

specialty lines: 2013 wrap-up

SPECIALTY LINES: 2013 WRAP-UP

An Advisen Special Report sponsored by OneBeacon Professional Insurance

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Introduction

The economy continued to improve in 2013, which generally benefitted the insurance market. For specialty insurers, however, the year posed a number of challenges. Healthcare reform continued to reshape the risk landscape of hospitals and other healthcare organizations. Lawyers and other professionals continued to feel the fallout of the credit crisis and recession as claims activity remained above historical averages. Network security challenges further evolved in the endless cat-and-mouse game between cyber criminals and system security experts.

Overall, insurance rates increased during 2013, driven substantially by a low interest rate environment that exacerbated the need for insurers to achieve an underwriting profit. With investment income down, insurers needed to make up the slack by improving their combined ratios. The market remained substantially overcapitalized and highly competitive, however, suggesting that insurers will be facing a stiff headwind for further rate increases.

The economy

The credit crisis and recession adversely impacted many specialty lines. Lawyers' professional liability, architects and engineers professional liability, employment practices liability and financial institution directors and officers liability are among the lines that experienced upticks in claims as an outcome of the credit crunch and adverse economic conditions. Economists declared the Great Recession over in June 2009, but the recovery has been agonizingly slow. For a number of specialty lines, the increase in claim frequency – and in some cases claim severity – has continued long after the official end of the downturn.

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Lawyers' professional liability

Lawyers professional liability (LPL) claims tend to be sensitive to economic downturns. An analysis by Mendes & Mount concluded that during the 25 years preceding the most recent recession, two of the most troubling economic periods coincided with higher claims activity.¹

The recession of 2008-2009 was no exception. After a brief downturn in LPL claim frequency early in the recession, the number of new claims began to increase, and continued to grow even after the recession had officially ended. Many claims stemmed from commercial and residential real estate transactions: a study of insurance claims by the American Bar Association found that, during the period 2008-2011, real estate matters overtook personal injury matters as the most-frequent subject of LPL claims. Other sources of claims included collections and bankruptcy work, mergers and acquisitions, and financial institution representation.

Companies and individuals who lost money during the downturn were motivated to recover their losses, and lawyers involved in money-losing transactions have been targeted. That state of affairs was exacerbated by the fact that, like other businesses under pressure, many law firms assumed risks during the economic downturn they might have avoided under other circumstances. Cost-cutting measures also may have weakened risk management practices.

The frequency of lawyers' professional liability claims since the official end of the recession has remained above historical averages. One reason that claims activity has continued to grow is simply a lag in filing and settling claims. Many suits being settled today have their roots in activities occurring during 2007-2009. A higher-than-average rate of law firm dissolutions, bankruptcies and mergers also has increased exposures to claims, and the pursuit of top-line revenue growth by acquiring partners with portable books of business – "lateral hiring" – has further contributed to higher claim frequency. In a survey of LPL insurers, "conflict of interest," which is a potential outcome of both mergers and lateral hiring, was the first- or second- most frequent cause of malpractice claims.²

Real estate professionals

The recent credit crisis and recession were triggered by a meltdown of the U.S. residential subprime mortgage market, which triggered a collapse of real estate markets throughout the globe. Claims against real estate professionals surged, and have remained above historical averages despite an improving economy and generally better real estate markets. Real estate appraisers have been especially exposed to increased claim frequency. Many suits, which

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have been filed by borrowers, lenders, investors and the FDIC, allege that an appraiser's inflated values resulted in the plaintiff borrowing, loaning or paying too much money. In 2013, many lawsuits against appraisers continued to relate to appraisals performed at the peak of the 2005-2008 real estate bubble.³

Design professionals

Design professional (architects and engineers) is another sector that has been prone to above average claim frequency in the aftermath of the recession. Claim frequency during and immediately following the recession was due substantially to extreme competition for projects, which led firms to accept unfavorable contractual risk transfer terms. More recently an increase in construction projects is likely to be the cause of an uptick in E&O claims. The sectors that have recovered fastest include those that typically pose greater professional liability claim potential, including single-family housing and high-rise condominium and apartment buildings.⁴

Employees

Employment-related lawsuits were fueled by recessionary job cuts. Age discrimination charges especially saw a sharp uptick, hitting a 10 year high in 2008. Overall, EEOC charges increased by nearly one third between 2006 and 2010, growing from about 76 thousand to nearly 100 thousand, and have remained at that level in 2011 and 2012. One reason for the consistently elevated activity is that the employment situation remains dismal in certain segments of the economy despite the slow but steady recovery.

Economic conditions, however, are only one factor in the historically high number of EEOC charges. Much of the increase is due to retaliation charges, which were the single largest category of EEOC charges in 2012, accounting for 38 percent of the total. The increase in retaliation charges may be indirectly an outcome of economic conditions, but some observers attribute it substantially to a 2006 U.S. Supreme Court case, *Burlington Northern & Sante Fe Railway Co. v. White*, which expanded the protection employees receive after making a workplace complaint allegedly protected under Title VII.⁵ Other experts note the Department of Labor retaliation guidance under the Fair Labor Standards and Family and Medical Leave acts as a contributor to the increase.⁶

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Directors and officers

Suits related to the credit crisis and recession naming directors and officers, especially the directors and officers of financial institutions, also have continued at an elevated frequency. Financial institutions of all sizes are affected, with community banks being especially hard-hit. Plagued by bad construction and commercial real estate loans, largely put on the books during the early and mid-2000s, many have shuttered their doors, and others continue to struggle. More than 400 banks across the nation failed during the four years from January 2008 to December 2011, of which 85 percent were small community banks.⁷

In part to seek recoveries for failed banks, the Federal Insurance Deposit Corporation (FDIC) has pursued legal actions against bank directors and officers. According to the FDIC “From January 1, 2009, through November 4, 2013, the FDIC has authorized suits in connection with 128 failed institutions against 1,038 individuals for D&O liability. This includes 83 filed D&O lawsuits (12 of which have fully settled and 1 of which resulted in a favorable jury verdict) naming 623 former directors and officers.” In 2013, through November 4, the FDIC authorized suits against 296 individuals.⁸

Directors and officers of distressed and failed banks also have faced lawsuits from investors and other stakeholders. Publicly-traded community banks are exposed to investigations and enforcement actions from the Securities and Exchange Commission.

Healthcare reform

The roll out of the Patient Protection and Affordable Care Act (PPACA, or Affordable Care Act) has been rocky. Despite the problems with the sign-up process, however, PPACA and related healthcare reform are transforming the practice of medicine and are having an impact on the liability exposures of healthcare organizations.

Many of the most significant liability exposures are related to the Medicare Accountable Care Organization (ACO) enabled by PPACA, as well as similar collaborative healthcare delivery models. According to the Centers for Medicare and Medicaid Services (CMS), an ACO is “an organization of health care providers that agrees to be accountable for the quality, cost, and overall care of Medicare beneficiaries who are enrolled in the traditional fee-for-service program who are assigned to it.”⁹ A Medicare ACO is eligible for Medicare shared savings based on its annual incurred costs relative to CMS-established benchmarks. The term “ACO” and the concept, however, increasingly go beyond the four corners of the Medicare Shared Savings Program, and now, according to consulting firm Oliver Wyman, is a “catch-

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all term for providers participating in population-oriented, value-based care delivery and reimbursement models.”¹⁰ According to Oliver Wyman, as of 2012 ACOs served as many as 31 million patients.¹¹

New healthcare delivery models are expected to improve outcomes, and therefore have an overall positive effect on malpractice and other medical professional liability risks. Nonetheless, some aspects of collaborative healthcare models, including ACOs, may change patient expectations, create new standards of care, and produce new types of information that can be used against a healthcare provider in court. Additionally, many hospitals have accelerated the acquisition of physician practices in preparation for providing the full continuum of care to ACO beneficiaries. With employed physicians, more risk is shifted from the physician to the hospital (or to the ACO itself). Also, some new healthcare delivery models expand the responsibilities of nurse practitioners and other types of providers, potentially increasing credentialing exposures and malpractice risk.

The Affordable Care Act also offers incentives for converting paper records to electronic health records (EHRs) that can be shared across various healthcare settings. According to the U.S. Department of Health and Human Services, “using electronic health records will reduce paperwork and administrative burdens, cut costs, reduce medical errors and most importantly, improve the quality of care.”¹² However, health records are highly sought after by data thieves. Despite the sensitivity of the information contained in these records, the healthcare industry has a poor track record for data security. A survey of 80 U.S. healthcare organizations by the Ponemon Institute found that 75 percent don’t secure medical devices containing sensitive patient data, while 94 percent have leaked data in the last two years.¹³ ACOs and related healthcare delivery models can pose significant data security risks since digitized records are passed among an array of practitioners and other users who likely vary widely in their data security practices.

In addition to data security concerns, healthcare organizations also need to be aware of the sometimes complex legal issues associated with sharing data within an ACO context. According to a PwC study, 38 percent of healthcare providers share patient information externally, but only 26 percent have identified contractual, policy or legal restrictions on how the data can be used. Additionally, only 17 percent have processes in place to manage patients’ consent for how their information can be used.¹⁴ Compliance with applicable laws, especially HIPAA, may require a large number of separate contracts among the parties involved with an ACO.¹⁵

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Cyber security threats

Awareness of data security threats is growing within organizations, but the range of cyber risks is expanding faster than all but the most sophisticated organizations are able to respond to. “Outmanned, outgunned and out of time,” is how one information technology journal characterized the network security situation at most companies.¹⁶

In 2013, protecting sensitive information such as payment card information and medical records remained a high priority for many organizations. Additionally, more organizations are now recognizing the vulnerability to cyber espionage of intellectual property such as business plans and trade secrets, in some cases conducted by state-sponsored hackers. Protecting all these types of information has become increasingly complex as more organizations rely on third-party service providers (“the cloud”) and struggle to minimize the risks posed by employees using their own laptops, tablets and smart phones for company business.

Operational risks, including cyber-related business interruption and contingent business interruption, also have emerged as growing concerns for many organizations. Increasingly, organizations are exposed to “hacktivists” – hackers motivated by social or political objectives – and cyber terrorists, whose principal goals are to disrupt operations and damage reputations.

Cyber security emerged as a hot button issue for directors and officers in 2013. In keeping with SEC guidance, a growing number of public companies are disclosing their cyber-related exposures. According to a memo from the King & Spalding law firm, “it is likely that this issue will continue to gain momentum among government regulators and opportunistic plaintiff lawyers seeking to catch the next wave of shareholder litigation.”¹⁷ However, a 2012 Carnegie Mellon University CyLab report found that board oversight of cyber security remains deficient.¹⁸

The Specialty Insurance Market

Underwriters across the spectrum are challenged to keep pace with rapidly shifting risk landscapes driven by regulation, technology, globalization and economic factors. Nowhere are the challenges greater than in the specialty insurance market, which by its nature is highly responsive to changing and emerging risks.

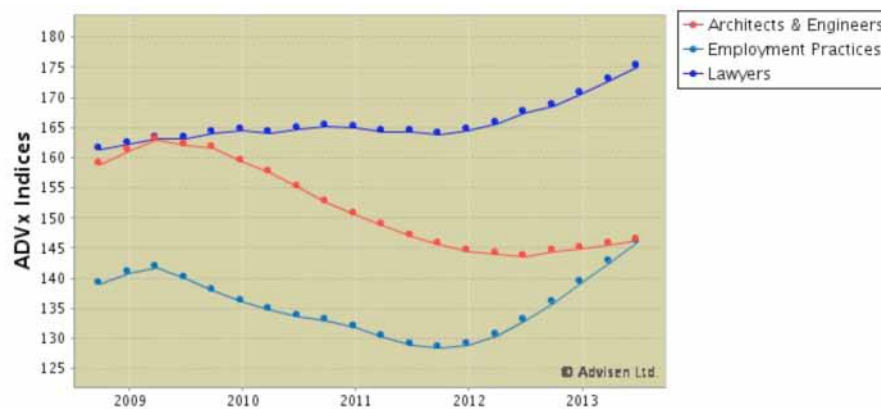
Two of the most dynamic segments of the specialty insurance market are healthcare and cyber liability. Hospital liability and managed care E&O policies and underwriting criteria

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have evolved to account for such things as the more expansive roles that hospitals play in many communities, the fact that many hospitals now employ a far greater number of physicians, and the expanding range of services provided by many managed care organizations. The market for technology E&O and cyber-related coverages has been a hotbed of innovation in recent years. Not only has it been necessary for underwriters to react to rapidly changing technology and emerging cyber threats, they also have had to respond to evolving customer expectations and a highly competitive marketplace that now is comprised of about 40 carriers vying for less than \$2 billion in premium, according to Advisen estimates.

While not all segments of the specialty insurance market are changing as rapidly as the healthcare and cyber sectors, all have been affected by the factors discussed above. Employment practices liability has become an essential coverage for a growing number of organizations, with many alerted to the breadth of their exposure as economic conditions sparked an uptick in claims, regulatory agencies increased enforcement actions, and social media created new channels for running afoul of employment laws. Private company D&O has been a comparatively high-growth line as more board members and executives become concerned about their exposure to claims from employees, regulators, creditors and other stakeholders. The distressed U.S. real estate market has been a big contributor to a surge in lawyers' professional liability claims, and has emphasized how essential insurance protection is for law firms.

Exhibit 1 **ADVx™ Premium Index**



While the overall impact on the economy may be positive, low interest rates put a strain on insurance company performance since investment income is a major contributor to the bottom line.

One outcome of the economic downturn has been persistently low interest rates, as the Fed has driven rates down to stimulate borrowing and economic growth. While the overall impact on the economy may be positive, low interest rates put a strain on insurance company performance since investment income is a major contributor to the bottom line. In response to the low interest rate environment, as well as to heightened exposures and higher loss frequency and severity in many specialty lines, underwriters have been demanding higher rates. Employment practices liability and lawyers' professional liability in particular have seen materially higher premiums in recent quarters, according to Advisen statistics (Exhibit 1). The market however, remains highly competitive and, by many measures, overcapitalized, raising the question of how long a period of steadily rising premiums is sustainable.

The economic outlook for 2014 is essentially more of the same. The Congressional Budget Office expects unemployment to remain near eight percent and the U.S. economy overall to remain largely moribund. Nonetheless, the claims picture in many specialty lines should begin to improve. Each successive year increases the distance from the credit crisis and recession, ultimately reducing the number of claims directly tied to those events. Additionally, statutes of limitations will have an effect in some areas. Some observers have attributed a surge in suits by the FDIC in 2013 to the impact of a three-year statute of limitations and the fact that the number of bank failures peaked in 2010.¹⁹

Regardless of the issues in rolling out the Affordable Care Act, or of efforts to defund or overturn the Act by Republicans, healthcare reform undoubtedly will continue in America. Hospitals and other healthcare organizations have recognized the need for more efficient and cost-effective healthcare delivery, and many are implementing changes parallel with and independently of PPACA. As a result, hospital risk managers will continue to be challenged by a rapidly evolving risk profiles, and underwriters will need to continue to innovate to meet the needs of the healthcare industry.

The demand for network security protection and related cyber coverages will undoubtedly continue to increase as the cyber risk landscape grows more complex and more dangerous. Brokers note that the conversation with clients and prospects increasingly turns to operational risks such as business interruption and contingent business interruption, suggesting potential new product innovation opportunities for underwriters. Advisen analysis of cyber insurance buying trends suggests that the market could triple in size over the next five years.

The growth potential for cyber-related coverages far eclipses other specialty lines, but many lines nonetheless offer insurers substantial growth opportunities as compared to

well-established standard lines such as property and workers compensation. As a result, specialty lines are attractive to many insurers, and competition is intense in many segments. Responsible competition will certainly benefit insurance buyers, and it seems inevitable that innovation and responsiveness to changing social, economic and legal conditions will remain hallmarks of the specialty lines market for years to come. ■

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