating the need for compliance to the Unfair Contract Terms Act. The feeling is that Auditors would be strongly advised to negotiate these clauses with their clients rather than taking a strong line on imposition. From past experience,

along with current PI claims across a variety of sectors, Willis believe the courts are likely to value the "negotiation approach" and will probably look for the methodology used in calculation of the quantum. The courts are also likely to review the link for the limit of liability used against the proportionate value of the audit, with consideration paid to the roles and duties of other people along with the PI coverage.

Willis welcome the Government's draft limitation clauses and feel this is a valid response to the increasing pressure and responsibility of auditors. Audit firms should consider taking an "each client approach" in terms of contract limitation and align their PI insurers to changes to their business process. It is essential to ensure that the firms' internal risk management systems can demonstrate that limitations are appropriate and have been considered for each client. With this in mind, Willis would recommend that these clauses should be carefully drafted by qualified lawyers specialising in this particular area of the law.

For further information regarding the issue of PI insurance and contract limitations please contact Joanne Willmore – Executive Director, Willis Professional Risks (willmorej@willis.com +44 (0) 207 975 2216).

To put the Company Law Reform Bill firmly into context, one needs to understand that its objectives are far-reaching, aiming to make the law more relevant to the needs of small companies and to 'shake up' this area of legislation. Making auditors responsible only for their share of fraud or negligence is just a small part of the Bill.

Among its other goals:

- The prospect of compulsory audit rotation could promote improved client service.
- The restructuring of company formation rules could provide a needed boost to the small-firm sector
- To encourage directors to pay attention to the long-term, and to consider other stakeholders in the business
- Severe punishments (including custodial sentences) for auditors making reckless statements.

Willis will keep you apprised of all further development and will report on the impact of changes in future editions

Artists impression of the "Willis Building" currently under construction in the City of London, due for completion late 2007.



# Managing Electronic Risk – "The Unseen Enemy"

Recent years have seen an increase in the frequency of attacks from external hackers on corporate websites. The impact of successful infiltrations can be widespread, ranging from theft of proprietary/confidential information to wide-scale business interruption. In the opinion of Willis' Steve Bonnington, electronic risk has not yet received the appropriate level of focus within the Accountancy industry especially given new ways of working that have been facilitated through recent technological progress.

Any accountant that receives or transmits data electronically to/from a client has a risk exposure. Those who operate over the Internet, or to whom the Internet is a key part of their business offering, have a heightened exposure.

## Hackers

When questioned regarding IT security, the first term that springs to mind is "hacker". This invisible individual seeks access to electronic data for purposes such as obtaining confidential client information; committing financial fraud; or even in some cases, self-gratification. Data from the Deloitte & Touche Global Security Survey illustrates the extent of the problem – in 2003, 39% of respondents claimed they had been attacked, by 2004 this figure had risen to 83%.

Whilst many firms believe themselves to be well-protected as a result of implementation of firewalls, encryption software, or IT security manuals, there is a frequently overlooked element of risk mitigation - Insurance.

It is interesting to note that studies reveal most security breaches are the result of "well-intentioned" employees inadvertently violating their own internal security policies.

## Virus Infection

One interesting finding that emerged from the DTI's "Information Security Breaches Survey 2004" was whilst most businesses possess anti-virus software, 50% of firms experienced a virus infection last year.

## Social Engineering

This term refers to the procurement of information regarding an organisation or computer system through means of human interaction. Many accounting firms have security procedures in place to protect against attacks over an electronic medium but do not integrate these with non-electronic security measures. Such strategies would clearly leave firms exposed to this alternative area of attack.



## Comment

It is interesting to note that whilst top-tier accountants have profited from the sale of consultancy services (e.g. the use of Tiger Teams to infiltrate a client's systems and evaluate their security provisions), the accounting industry as a whole is not well-protected with many cases where the risks are not fully understood. Understanding what the "crown jewels" of your organisation are is critical to developing an effective security strategy.

One major threat arising from IT fraud is a perceived lack of confidence in the very electronic facilities used to deliver such services. In the current business environment there are a great number of very real costs associated with security breaches. For example, the Turnbull Guidelines state that directors may find themselves in breach of duty if it is found that their cyber-crime risk management procedures are inadequate. According to the DTI, "Information security must be seen as a management and business challenge, not simply a technical issue to be handed over to the experts." Management has a responsibility to consider all security solutions.

## Where could insurance fit in?

Insurance should never be considered as a replacement for an effective IT security strategy, rather an integrated feature of a well-thought-out overarching strategy.

Whilst the first 'cyber-liability' or 'e-insurance' products were considered expensive, the market has softened considerably in this field due to the entry of new competition. Some underwriters offer these products as add-ons to existing professional indemnity covers. In the past, costly IT security audits were required before insurance quotes were given, but now a proposal form may suffice. Protection is available to mitigate both employee and business losses.

The new-style products fill the void created by traditional insurance policies that do not cover e-risks. Coverage includes claims made by third parties and employees as well as the losses a business may suffer itself. For example, if a company experiences a serious virus attack, cover may include:

- payment of costs for IT experts or forensic consultants to repair systems and restore data
- reimbursement of lost revenue as a result of system downtime
- payment of legal costs and any damages awarded against the company if a third party holds that company responsible for their losses due to forward transmission of the virus
- covering of the costs of a PR consultancy to minimise damage to the company's reputation

Products have now been designed to be affordable for smaller businesses with premiums starting from as little as £750 for comprehensive cover of up to £250,000.

In today's fight against cyber crime, no weapon in the accountant's arsenal should be overlooked.

Willis has further information on the coverage that is available in the commercial market in respect of 'cyberliabilities,' and would be happy to discuss this further with you. Please direct all enquiries to Steve Bonnington (bonningtons@willis.com).

## Meet the Team

### Nick Rudnai

Nick graduated in Modern Languages at Southampton University, a city he is regularly drawn back to as a long-suffering Saints supporter.

He began his career with Royal Insurance International, choosing to move into the broking sector in 1983 where he specialised in the construction & property sectors. In 1989 he was invited to join Alexander Howden to head their International Professional Indemnity team, and through mergers became an Executive Director in Aon Professional Risks by the time he left to join Willis in 2003.

Nick now leads Willis' Professional Indemnity business in London, with a mandate to build upon past success and ensure that Willis becomes, and remains, the first name professionals turn to in this important and rapidly growing sector of the insurance industry.

"It was the scale of Willis' opportunity that attracted me to join. With a first-class brand, the right business model, quality systems and what I regard as the very best team of specialists in the business, Willis can be totally focused on our clients and their risks.

Our people work hard, never accept second best, and just keep raising the bar for themselves and those around them. It's hard to think of anywhere else I'd rather be – except perhaps watching the Saints get back into the Premiership!"



## Breaking News

If you are involved in financial services activities you are invited to join Willis for a free breakfast seminar on 6th October. The morning seminar is free of charge, and will be held in our London, Ten Trinity Square HQ. The event will involve a range of topics such as Professional Indemnity claims, PI market conditions and risk management. In addition, we are fortunate to have Caroline Mitchell as a keynote speaker. Caroline, an Ombudsman from FOS, will have the opportunity to respond to critics of the decision in the FOS v IFG Financial Advisors judicial review. Other speakers will include a representative from Fishburns Law, Robin Simon and Andrew Fryer from Willis.

For further questions, or to reserve a place for the free seminar, please contact Claudia Green (greencl@willis.com or +44 (0)20 7975 2074).

## Stop Press

### £77m PI Claim Notification Update

In the most recent edition of our newsletter we reported news of a £77m potential Professional Indemnity claim which had been reported to the market. Following the article we have been inundated with requests for further information which will be disclosed when possible. Clearly this is a subject governed by strict confidentiality rules which prohibit detailed information release.

At this stage we are, however, able to advise that the matter arose from a UK regional location. This detail will be a surprise to many firms who have been seeking confirmation that the matter arose from a London location. Whilst the Professional Indemnity market is negotiating the quantum value on this individual matter, it further illustrates that reductions in regional charge-out rates do not always correspond to a reduction in a firms' risk exposure outside London.

### Breaking News

Willis has won the Reactions Award for Insurance Broker of the Year and Most Innovative Broker of the Year 2005. The awards are voted for by the readers of Reactions and are open to all industry participants.

Willis is one of the World's leading risk management and insurance intermediaries. We have 15,800 professionals in over 300 offices around the World.

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