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Insurance Market

Rates have continued to gradually soften throughout the first half of 2010 to all-time lows but have bottomed out over the second half of the year. The soft market conditions have now endured for the past five years.

Santam Limited the only local Insurer that has consistently maintained a presence in the PI Insurance market over the past 25 years experienced a challenging first half in 2009 which improved over the second half. It experienced a pleasing overall performance for the year ending 2009 against the backdrop of the difficult economic climate and underwriting conditions coupled with the continued pressure of the softening market. The overall net underwriting margins were adversely affected by negative margins in the property and motor classes. The corporate property book was badly affected by unprecedented fire claims in the first half of the year. Santam's interim results as at June 2010 were significantly higher than that for the same period in 2009. This was due to improved margins in the property and motor classes as well as the absence of large industrial accident and fire claims. Domestic insurance industry premium growth for the balance of the year is expected to remain below the nominal growth of the economy due to the slower than expected rate of recovery of the domestic economy.

Santam's international solvency ratio remains at 44% which is well above the minimum regulatory requirement of 25%. Global Credit Rating Company ("GCR") has accorded Santam a domestic ZAR currency claims paying ability rating of AAA (triple A), which is the highest rating that can be attained by an insurance company.

Lloyd's, the world's leading specialist insurance market, reported profitable results for 2009 which was up 103% from 2008 due to the lower level exposure of catastrophe related losses and despite the economic turbulence. The good result for 2009 was built on a resolute focus on underwriting discipline coupled with a strong balance sheet and a conservative investment strategy. Lloyd's interim results for the first half year to 30 June 2010 were however down 52% from the same period in 2009. This was due to significant claims from natural disasters and extremely challenging investment conditions.

Standard & Poor's as well as Fitch Ratings rates Lloyd's insurer financial strength at A+ which places Lloyd's in the strong category for claims paying ability.

Santam & Lloyd's are currently the dominant providers of PI insurance for the Built Environment Professionals in the South African market.

Review of the Schemes Performance

The South African Construction Industry has seen through the peak of the boom and the sharp decline in construction activity deepened with the conclusion of the 2010 Soccer World Cup and has failed to pick up meaningful momentum since then. The industry seems to be pinning its hopes on an anticipated revival next year with new infrastructure projects expected to kick in and pull the industry out of one of its slackest period in the last decade. This has been confirmed by recent statistics that show that the industry growth indicators have been declining since the third quarter of 2009 and that the construction industry has one of the lowest growth figures since early 2008. The slowdown in the industry has directly translated into a reduction in Member firms net fee turnover in 2010 with significant reduction in forecasts for the 2011 financial year as well. This in turn directly translates into lower premium contributions into the anticipated claims pool.

The soft market conditions however worked favourably for member firms with reduced rateable fee turnover. Firms that have had reduced fee turnovers saw reductions in premium spend as premiums are largely directly rated in relation to fee turnover. We have seen acceptable rate decreases in the region of between 5% to 10% depending on the individual firm’s profile thus resulting in lower premiums being payable for firms that have had an increase in rateable fees. Firms that have had adverse loss ratios saw their rate remain flat in 2010.

Insurers have in 2010 incentivised member firms by affording them a 25% (up from 20% the previous year) discount on the deductible payable in the event of a claim provided they prove that they had adhered to a Quality Management System approved by CESA. In addition Insurers have further incentivised member firms by offering a 50% discount on the deductible payable in the event of a claim if the firm had limited their liability contractually with their client to a fixed amount or multiple of the fee earned on a particular project which was lower than the PI limit of their policy. If a situation arises where both discounts are applicable then the higher of the two applies.

PI claims are long tailed in nature and any particular year of insurance generally matures after a period of 60 months has elapsed. The claims experiences for the 2002 to 2005 years have matured and remain profitable for Insurers with loss ratios on average of 75%. Underwriters adjusted the rates over these years in an attempt to recover the huge losses sustained in the preceding years which had an average loss ratio in excess of 150%. Post the construction boom, an influx of notifications of potential claims and/or circumstances that may lead to a claim is clearly noticeable with the number of notifications increasing significantly since 2007. The 2007 and 2008 year of account has had 90 and 124 notifications reported respectively. Claim trends that are filtering through emanate from inexperienced Consulting Engineers, inadequate or lack of supervision, the fast tracking nature of projects and cost overrun claims. It seems that post the financial crisis and the economic downturn, clients are concentrating more on trying to recover monies of which they over-extended during the boom times hence are pursuing claims more vigorously against consulting engineers.

We are aware of a few large claims against Single Project Policies, relating to the soccer stadia, Gautrain and the related infrastructure surrounding the 2010 Soccer World Cup which, combined with the claims on the scheme, may influence the local PI market adversely. We have maintained previously that past experience suggests we should expect an increase in the loss ratios going forward as claim frequency increases after a period of increased construction activity and it seems that the above is testimony to this. The 2006 year of insurance is due to mature at the end of 2010 year of insurance cycle and is estimated to conclude around an 80% loss ratio. The 2007 to 2010 years have not matured as yet and it is thus too early to draw any conclusion from them at this juncture.

The Scheme was insured by a basket of Insurers made up of Santam Ltd underwritten by Stalker Hutchison & Admiral Underwriting Agency, Lloyd's & Lombard Insurance underwritten by Leppard & Associates and Marketform (Lloyd's Syndicate) underwritten by General Professional Liability Acceptances in 2010. Stalker Hutchison & Admiral representing Santam Ltd has historically held the market share and currently holds 68% of the CESA Scheme. Leppard & Associates hold 23% and GPLA underwrite 7% of the Scheme.

Premium Collection Chart

Year of Account	No. of Policies	Nett Premium	Gross Fees	Premium as % of Gross Fees
2001	370	R 17,704,508	R 1,709,900,000	1.04%
2002	379	R 23,170,024	R 2,245,700,000	1.03%
2003	364	R 26,543,317	R 2,308,000,000	1.15%
2004	360	R 32,816,966	R 2,864,300,000	1.15%
2005	355	R 32,825,543	R3,100,000,000	1.06%
2006	381	R41,694,858	R3,929,000,000	1.06%
2007	380	R48,182,273	R4,846,000,000	0.99%
2008	387	R56,133,029	R6,347,000,000	0.88%
2009	369	R49,707,512	R9,456,000,000	0.53%
2010	359	R43,485,000	R9,476,000,000	0.46% *

* Estimated To 31 December 2010

2011 Scheme Structure

The Scheme is currently stable with loss ratios running at sustainable levels; however increased cost of claims as clients become more risk averse and the economic volatility may influence and affect the scheme going forward. The exponential increase in claims notifications and settlements of a few large claims under the scheme has seen rates bottoming out over the latter part of 2010. Looking forward into 2011 we can expect insurers to indulge the soft market conditions in the short term in the face of increased competition in the PI market. 2011 will see no rate increases with a nominal decrease in rates on profitable individual portfolios.

The concerning factor, as stated earlier, is the current claim trends that are starting to filter through as well as the increase in notifications being reported. We have always maintained that the point of departure going forward must be sustainability ie. the premium pool must be able to support the anticipated claims. The rationale is to avoid significant peaks and troughs in the cycle and to attempt to ensure some predictability as to the cost of PI insurance. The reserves held by Insurers must therefore be able to sustain the anticipated claims. The bottoming out of rates into 2011 will seek to ensure sustainability in the scheme going forward.

In 2011 we have negotiated with Underwriters as follows:

1. No rate increases with nominal rate reductions for all member firms based on their individual risk profile.

2. The insuring clause on the bespoke CESA PI policy wording will be changed from an errors and omissions wording to a legal liability wording, thus providing even wider coverage to member firms.

3. A dispute resolution mechanism will be incorporated into the wording to deal with the difference of opinion and/or interpretation of any provision within the PI policy.

4. The PI policy will incorporate a provision in the wording to cater for liability attaching to a member firm or its employees arising out of any appointment as Health and Safety Agent as contemplated by the Occupational Health & Safety Act and the construction regulations as promulgated there under.

5. Firms that have a Quality Management System (QMS) in place, which have been declared to CESA, will be looked upon more favourably from an underwriting perspective. Currently only around 50% of member firms have confirmed that they have an established QMS.

6. Firms that adhere to the CESA declared QMS will still be entitled to a 25% discount on the deductible payable in the event of a claim.

7. A 50% discount on the deductible will be claimable in the event of a claim being settled where the member firm was successful in limiting their liability in contract to a fixed amount or a multiple of the fee earned on the project as provided for in the CESA standard form of agreement or any other standard form of agreement.

8. Firms that have an adverse loss ratio on their portfolio will either have a nominal rate increase applied and/or a higher minimum deductible level may be imposed.

9. Insurers will continue to provide greater discounts to those firms opting to take higher levels of self insurance.

10. Underwriters will continue to provide the Public Liability extension at a maximum of R5m per claim at no cost, with an additional premium being levied should member firms wish to increase their limits above R5m.

11. The extension relating to loss of documents has been increased to R1,500,000 from R500,000.

12. The fee recovery extension limit will be increased to R1,500,000 from R500,000.

13. Deductibles being the insured's first amount payable in the event of a claim will only be payable towards the damages of the claim.

14. The criminal and statutory defence costs extension will enjoy the same level of cover as the PI limit of Indemnity on the policy in question.

15. A design and construct or specialist sub-contractor extension will be added as a standard extension across all CESA policy wordings.

SHA and Leppard & Associates have been the premier underwriters in the PI market and have been underwriting this class of insurance for the past 20 odd years. In the current soft market conditions, with increased competition and plenty capacity available in the market, GPLA has also proven to be a viable alternate Underwriter with sound claims paying ability. Thus we can accordingly vouch for all three of these underwriters, who form the basket of Insurers, for both their underwriting capabilities and claims handling authority.

We believe that in 2011 member firms should have the choice of the above three premier Insurers who have established pedigree in the market. To the extent, as required by member firms, we shall approach the alternate markets available in the engineering PI insurance sector. The current arrangements with the basket of Insurers competing against each other for a share of the book of business works favourably for member firms from a pricing perspective with all Insurers providing the same product and coverage.

Public Liability cover above the primary free of charge limits offered may now be purchased with an increased limit even if the said limit exceeds the PI limit under their PI policy.

On the basis set out above we believe the Scheme will continue to represent the vehicle of choice for members having regard to product, price, coverage and sustainability.

Our arrangement with semi-retired Consulting Engineer Mr Ivor Evans to assist us with professional liability case studies will continue throughout 2011. We are currently collating and identifying prospective claims as case studies for the next edition of our Professional Indemnity Claims and Lessons to be Learned booklet, which we hope to have ready for distribution to member firms by mid 2011.

The Broking and Legal Risk Management Service to the CESA members will continue to be undertaken by our Professional Services Division. Glenrand M·I·B will maintain its support to the members of CESA through the following services:

1. Representation on the Quality and Risk Management Committee
2. Representation on the Supply Chain Management Committee
3. Representation on the Construction Regulations Task Team
4. Representation on the FIDIC Risk and Liability Committee
5. CESA legal Forum
6. Risk Management to Individual Firms
7. Quarterly reporting on claims experience
8. Collaboration with the school of Consulting Engineers
9. Participate and advise the Business Integrity Task Team (BITT)
10. Case Studies
11. Assisting the CESA with the revision of advisory notes when required
12. Sponsorship of the Excellence Awards and Engineers Conference
13. Place and pay for the sole practitioners run-off policy

Broking Services

The broking services team dedicated to the CESA member firms comprises of:

Malcolm Padayachee (Principal Broker);
Nhlanhla Dube (Account Manager); and
Marubini Madilonga (Internal Broker).

Our services include but are not limited to the following:

a) Collating underwriting information for purposes of the renewal of the PI Programme during the Period of the Services.

b) Negotiating renewal terms with Insurers on behalf of member firms.

c) Advice on the structure of PI Programmes.

d) Reporting on developments in the Insurance market.

e) Presentation of proposals in respect of each renewal during the Period of the Services.

f) Placing cover on the agreed basis with Insurers and detailing arrangements to the member firm in question.

g) Furnishing confirmation of cover and letters of comfort on request from member firms.

h) Attending to preparation and submission of the policy documents.

i) Quarterly claims review.

Claims Handling

Malcolm Padayachee will remain involved in the handling and facilitating of CESA member firms claims.

We are actively involved in the conduct of claims from inception to finalisation. We pro-actively engage with Underwriters to bring a speedy and amicable resolution to claims. We attend consultations with clients, Attorneys and Loss Adjusters and also attend site inspections when necessary. We ensure that our Clients are treated fairly by Underwriters and/or their representatives. We strive to ensure that no claims are rejected by Underwriters without sound justification.

Limits of Indemnity

The minimum limit of Indemnity required to be held by members was increased by CESA in 2007 to R2m each and every claim and that requirement still remains. We have found that due to the soft market cycle we are currently experiencing, together with the discounts offered on deductibles for QMS adherence, and contractual limitation of liability, the trend has been for member firms to opt for higher limits of indemnity which is available at cheaper prices and also opt for higher deductibles to get the benefit of the premium saving. As a consequence only 9% (down from 13%) of member firms are on a R2m limit of indemnity, 39% (up from 14%) are between R2,5m and R5m, 33% are between R5,5m to R10m, 11% are between R10,5m and R25m and 8% are above R25m. Member firms are therefore embracing the cost efficiency in procuring higher levels of protection.

Run off for Sole Practitioners

Glenrand M·I·B will continue to place and pay for the above cover in 2011. In line with the CESA requirement that the minimum limit be on an each and every claim basis, we have negotiated the cover with effect from 1 January 2011 as follows:

Insurer:	Santam Limited
Limit of Indemnity:	R2,5m each and every claim for any one retired sole practitioner
Deductible:	R25 000 each & every claim

Legal Risk Management Services

The Legal Risk Management Service (LRMS) will continue to be undertaken by:

Meggyn Visser (Senior Risk Advisor); and
Siva Naidoo (Risk Advisor)

The number of contractual queries dealt with has increased in 2010. In the last year LRMS has vetted in excess of 512 contracts for various consulting firms. These reviews have included issues such as appointments, joint venture and sub-consultancy agreements. We have also handled a number of queries on signing duty of care undertakings to client's financiers and appointment of Consultants as OHS Agents.

In particular this year we have collaborated with major Health & Safety Specialist companies on correct documentation for Consultants when dealing with Health & Safety, and our joint recommendations submitted to the Labour Department who have agreed to follow our recommendations. We have negotiated with all of the major banks 'Duty of Care" wording that does not prejudice the consultants.

We have assisted in the drafting of a new CESA Sub-consultancy Agreement, and we have redrafted the CESA Short Form of Agreement.

Several very important Advisory Notes were produced, including Limitation of Liability and Health & Safety, and we continue to be available to CESA's Contractual Affairs Manager for queries members may have, including those of a Statutory nature.

LRMS continues to present road shows to various member firms with various risk awareness topics exposing hundreds of Professional Engineers to crucial risk management issues. The presentations are accredited with Continued Professional Development (CPD) points, and we will continue with these and new presentations on topical industry related subjects, going into 2011.

Further to the above we continue to remain in touch with the industry through our involvement in various committees of CESA, FIDIC and the Labour Department.

LRMS have had an enormously positive response from members, who have found the information and service we provide, invaluable in their operations and vitally important in their risk and quality management. More and more member firms are making use of this service on a daily basis, and Legal Risk Management Services is definitely one of the many advantages of being a CESA member.

In 2011 we will continue to deal with the high demand and the tremendous growth we have experienced in this area. We are now primed to continue to provide a premier service to CESA, its members and the Scheme.

Claims

Claims in excess of R500 000:

The four largest as at 30 September 2010 (2005-2008)

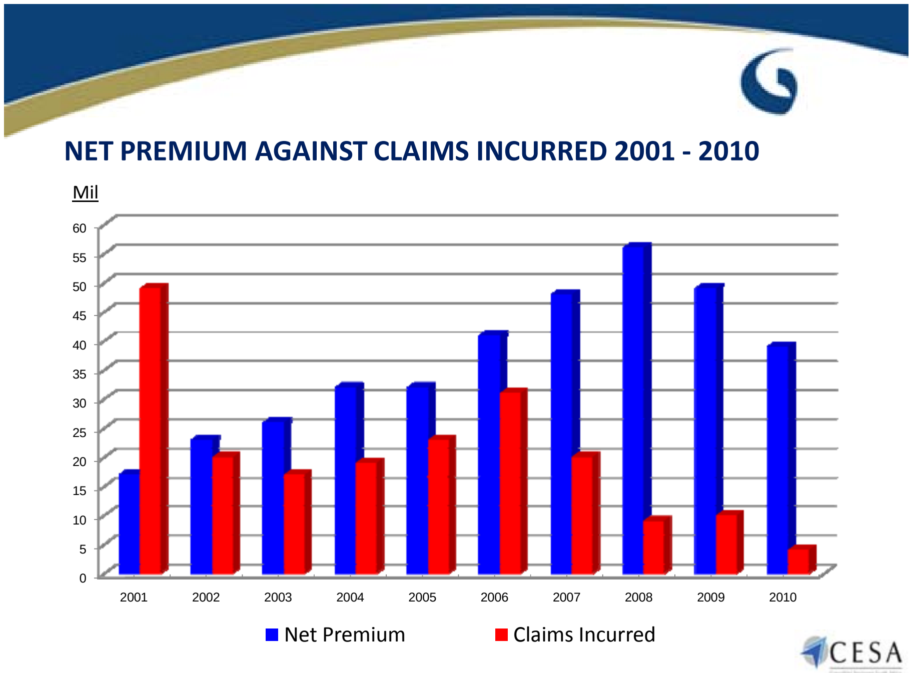
2008	Incurred	Paid
Inadequate design of roof structure	R 649 687	R 578 392
Design error in tailings dam	R 315 745	R 315 745
Cost overrun	R 2 233 247	R 218 019
Electrical installation	R 121 913	R 121 913
2007		
Inadequate design of slab	R 5 286 796	R 5 286 796
Design error in block paving	R 1 623 755	R 1 623 755
Error in design of floor panels	R 810 612	R 757 361
Defective design of floor	R 2 879 038	R 363 091
2006		
Inadequate design of block paving	R 6 684 695	R 6 010 633
Inadequate design of a slab	R 2 801 717	R 2 801 717
Inadequate design of slab	R 1 916 389	R 1 916 389
Incorrect Geotech. report	R 1 781 288	R 1 781 288
2005		
Inadequate block paving design	R 5 123 560	R 5 123 560
Stress cracking of newly cast reinforcing	R 1 271 151	R 1 271 151
Design servcies on mine	R 5 541 045	R 1 144 014
Inadequate design	R 1 483 639	R 732 305

Claims Triangle:

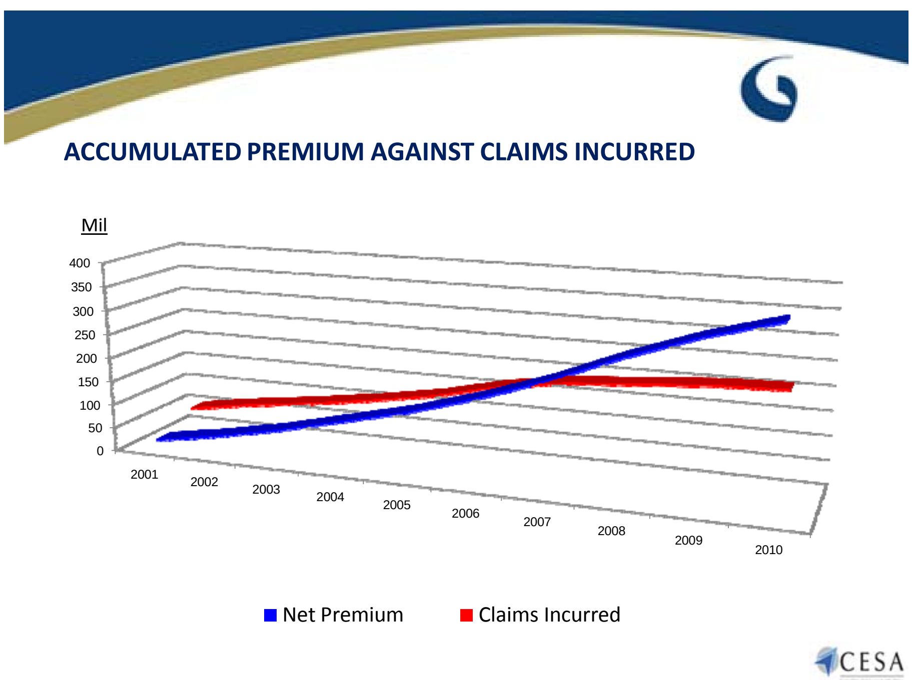
See Attached

Claims Graphs:

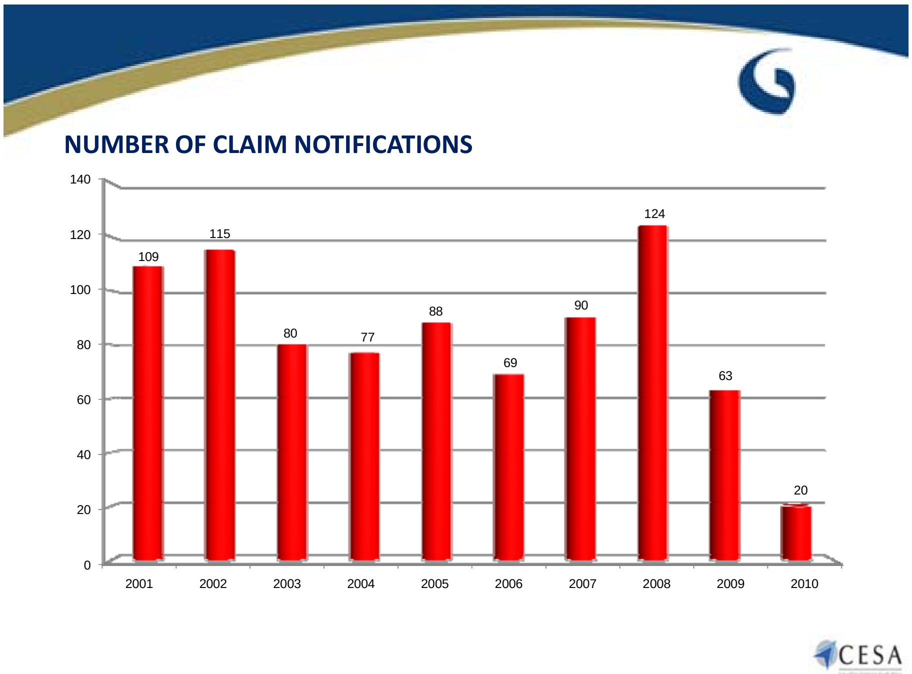
Premium vs. Claims



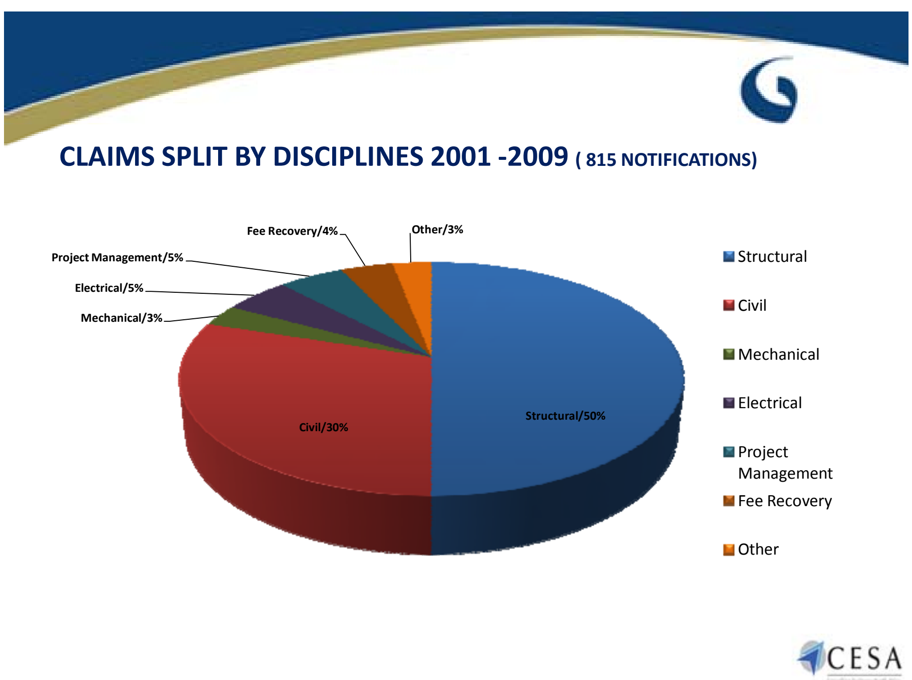
Cumulative Position

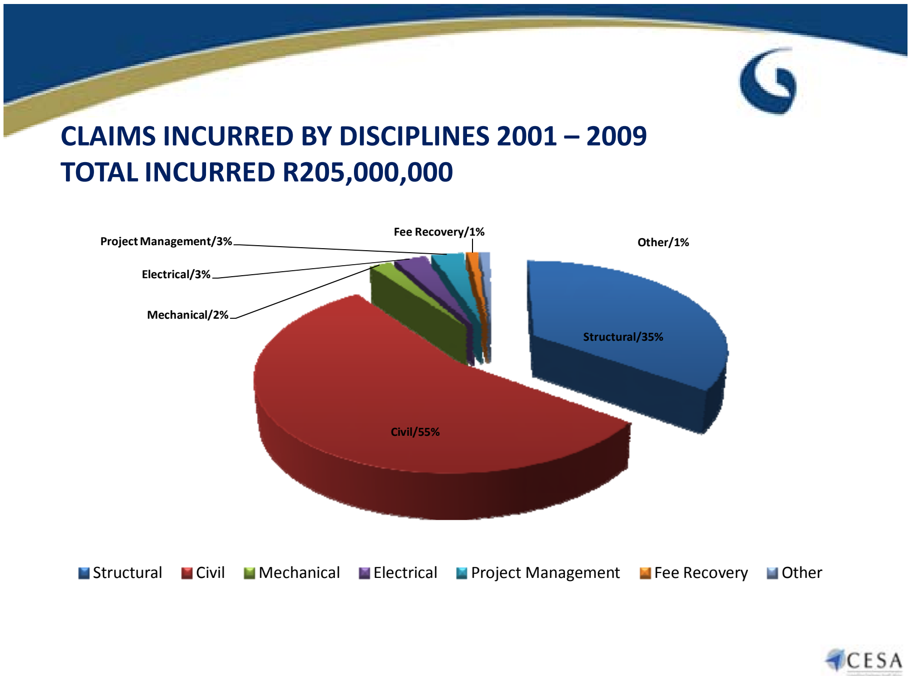


Claim Notifications

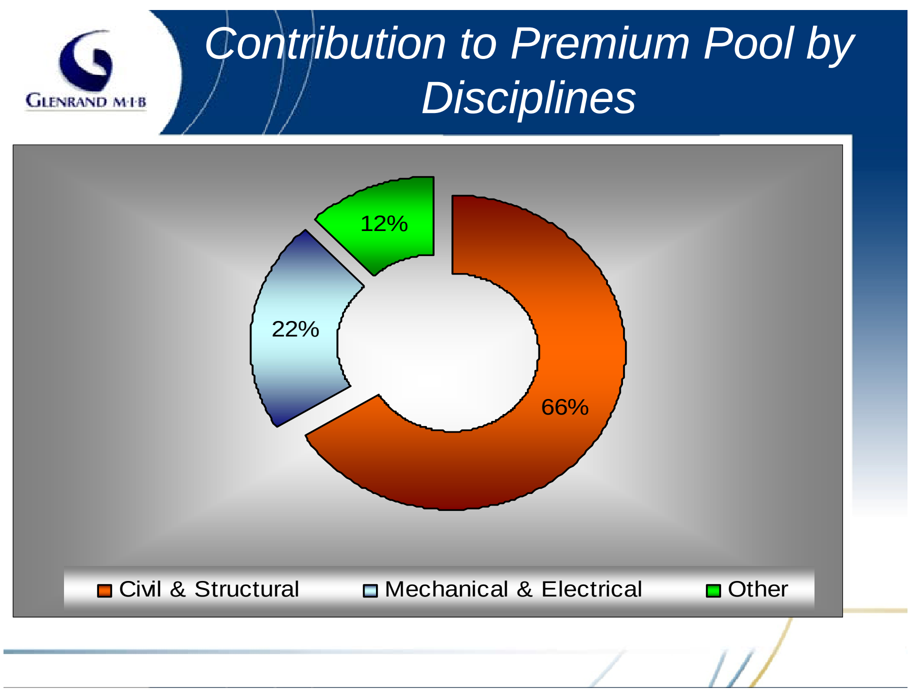


Claims Split

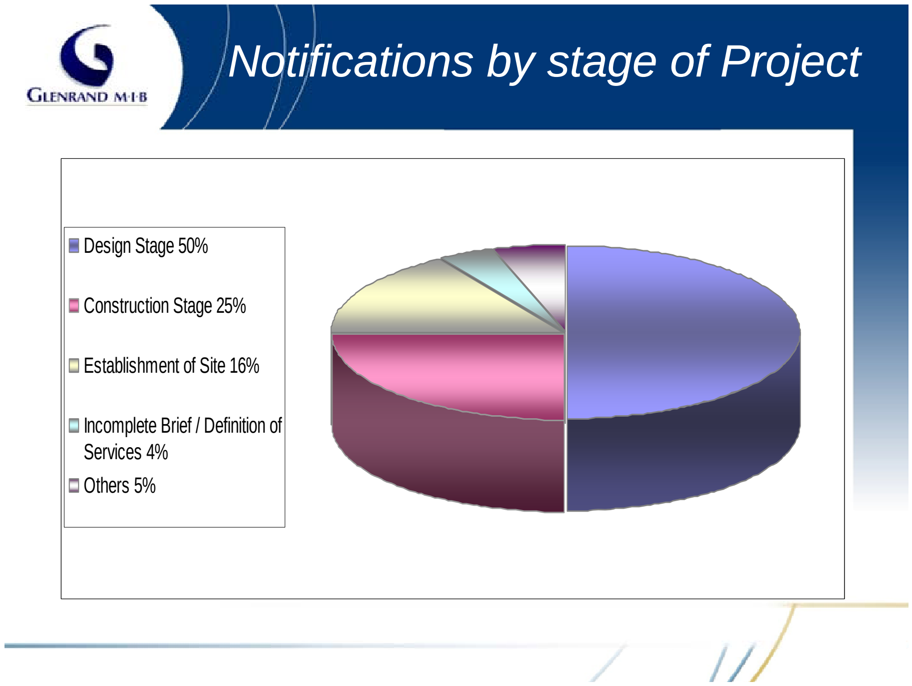




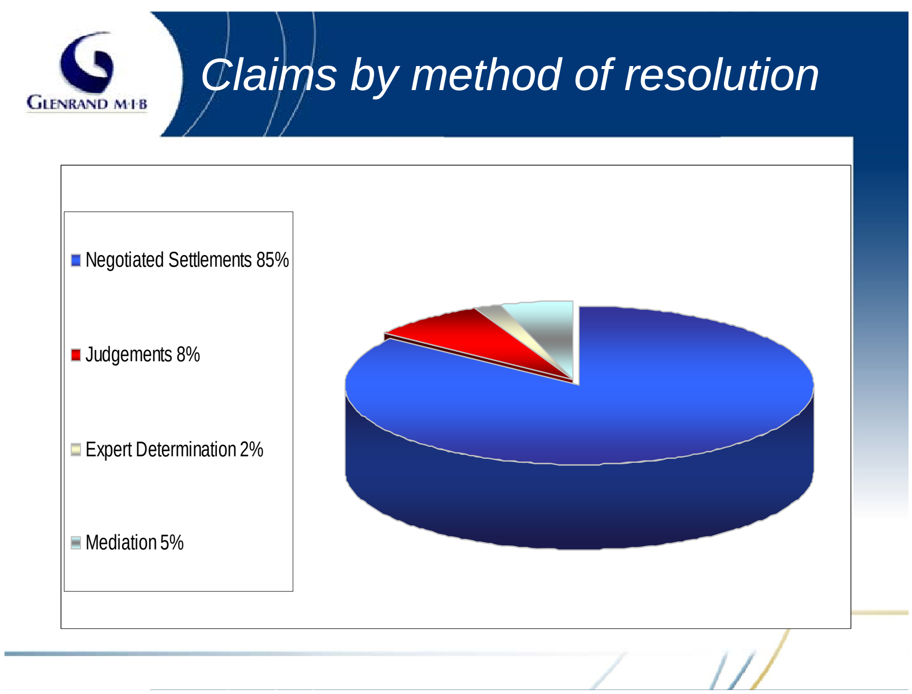
Premium Split



Notification by Stages



Dispute resolution methods



Conclusion

Over the past five years we have seen continued softening of market conditions in the PI insurance sector and it has only bottomed out during the latter part of 2010. This was due to a relatively benign claims environment experienced over the past five years as well as increased competition in the market. We forecast that this state will persist certainly for 2011 and predict a slight hardening of the market in 2012 due to economic pressures/volatility and the increase in the cost of liability claims. Effective risk management will offer a solution in this climate and a renewed focus to formulate an effective risk management strategy to mitigate potential loss could prove a key factor in staying the onset of the PI hard market cycle. Insurers will definitely afford greater discounts to firms who demonstrate effective adherence to risk management policies within their companies.

I would like to thank all the Members of the CESA Quality & Risk Management Committee for their assistance during the past year and would like to wish you all the best over the festive season.

Malcolm Padayachee
Principal Broker
Glenrand M·I·B Professional Services