Directors & Officers (D&O) Liability

2021 Australian Insurance Market Recap Series

February 2022

At a glance

13%
Global commercial insurance prices rose 13% in the fourth quarter of 2021

18%
FINPRO insurance pricing increased 18% in the fourth quarter of 2021, down from 25% in the previous quarter

Rates and Competition
Competition developed, particularly for excess layers. Client D&O insurance premium pool now in excess of $1.5b - a stark contrast with 2020 and clearly to the purchaser's advantage

Purchasing behaviours
Clients explored alternative D&O program structures, most notably lower limits to mitigate premium increases.

D&O
The levelling out of pricing in Directors & Officers programs continued

Pacific Pricing
The overall rate of increase declined, matching the global pace of 13%

Professional Indemnity
A disjointed and inefficient market place in 2021. Premiums increased again as capacity continued to tighten

Shareholder Class Actions
The 2021 easing of directors' Continuous Disclosure obligations under the Corporations Act, seen as a positive for clients and their D&O Insurers

Claims activity
2021 underwriting year generally saw both the frequency and severity of claims activity tracking close to prior year averages

Outlook
The increased appetite for new business at year-end 2021, is anticipated to continue into 2022

Optimism for D&O

How times are changing – after a challenging couple of years, it appears there is room for some optimism in the Directors & Officers (D&O) liability insurance market, with pricing moderating further as we head into 2022.

Back in our 2020 Market Recap article, we reported that the prevailing conditions at that time were amongst the worst seen in living memory with average premiums rising in excess of 200%, average retention levels increasing by similar amounts and clients finding it exceedingly difficult (and expensive) to procure their expiring programs in a diminishing market.

This followed an equally challenging year for the D&O market in 2019. By the fourth quarter of 2020 we finally started to see some moderation. Pleasingly this trend continued throughout 2021 bringing some welcome stability in another pandemic impacted year. For many clients, this improvement follows three renewal cycles of unprecedented premium rises and the ongoing corrective actions of D&O insurers seeking to remediate their generally loss-making D&O portfolios.

There have been three key drivers to the turnaround in this market:

Rates and competition

Simply put, premiums have risen to sustainable levels with the overall pool now estimated at multiples of what it was in 2016 (we estimate the D&O insurance premium pool attributable to Australian domiciled clients now to be in excess of $1.5 billion). Where previously the pool was drastically insufficient to meet current year and tail year losses, the current annual pool is sufficient (or at least close to approaching sufficiency). Of course with improved rates, comes competition. Whilst we reported in our 2020 Recap that six D&O insurers had left the market, we can now report that in 2021 at least six entered the market, in each case a Lloyds syndicate. Despite new entrants typically not having appetite for primary layer business and being selective with industry type and attachment, their participation is having the most impact within the lower excess layers, allowing for many programs to have stabilised or flattened at the end of the 2021. The contrast between 2020 and 2021 is stark and clearly to the purchaser's advantage. See further in Figure 1 below.

Client purchasing behaviours

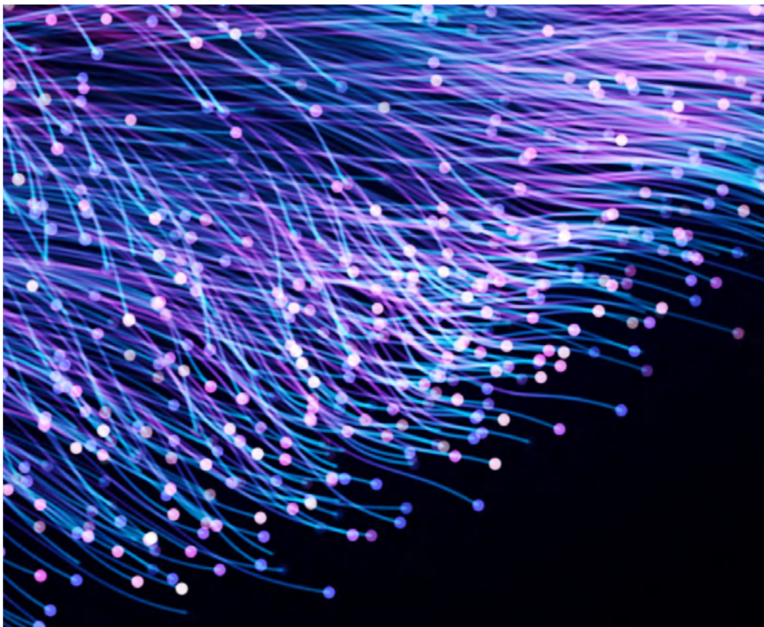
Clients generally reduced the size of their D&O programs in 2021 and/or many discontinued with the purchase of Side C and in a few cases Side B (refer Figure 2 below). This reduction of limits purchased and the increases in deductibles continues an ongoing trend since 2019 whereby clients have altered buying behaviour in an attempt to mitigate the full impact of pricing increases and/or due to capacity shortages. In some cases clients also chose to take on substantially higher retention levels although we saw little move to Captive facilitated programs. The collective impact of this trend is that there is less limit or a less exposed limit in the situation where retentions are taken higher and/or Side C (or Side B) is not being purchased, meaning there is less to go around in a hungrier and more populous pool of insurers! As above, further competition is thereby created.

Macro factors

Pleasingly there has been some positive news this year in terms of the regulatory environment and as it relates to shareholder class actions. Changes to 'Continuous Disclosure' obligations under the *Corporations Act* have been implemented following earlier delays in the Senate and a lengthy Parliamentary review process in which Marsh successfully advocated for our clients through formal Law Reform and Parliamentary Joint Inquiry submissions.

The easing of the Continuous Disclosure obligations now means that a director needs to have acted with 'knowledge, recklessness or negligence' in order to be liable for a Continuous Disclosure breach – a change to the former no-fault mechanism. Whilst positive at this stage, it is still early days and the full impact of these changes is yet to be seen.

We continue to monitor for developments in this area as well as in regard to the enhanced regulation of litigation funding firms. The proposed 70/30 cap on litigation funders' earnings has met with staunch resistance from those with a vested interest and it is unclear whether this measure will clear Parliament. In spite of this, the changes that have been implemented and proposed, generally can be seen as positive developments which will more than likely be of benefit to both our clients and their D&O insurers.



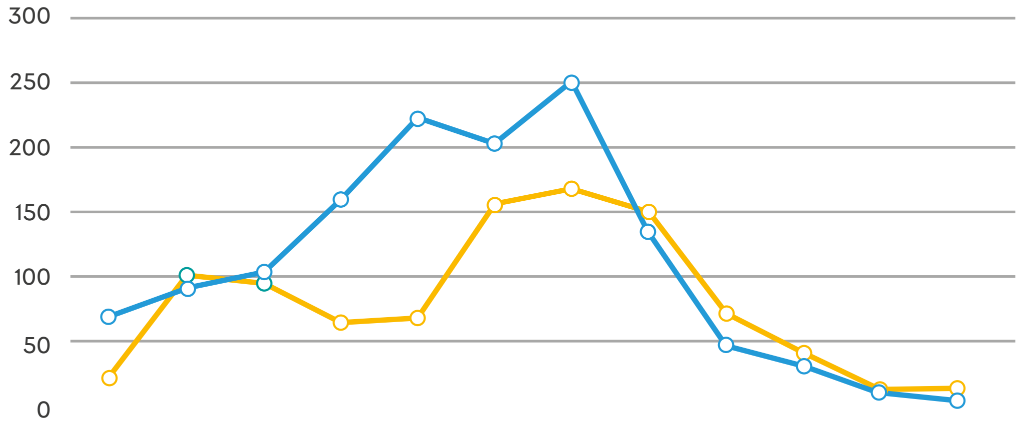
Claims activity

Added to the above three factors is subdued, but by no means diminished claims activity. We did see an uptick in new claims activity in H2 2021 and the first substantial settlement of more than $100 million since late 2016. However, the 2021 underwriting year generally saw both the frequency and severity of claims activity tracking close to prior year averages and it is significant to note the robust 2021 premium pool pot sitting in reserve to meet both new and prior year development claims.

Globally, this trend is being mirrored in the larger US market (often seen as a bellwether for future trends) as reported by Marsh's sister company NERA in their Recent Trends in Securities Class Action Litigation: 2021 Full-Year Review. The number of US federal securities class action suits filed in US courts decreased by 36% from last year to 205 in 2021, hitting its lowest mark in over a decade (see Figure 3 below). In addition, the average settlement value fell over 50% in 2021 to USD $21 million, the lowest recorded average in the last 10 years, while the median settlement value was USD $8 million, the lowest recorded since 2017. These improved numbers are likely to have a positive impact on profitability and in turn insurers' appetites to remain (or enter) the D&O insurance space - both globally and here in Australia.

Figure 1

ASX 300 Quartlery Program Rate Change and Primary Rate Change Since 2019



Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021
71	94	105	160	223	204	250	135	49.88	33.9	13.7	7.94
24	102	97	67	71	156	169	151	75	43.07	14.91	17.3

Program Rate Change | Primary Rate Change

Average Rate Change (%)

Source: Marsh FINPRO track

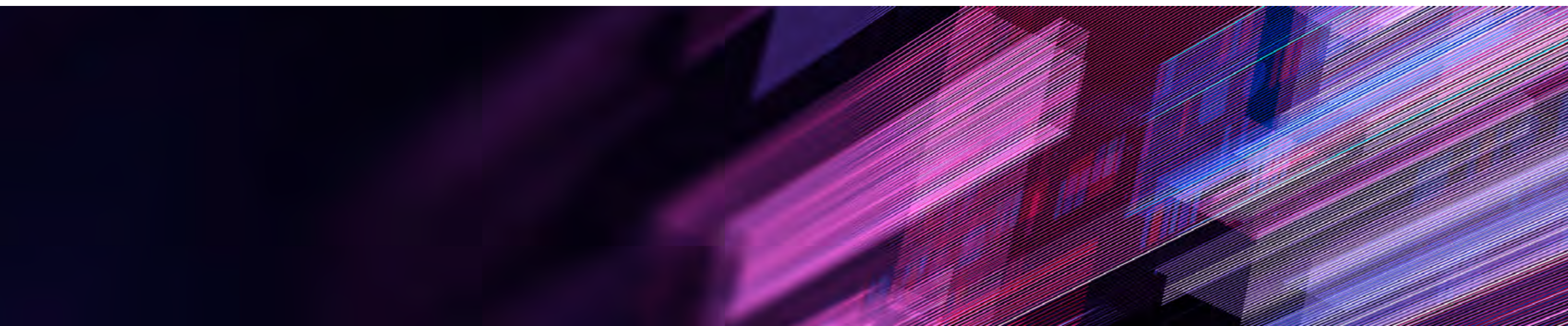
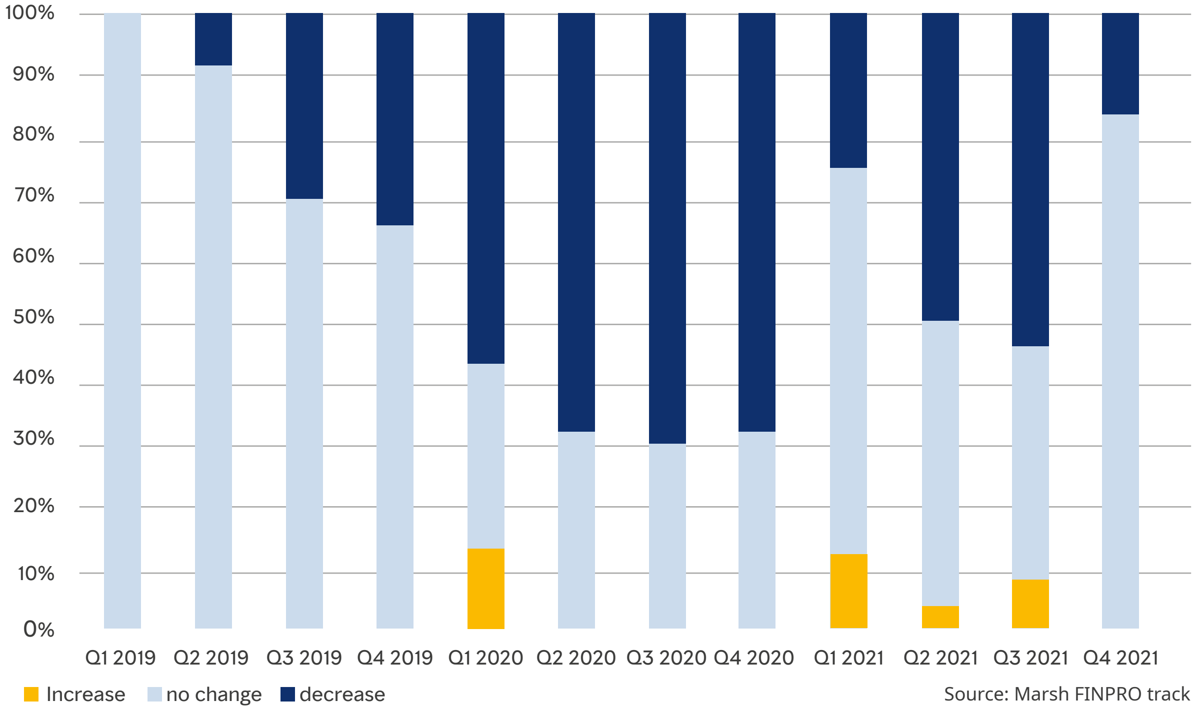


Figure 2

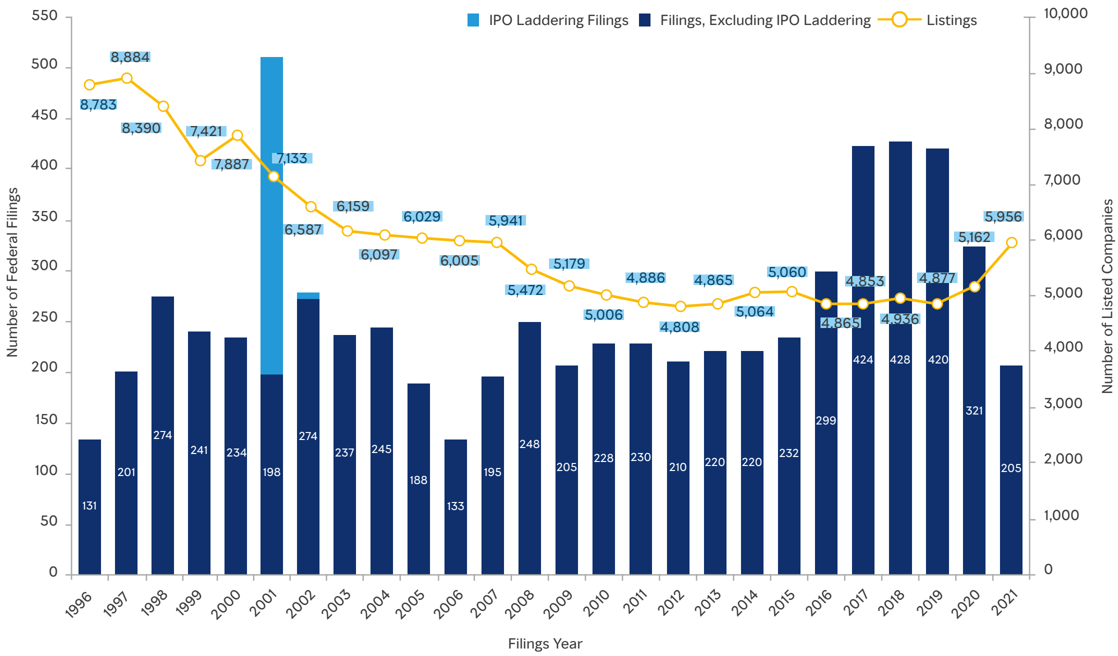
Companies which Increased/Decreased Side C limits



Source: Marsh FINPRO track

Figure 3

Federal Fillings and Number of Companies Listed In the United States



Other classes of financial lines

Private D&O

Although D&O insurance rates continued to rise in 2021 for private companies, in most part, the increases have been less severe than we have seen in the Public Company D&O market.

With the exception of those clients who suffered significant financial disruption due to COVID and difficulties securing coverage, insurers typically showed strong appetite to renew their existing business subject to a single digit or low double digit percentage rate increase.

In many cases, increased deductibles and/or tightening coverage terms and conditions were of more importance to underwriters in 2021 than the need for significant rate increases.

Professional indemnity

Disappointingly, the professional indemnity market was shown to be a disjointed and inefficient market place in 2021. Although most insurers have appetite for low hazard risks, many insureds who are in perceived high risk industries (e.g. financial planners, property valuers and certain design and construction professionals), saw incumbent insurers reduce capacity at renewal. And due to a lack of competitive tensions, any required replacement capacity has often cost multiples of the previous year's premium.

Financial institutions

Financial institutions (**FIs**) are closely reviewing the profitability of their counterparties – commonly referenced in what the (re)insurance market terms "combined ratios". Since 2017 (re)insurers' combined ratios have exceeded 100%, meaning that their claims and operating costs have exceeded their premiums and investment returns. However H12021 witnessed a return to profitability for many (re) insurers including Lloyds (92.2%), AIG (95.5%), Chubb (88.6%), QBE (90.2%) and AXA (93.3%). This return to profitability is driving competition and new (re)insurance market entrants (as noted in the D&O segment) eager to participate on a financial institutions' insurance program.

Notwithstanding the industry's positive performance, factors such as the pandemic's impact on the current interest rate environment, and rising inflation may temper growth as insurers struggle to achieve satisfactory investment returns while claims costs continue to increase.

Many larger financial institutions have seen the benefit of captive insurance company utilisation over the hard market cycle and have taken to managing risks on their own balance sheet. As premium rates start to soften it will be noteworthy which of these FIs re-enter the insurance market.

Moving forward, underwriting focus will consider emerging risks including digitisation, M&A activity, ESG, and climate related financial disclosures. FIs with exposure to highly impacted sectors — oil/gas, travel, hospitality, and commercial real estate — face formidable challenges.

Crime

Crime placements continue to face difficulties, with few insurers willing to write this class. When coupled with the ongoing prevalence of social engineering fraud type losses, premiums have continued to rise and clients have often found themselves with limited options.

Where to from here?

The increased appetite for new business at year-end 2021 is anticipated to continue into 2022. It is likely that further capacity will enter or return to the market in 2022 which will further increase competition for excess programs. Meanwhile, those insurers who have grown scale in the size of their book are more likely than ever to provide competition for the primary layer of D&O accounts.

Unfortunately those industries directly affected by the pandemic, including travel, leisure, and hospitality, are still likely to have challenging 2022 renewals, as insurers remain cautious of industries that are likely to continue to be challenged by prolonged border closures and the potential for balance sheet deterioration due to likely inflationary cost pressures and supply chain constraints.

ESG

Insurers now have a laser like focus on Environmental, Social, and Governance (ESG) issues with many insurers actively reducing their exposures to certain sectors, including but by no means limited to, the energy and extractive industries.

ESG credentials vary from firm to firm and across industries, nevertheless, those clients that are able to differentiate and highlight their corporation's ESG character will benefit in 2022 and into future policy periods, with insurers more willing to compete for their business.

Naturally, also, those who have brought claims to the market, face financial difficulties, or other challenging circumstances will generally be met with caution from the underwriting fraternity and for now at least, hard market conditions will prevail.

Otherwise we assume a continuation of these softening conditions into 2022 and we look forward to working closely with all our clients on executing strategies that aim to maximise returns from these improving conditions.

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