

March 16, 2018

Plan Credit withheld for 2018. Premium increase of 5% continues for a second year.

Steady increase in defence costs, increasing length of time to reach settlements and regulatory requirements offset decline in number of claims for a “break even” year.

PLAN CREDIT WITHHELD

Results for 2017 ended with a small profit of \$72,000, a considerable improvement over the 2016 loss of \$1,740,000, the first loss in the history of the program. Despite the improved performance, the results were again impacted by an actuarial adjustment to reserves for unsettled claims. The continuing issues identified by the actuary were:

- continuing growth in total claims costs, in particular defence costs; and
- increase in the time it takes to reach a settlement of claims.

These concerns again triggered a reassessment by the actuary, increasing the amount to be set aside as reserves for payment of defence costs and damages for previous years. To the good, the actuarial adjustment was significantly less than the prior year. However, as a result of the reduction in profit due to the actuarial

adjustment, the nominal surplus remaining is insufficient to justify a Plan Credit.

Graph 1 on the following page shows the results for 2017 and prior years for comparison. It illustrates why the volatility in claims in recent years continues to be a major concern. Annual fluctuations in the number and costs of claims augmented by actuarial adjustments have significantly impacted the Company's financial results. These factors are expected to continue until the growth in defence costs and the length of time for claims settlements abate.

The Plan Credit is based on the net profit for the last year after allowances for the retention of capital recommended by our independent actuary to comply with regulatory requirements and potential volatility in claims costs. The amount is then distributed to policyholders in accordance with their pro-rata contribution towards that year's premium.

5% PREMIUM INCREASE CONTINUES FOR 2018

In response to the “break-even” results for 2017, and the actuary's continuing concerns respecting adequacy of reserves for unsettled claims, the Board has decided an increase in premiums of 5% continues to be required this year.

It is anticipated that the 5% increase will need to be in place for several years until the aggregate premiums are sufficient to address the current gap between our annual capacity for payment of claims of about \$10 million and

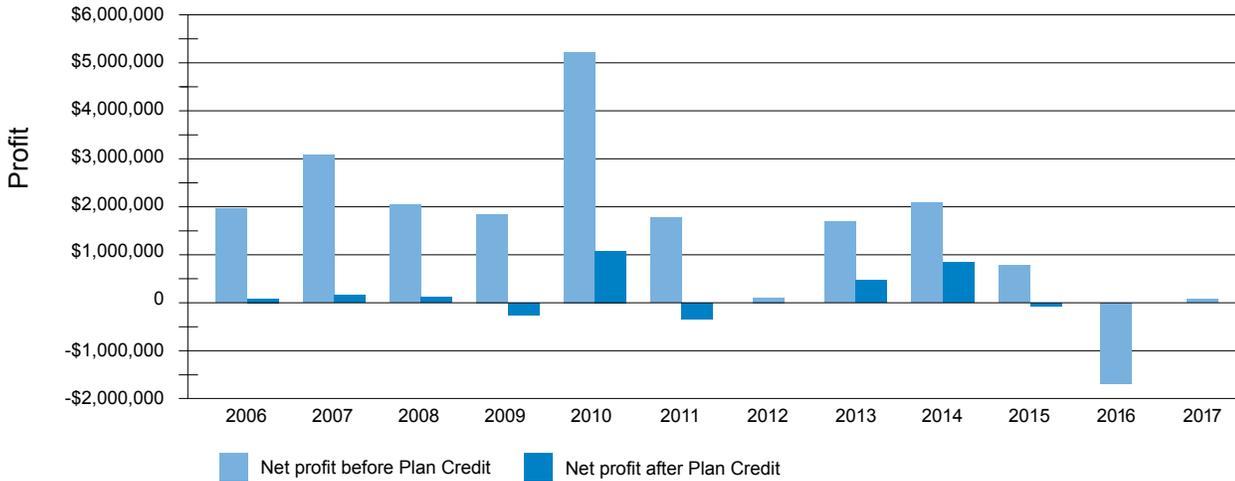
the increased potential annual claims exposure of about \$12.5 million. This approach will allow the Company to pay normal claims through annual premiums, and for catastrophes by means of reinsurance and available capital.

Regardless, annual surpluses will continue to be returned to policyholders as Plan Credits, unless these funds are required to be retained by our actuary, auditors, insurance regulator or sound insurance business practice.

Refer to Graphs 1, 2 and 3 on the following pages.

GRAPH 1: NET PROFIT COMPARISON

Key facts: Profits have fluctuated dramatically in recent years. 2017 shows a return to “break even” after the first loss in the 30-year history of the program experienced in 2016.

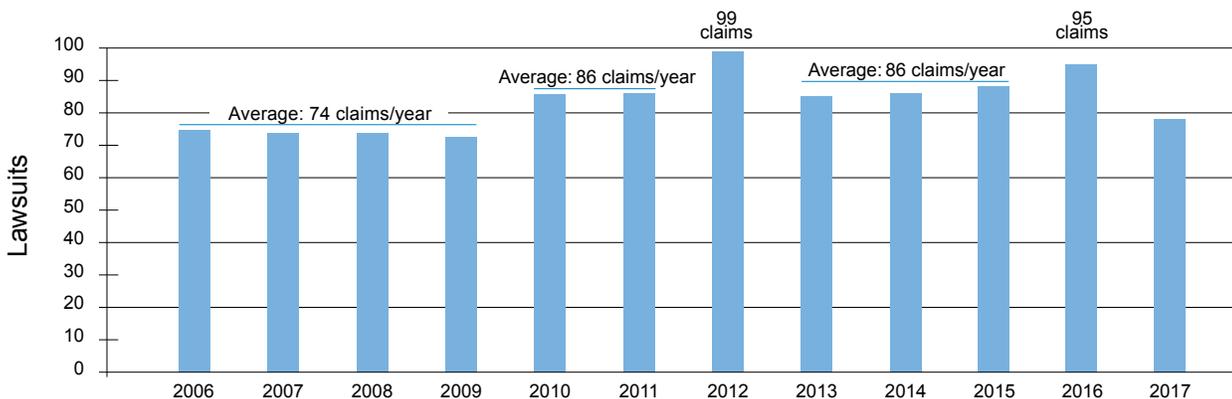


The Graph shows that in several prior years (2009, 2011, 2015) the funds allocated as a Plan Credit resulted in a minor loss; however, in each of those years there was a profit before the Plan Credit was determined. In 2016 there was an operating loss and accordingly no Plan

Credit. In 2012 and in 2017 there was no Plan Credit due to minimal net profit. Actuarial adjustments to reserves were significant factors impacting the results for 2016 and 2017.

GRAPH 2: NUMBER OF LAWSUITS

Key fact: Despite a spike in numbers in 2012 and 2016, the number of lawsuits against architects had been relatively constant since 2010. 2017 saw a decline in numbers of lawsuits from the spike in 2016.

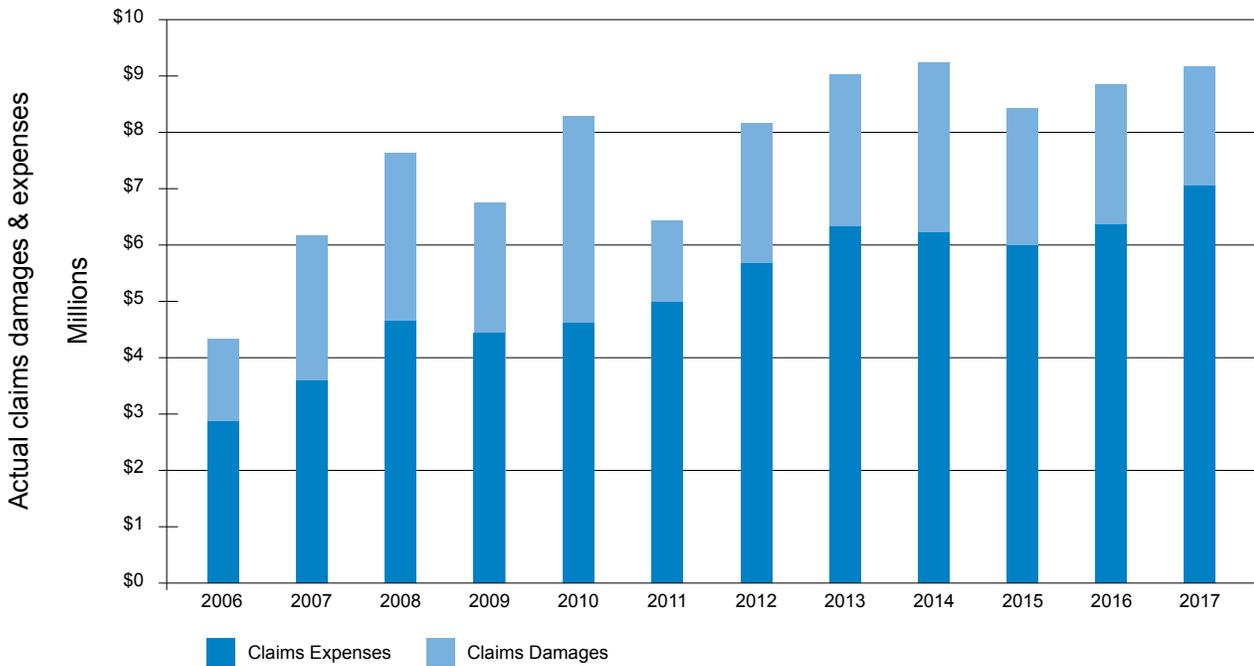


As you can see in Graph 2, the number of lawsuits against policyholders has increased gradually but steadily, in steps, almost doubling in number from the early 2000s. Although both lawsuits and numbers of policyholders have increased, there have been significantly more lawsuits per policyholder since the early 2000s – and a significantly smaller increase in

the number of policyholders paying the premiums. It is too early to know whether the drop for 2017 is an anomaly in a generally upward trend, or indication of stability in numbers of lawsuits against architects. Taken together, the average for 2016 and 2017 is in line with the average for the previous 3 years.

GRAPH 3: COMBINED DAMAGES & CLAIMS EXPENSES PAID

Key Facts: In 2017, the total of damages and defence costs combined neared 2014’s all-time high. Defence costs reached an all-time high in 2017.



As Graph 3 illustrates, actual payments for damages and expenses in 2017 were the second highest in history, just shy of the peak in 2014. Claims expenses alone were the highest in history, continuing the long term trend in evidence over the last two decades. Claims expenses as a percentage of the total have

been gradually increasing from approximately equal to damages in the late 1990s, to an average of over 70% of the total for the last three years. In contrast, damages actually paid have remained relatively static, suggesting that the vigorous defence approach has been successful.

How do our circumstances compare to other insurers?

We are assured that we are not alone in seeing significant increases in claims costs and projected premium increases by insurers generally, although unlike Pro-Demnity, the increases will not be as uniformly applied or as open and transparent to clients as is the case with Pro-Demnity.

Pro-Demnity is a “mono-line” insurer. It currently has only one line of business, the provision of professional liability insurance to Ontario architects. There are positive and negative implications.

Claims against Ontario architects are the only generator of damages and costs to Pro-Demnity. The Company is isolated from other potential sources of loss borne by other insurers, for example from weather-related disasters such as hurricanes Harvey, Irma and Maria and California wildfires that reportedly reached \$306 billion US in 2017. These catastrophic losses have impacted the global

insurance markets, leading to re-consideration of business models, required injections of capital and sales and mergers as the insurance market reacts to the losses. Insurers offering professional liability insurance in combination with other lines that are subjected to such extraordinary losses will inevitably be impacted.

However, Pro-Demnity cannot spread its own business risks across several lines of business. As a “mono-line” provider, we cannot anticipate profits from other lines of insurance offsetting losses suffered elsewhere, a factor recognized by the Company’s actuary in its assessments.

For most of the past decade investment income has been limited due to extremely low returns on suitably secure investment vehicles. Premiums paid by policyholders are the only material source of revenue available to Pro-Demnity to address damages and claims expenses.

The steady increase in costs to provide a vigorous defence to architects as mandated and expected by Ontario architects, combined with the policy of operating on a “not for profit” basis by returning surpluses as a Plan Credit rather than accumulating additional capital

in profitable years, and the actuarial adjustments to recognize the projected increase in damages and defence costs for unsettled claims have all contributed to the need to increase premiums.

What is Pro-Demnity doing to address claims expenses?

There are several factors that have been identified as contributing to the growth in claims expenses.

- Larger, more complex projects involving greater numbers of parties
- Increased complexity of claims with longer settlement periods
- The two year discoverability period under the Limitations Act, 2002 accelerates involvement of legal counsel
- Litigation is more complex with associated increases in costs
- Lawyers’ fees and associated costs have increased in sync with inflation
- Costs of experts to assist in defence of architects have increased

Pro-Demnity cannot impact the systemic realities; however, it is addressing the factors that are within its control.

In-house Legal Department

Pro-Demnity is establishing an in-house legal department with a view to reducing legal costs. An in-house lawyer will assume primary responsibility for smaller claims and the initial response and triage of larger, more complex claims. The objective is to reduce or postpone reliance on outside lawyers until the seriousness and complexity of each claim has been confirmed.

Experts

Expert opinions are an essential tool in establishing that an architect has met the prevailing standard of care. However, these opinions can be very expensive. The expert may have to invest significant time in reviewing project records and other material in order to provide a reliable assessment. Expert opinions for delay claims can be a particularly costly exercise, involving both analysis of what actually happened on the project and rebuttal of the plaintiff’s delay claim expert’s lengthy submissions.

Pro-Demnity Claims staff will be considering alternatives to commissioning extensive expert opinions, taking advantage of our Claims Managers’ own architectural expertise and experience without prejudicing the ability to provide an effective defence to our insured. When retention of an expert is required, it is hoped that the scope of the opinion and related efforts by the expert may be more effectively targeted once the nature of the action has evolved.

Be assured that Pro-Demnity is not changing its mission to provide a vigorous defence to all Ontario architects facing claims. However, it is anticipated that the inception of an in-house legal department and more efficient use of experts may make a helpful dent in the trend to increasing costs to defend claims.

What can architects do to help reduce costs of their insurance?

The primary generator of costs borne by the Pro-Demnity program is claims for damages incurred by Ontario architects and the related costs to defend these claims. Many factors that impact a client’s decision to pursue a claim are beyond an architect’s control. However, there are some measures architects can take that can reduce their attractiveness as a target or assist their insurer deliver a more cost effective defence.

The 2017 Plan Credit Bulletin included a list of 14 recommendations gleaned from 30 years’ experience defending architects facing claims. Those remain

important and the 2017 Plan Credit Bulletin can be accessed via the Pro-Demnity website. However, 2018 brings a new tool that architects can utilize to increase their awareness of the factors that contribute to claims and costs incurred to resolve claims.

Claims Experience Workbook

Every Ontario architectural practice insured under the Pro-Demnity program will have received by mail a copy of a new *Claims Experience Workbook* endorsed by Pro-Demnity and the OAA. The *Claims Experience*

Workbook draws on the findings of a research project into all of the claims arising in a five year period where information was sufficiently developed to allow meaningful analysis.

The *Workbook* includes new information about what has triggered claims most often, which building types were involved, and who else in the design team was named...in short a readable account of how architects managed to get into trouble.

The two highest cost categories of claims were identified:

- water-related claims...through building enclosures, or through pipe or equipment failures;
- construction phase...errors or omissions in the provision of consulting services during construction;

with detailed explanations of how each of these categories contributed to the claims costs borne by Pro-Demnity on behalf of Ontario architects.

The *Workbook* includes recommendations directed at avoidance or reduction in severity of similar claims, identification of available resources for reference and a set of quality assurance Checklists and Worksheet that architects can utilize or adapt for use on projects by their own practice.

Loss Prevention Event

Commencing in 2018, Pro-Demnity will be offering a Loss Prevention Program based on the information included in the *Claims Experience Workbook* and use of the Checklists and Worksheet. This will supplement the program: *Lessons from Claims...What gets architects into trouble most often* that was delivered across the province throughout 2016 and 2017.

The new program based on the *Claims Experience Workbook* will be offered at the OAA Conference in May, 2018.

Grenfell Tower Fallout

On the night of June 14, 2017, a fire destroyed the 24-storey Grenfell Tower apartment block in London UK. About 80 residents of the building died. Fallout from the disaster is impacting the architectural profession in the UK and prompted interest in similar concerns elsewhere.

The source of the fire was a faulty refrigerator in a lower floor unit. The local fire department responded, extinguished the original fire and was wrapping up their operations before it was realized that the fire had spread from the interior into the exterior cladding system. The cladding assembly had recently been installed as a retrofit to reduce energy use and improve the appearance of the 1960's era building.

Given a few minutes head start before the fire department realized the fire was spreading through the cladding, the fire quickly spread around the entire building exterior, migrating back into the interior at every floor.

An array of investigations and inquiries are currently underway. Initial reports and information have focussed on a range of issues including:

- adherence to codes and standards by designers and contractors
- "value engineering" that introduced a combustible assembly as a cost saving measure
- substitution of non-compliant combustible materials as a cost saving measure

- improper use of a combustible assembly on a high-rise structure (above 18m)
- inadequate oversight by authorities having jurisdiction
- lack of sprinklers in a high-rise residential building
- single exit stair, apparently allowed by code
- inadequate maintenance and management of the building
- directions to residents to remain in their units that doomed many as exit routes were blocked and the fire spread back into the interior from the exterior cladding.
- extent of use of the failed cladding system and non-compliant combustible products on other buildings
- adequacy of building codes and regulations
- fires elsewhere involving similar cladding assemblies and materials

As in Canada, use of combustible materials is allowed in a "non-combustible" assembly, subject to the non-combustible component(s) meeting a designated fire resistance test or standard. It is reported that in the immediate aftermath of the disaster, tests carried out on combustible products used in the cladding assembly failed in every instance.

UK insurers are currently attempting to assess the extent of their own organizations' and the insurance market's exposures to what appear to be a potentially catastrophic loss. Claims have arisen on many fronts...

including from owners of many other UK buildings who are demanding that the same non-compliant claddings and products used on their buildings be replaced, at the designers' and contractors' expense.

Concerned insurers have instituted a "Risk Assessment Questionnaire" and declaration related to cladding, insulation, façade and wall panelling to be completed by their insureds or applicants for insurance to assist identify the extent of exposure to losses stemming from the Grenfell Tower circumstances. Undoubtedly there will be underwriting implications impacting availability and cost of professional liability and other insurance.

Other issues will also factor in the formal inquiries, including responsibility and culpability of the municipality that owned and managed the housing project, and the role of the design professionals, who as professionals, are expected to meet a duty of care to the public.

As the details are provided and conclusions and recommendations emerge from the reviews and inquiries, it may be anticipated that the fallout will travel beyond the UK borders.