The Willis Index

Willis

FINEX Accountants' and Auditors' Newsletter

The Accountants' PI Insurance and Risk Management Quarterly

Autumn 2006

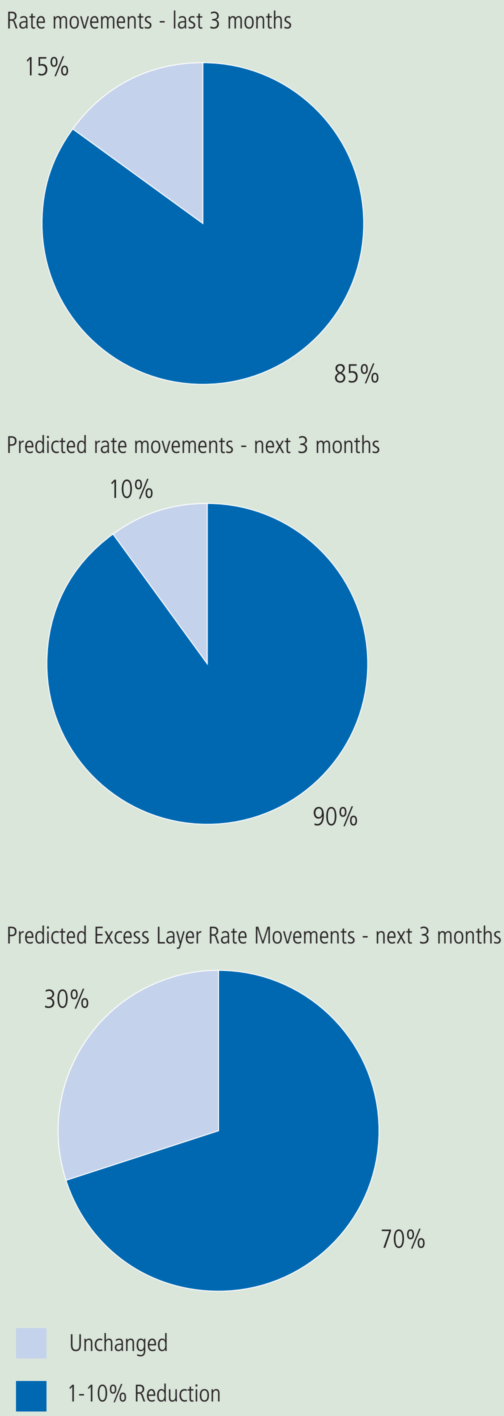
Market News

Our survey results indicate that insurers have not offered further rate reductions to those already introduced earlier this year, and nor do they anticipate doing so in the coming three months. Our view is that there will be no change in the market until the end of this year.

In August, the Bank of England raised interest rates for the first time in two years, and there is considerable speculation that a further rate hike is likely in November. Whilst the US Federal Reserve held interest rates at 5.25% in August (after increasing them at 17 successive policy meetings since June 2004), it is apparent that policy-makers are responding to fears of inflation. Our view is that, with increased costs of capital, insurer margins could come under pressure. We had previously commented that the rate decreases seen would be unsustainable, and now external factors are reinforcing this view. Capital providers' expectations on return levels will increase, forcing insurers to respond. Depending on the flexibility/responsiveness of insurers' business plans, there may be a time-lag before the changed trading conditions impact on premium rates.

We anticipate that following a review of annual results and the January reinsurance renewals, the market may begin to show rate increases as a result of external forces. We anticipate that these will feed through into business plans for insurers throughout the marketplace, and that the accountancy sector will be affected (though potentially not to the same extent as some other areas such as the property casualty insurance sector).

PI Primary Premium Movements



The data is based on criteria presented by multiple risks and does not relate to any one risk in isolation. The rate reductions are not cumulative.

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 Accountancy 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.

Willis voted European Commercial Broker of the Year 2006 for the second year running

Willis voted Best & Most Innovative Insurance Broker 2006 for the second year running

Contents

Explaining the Market Cycle

One of the areas that we are most often questioned on by our clients is the state of the market, and our predictions for the future. This is a key part of the value we provide since partners and risk managers must be in a position to accurately budget for their insurance spend some time ahead of the purchase.

To the outsider, the insurance market cycle may seem both arbitrary and random. Given the fact that each risk is reviewed on its own individual merits, the risk profile of a firm would seem a plausible explanation for why a premium may go up one year and down the next (in the absence of changes to the claims history). However, this view is somewhat flawed. In this article we explain the market cycle in the context of the broader forces that impact it, and how it will impact on individual clients.

The market cycle is the direct result of the constant interaction between demand for and supply of insurance capacity. In this context, supply is determined by the industry's capital base and demand is a reflection of the number of (and, indeed, capacity requirements of) insurable risks. The market achieves equilibrium where the two are perfectly balanced, and the Return on earnings is at a level satisfactory to capital providers. In an environment of zero inflation (a convenient assumption), rates would be static. As with any market, though, competitive forces may drive the market from equilibrium (even when achieved), meaning that equilibrium is a transitory position.

When demand for insurance exceeds supply, the market is said to be in a "hard" stage; and when the reverse is true it is said to be "soft". The market has been either softening or "soft" for the past two to three years, but by analysing the last hard market, we can see parallels between present market forces and those prevailing then.

The hard market of the early 2000s was characterised by the huge diversity of forces driving it. With 9/11 and numerous accounting scandals generating losses, and uncertainty about the validity of results of corporate America, the market was in a state of disarray. Asbestosis claims were apparently never-ending, and the Property and Casualty sector was hit hard.

So, what characterises a hard market?

A hard market is characterised by price increases, and a highly analytical approach to underwriting, with considerable attention paid to loss control measures. Coverage is increasingly restrictive, and higher deductibles are applied. Underwriters look for opportunities to 'correct' previous pricing and may even withdraw from classes of business that do not meet rate of return requirements. The insurance buyers among you will recall premium increases of well over 20% (even where you had no earned fee increase). As conventional insurance premiums rise, companies search for mechanisms to internalise and finance risk, and to escape the vagaries of the market, by reviewing other strategies such as captives.

So does the past give us any clues as to the future direction of the insurance cycle?

The losses caused by Hurricanes Wilma, Rita and Katrina in 2005 (amounting to approximately $40bn) exceeded those of 9/11, and it is therefore clear that a degree of correction in the market as a whole is still required to rebuild the capital base. Equally, as discussed, adjustments to interest rates also provide pressure to increase insurance rates. Within the accountancy sector as a whole, we suspect that, given the internal costs of underwriting and compliance, insurances for some firms are being written at a loss. Our survey results bear out the view that rate increases are on the horizon.

Our advice to all accountants is to ensure that any tabled risk management improvements are actioned in the near future since, as the market hardens, the first area underwriters begin to scrutinise are loss control procedures. You should also ensure that your advocates in the insurance market fully understand your firm and what you do, so that you can be confident of the best possible outcomes.

Update on Company Law Reform Bill

The Bill has not yet passed through the Committee stage, where amendments are often made. However, at present, the Bill does allow for the possibility of "Liability Limitation Agreements" being reached between a company and its auditor (if approved by shareholders and if only applying to one financial year).

The mechanism for limiting liability may be a monetary cap and/or proportionate liability. In the event of proportionate liability being agreed, the auditor can limit his/her liability to the extent that he/she is responsible for damage suffered (taking into account the fault of others).

Auditors will, however, still need to consider standard contract law, which dictates that contract conditions must be fair and reasonable to hold.

Regulation

Having spoken to industry regulators at recent training seminars, we have seen an increased level of enforcement in this field. Regulatory bodies have very specific requirements in respect of both minimum levels of indemnity and maximum excess levels, and therefore we recommend reference to your relevant professional body and/or your broker.

Update on Legal Services Bill

In our Summer 2006 Willis Index we discussed proposals made by the Clementi Review in respect of the creation of Multi-Disciplinary Partnerships.

The Department of Constitutional Affairs has subsequently responded to the Legal Services Bill, and it appears that they are attempting to allow accountancy firms the possibility of inclusion under the "Alternative Business Structure" heading. If legislation were to reflect this, it would make it possible for different professionals to work alongside one another in the same firm.

Whilst convenience for customers would be one potential outcome, accountancy firms could expand into areas such as probate, which were previously unavailable to them.

Willis' Accolades

Willis Named "European Commercial Broker" for the Second Year in a Row

Willis was named the "2006 European Commercial Broker of the Year" for the second consecutive year. Presented as part of the annual European Risk Management Awards conducted by StrategicRISK, the award is determined by the vote of over 4,000 risk and/or insurance managers or directors of multinational companies across 13 European countries.
Joe Plumeri, Willis Chairman and Chief Executive Officer, said: "What makes this honour even greater is that it was bestowed upon us by the client community — who better to gauge the performance of the broking industry? Our total dedication to our clients through our Client Advocate model is clearly differentiating Willis in this competitive market."

Willis Named Best and Most Innovative Insurance Broker for the Second Year Running

Willis has retained our prestigious Broker of the Year and Most Innovative Insurance Broker of the Year accolades for the second year in a row in the annual reader poll conducted by Reactions magazine — a leading financial magazine for the global insurance market.
Each year, Reactions conducts an extensive poll of its readers to find out who they think are the best firms, deals and individuals in the global reinsurance market. Reactions' readership comprises key decision-makers in the global insurance industry as well as risk managers and chief financial officers of FTSE 500 and Fortune 500 corporations.

Meet the Team

Guy Robinson

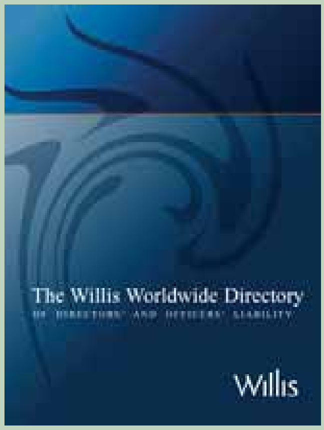
Guy has worked in the Insurance industry for over eight years. He graduated from Manchester University with a BA Hons in Theology and has worked as both an account executive and a broker, He has an in-depth understanding of the activities and services performed by his clients. His industry knowledge is varied thanks to his experience with different professionals including accountants, solicitors and contractors. Guy says: "The accountancy PI market is delicately poised at the moment and an external shock, for example further corporate restatements, could lead to a re-alignment of premium levels."

Phone: +44 (0)20 7975 2678
Email: robinsongfd@willis.com

Breaking News

Willis have published a unique guide entitled "The Willis Worldwide Directory of Directors and Officers Liability".

We are delighted to announce that the directory is free to existing Willis clients. For information on purchasing the directory please send an email to D&O@willis.com. It is available at a cost of UK£150, US$270 or EUR 222.



Professional Indemnity Seminar

Willis is planning a complimentary seminar on the PI buying process and Risk Management with guest speakers for December 2006. We would be grateful for broad 'expressions of interest' at this stage to establish whether such an event would be well-received.

The Willis Index

The Willis Index provides quarterly updates on the ever-changing Insurance Market, including commentary on market conditions, case studies and insurance product developments. FINEX also produces newsletters reporting on Directors' and Officers' Liability, Financial Institutions, Environmental Liability and Mergers & Acquisitions. For further information please contact us.

Willis is one of the world's leading risk management and insurance intermediaries. We have over 15,000 professionals in over 300 offices around the world.

For further information please contact:

Steve Bonnington
Tel: +44 (0)20 7975 2086
Email: bonningtons@willis.com

David Turner
Tel: +44 (0)20 7975 2218
Email: turnerdl@willis.com

Joanne Willmore
Tel: +44 (0)20 7975 2216
Email: willmorej@willis.com

Andrew Fryer
Tel: +44 (0)20 7975 2312
Email: fryerah@willis.com

Willis Limited, Registered number: 181116 England and Wales.
Registered address: Ten Trinity Square, London EC3P 3AX.
Lloyd's Broker. Authorised and regulated by the Financial Services Authority.

WPR/3951/10/06