MARSH

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Directors & Officers Liability Insurance Market Update

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Insurers seek to mitigate exposures amid rising claims activity

The insurance market in Australia for professional indemnity, directors and officers liability and financial institutions is more challenging than it has been in the past decade. Driven by an abundance of claims, the number of claims and reported circumstances are exceeding the total insurance market premium pool by a significant margin. Some leading insurers have struggled to adjust to the current market and economic conditions and are either seeking to mitigate their exposure via reduced capacity or elevating their attachment points. In some cases, insurers are electing to exit market segments altogether.

Notably, buyers that operate in sectors now deemed medium or high hazard are facing insurers exerting significant pressure for higher deductibles and premiums to be applied on both renewal and new business.

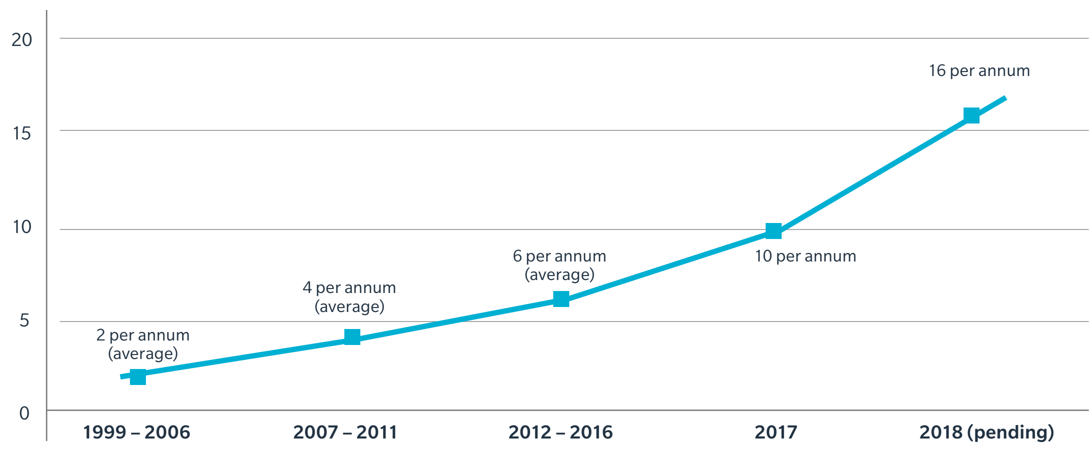
MARKET CAPACITY AND APPETITE

Insurance capacity continues to be generally available for all the relevant D&O sectors, but for a price. Insurers are declining to renew programs where they cannot achieve their required premium increases, and product line underwriters are under intense scrutiny from management to be unyielding on pricing improvement.

Insurance placement has therefore become challenging, in particular for clients purchasing cover for Security Entity claims (shareholder class action). There is now very limited insurer appetite for Security Entity Cover (Side C) insurance locally or in international markets for Australian risks attaching under $100M. Currently premiums above $100m attachment remain stable but with major global insurers now looking more closely at their cost of capital, change may be on the way. Conversely, insurance premiums below $100m are rising substantially albeit not to levels forecast by insurers and actuaries.

FIGURE 1

Number of securities class action claims in Australia



Source: Marsh data

IMPACT OF CLASS ACTION CLAIMS

In their recent white papers[1], XL Catlin and Wotton & Kearney have sought to set the tone of the conversation for some of the factors affecting listed companies and security entity claims in Australia.

There is a strong view amongst insurers that the market is dramatically under-priced and that premiums need to increase in multiples to return the market to profitability. Actuarial firm Finity Consulting's recent "Show me the numbers" assessment at the National APIG Conference in September 2017, suggested that the local D&O insurance market remains 100% under-priced but 250% under-priced on ASX listed programs, in particular those with Security Entity Cover (Side C).

While class action claims are driving a specific response due to their severity in a relatively small Australian D&O premium pool, the frequency of such claims, albeit increasing, remain significantly below what is experienced in the US and some European countries.

To some degree, the D&O policy is now acting as a de facto "corporate guarantee" and, with this trend, the relatively modest local premium pool must become larger or be diversified into global markets - with premium rates reflecting US and European risks - if the market is to remain functional.

Recent court decisions continue to demonstrate that Australian companies are subject to a strong regulatory environment, which in turn encourages local and international investment in Australian companies. As the claims experience resulting from these more stringent standards comes into alignment with regimes abroad, it is now apparent that D&O premiums in Australia are beginning to reflect closer to prices charged in the US and some European jurisdictions.

1. *How did we get here? The history and development of securities; Show me the money! The impact of securities class actions on the Australian D&O liability insurance market,* XL Catlin and Wotton & Kearney, 2018

IMPROVING D&O RISK PROFILE

Whilst many of the current risk drivers affecting premiums are not within control of buyers, there are factors to focus on that may provide an improvement in the premium offered by insurers.

The following items may positively influence Insurers' perception on risk, potentially offsetting the impact of the general drive to increase the premium pool size to manage risk and class volatility:

- Business complexity and transparency of the company's financial condition
- Internal company controls and review (and subsequent disclosure implementation)
- Director quality and board independence
- Market capitalisation
- Company culture

MANAGEMENT LIABILITY

Despite the significant, year-long pricing correction from the existing market leaders, management liability portfolios are only just beginning to stabilise with loss ratios expected to break even some time in the second half of 2018. Local insurers have expressed the view that the pricing correction has not been sufficient to attract their participation, and thus competition, against the existing market leaders.

FINANCIAL INSTITUTIONS

Financial institution insurers are also experiencing similar tough insurance conditions as evident in the PI and D&O market. The frequency of current claims and increased costs of defending regulatory investigations, such as the current Royal Commission, are dwarfing the current FI insurance premium pool estimated at $250m. Many insurers claim to having not made a profit in the FI space for over 10 years.

Looking ahead

The market looks set to continue seeking price increases through the rest of 2018, even if the class action activity proves to have peaked. Indeed, in their most recent market assessment , Finity Consulting suggests that even after the most recent round of increases, another 35% - 55% would be required to stabilise the local D&O market.[2]

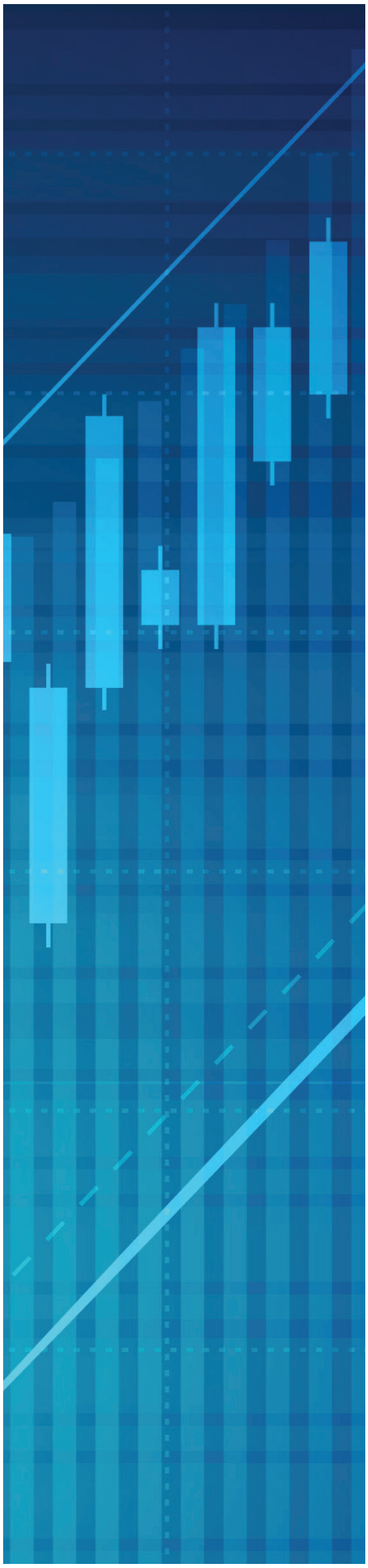
Given so many past and current class actions centre on the company's attitude towards risks and continuous disclosure, it is only logical that insurers are seeking to better understand both the Board and management's practices in this regard. Specifically, insurers are keen to understand the framework for disclosing risk, including timing to provide revise guidance back to the ASX for key metrics.

Insurers are also showing greater interest in a company's remuneration guidelines for short and long term incentives, and whether there have been changes over the preceding years.

As the cost of Security Entity Cover (Side C) increases and availability becomes tighter, many buyers will be carefully re-evaluating their company's decision to continue to purchase this cover. This may reignite the age-old debate of needing to balance the company interest against that of directors and officers.

For many, the insurance program still represents significant value, with some programs still more affordable now despite the current claims environment, than five years ago, when coverage also had lower limits.

We expect insurers to continue recalibrating upwards in both pricing and deductibles while claims activity will be more closely scrutinised.



2. Optima Lite 2017

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