howden

LIGHT ON THE HORIZON

Directors' & Officers' Liability Insurance

2022 Outlook

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2022 Outlook Summary

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In Q1 of 2022, premium rates generally have plateaued, but we are seeing meaningful decreases where programmes were substantially over-priced (due to sector, level of distress or lack of capacity).

2

Insurer claim settlement levels remain high,notwithstanding current reductions in the number of US securities claims and lower levels of D&O litigation more broadly (on the back of pandemic-related government support schemes).

3

Predicted that ESG claims could become a major D&O claims driver in 2022 and beyond. We are already seeing examples of company statements on ESG being challenged by either shareholders or regulatory authorities.

4

Impact of Covid on the D&O market still unknown, as, up until recently, it has been masked by the numerous government support schemes across the world.

5

Broadening insurer appetite and new market entrants are driving competition and impacting positively on pricing.

6

Increased insurer capacity per risk as insurers seek to retain premium income.

7

BIPAR capacity (where an insurer participates on the same programme layer as other insurers, but applies differential pricing for their capacity) and inverted layer pricings disappearing.

Overview

From 2018, the Directors' & Officers' Liability Insurance (D&O) market has been extremely difficult, with reduced capacity and insurer appetite resulting in substantial premium increases. These 'hard market' conditions were driven by successive years of insurer portfolios under-performing, resulting from both under-priced capacity and the level of global D&O claims activity.

This made purchasing D&O substantially more expensive. Yet despite the pricing hikes, demand for D&O insurance has continued as directors and officers face heightened exposure to emerging risks, from regulatory scrutiny through to ESG and cyber security.

However, the 2022 London D&O market outlook is brighter, with premium prices already starting to plateau and even move downwards, driven by improving insurer appetite and more capacity being available, with a wave of new insurers and ESG-propelled capacity initiatives entering the market. This change in market appetite and price is a reflection of insurers being in growth mode on the back of the positive rate environment and masks the fact that there are still concerns for D&O underwriters and macro-economic factors that can drive claims activity. The current geopolitical pressures and the conflict that is sadly continuing in the Ukraine may well lead to longer term implications for the D&O market given the potential for global recession, spiralling inflation and insolvencies, but this is yet to be seen.

In this report, we set out our views on the D&O Liability Insurance outlook as we move into 2022 and what is going to be a transitional year for the London D&O market.

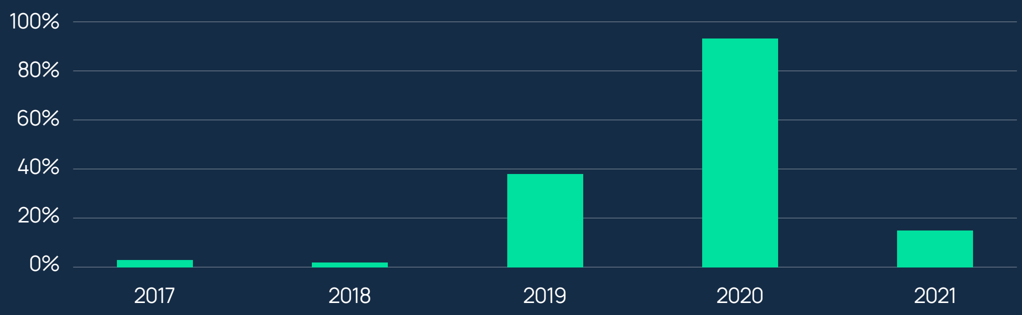
Premium rate outlook

Premium rates have plateaued

We saw the steepest rate increases from the 2019/20 to the 2020/21 periods. This was reflective of insurers 'correcting' the pricing of their portfolios.

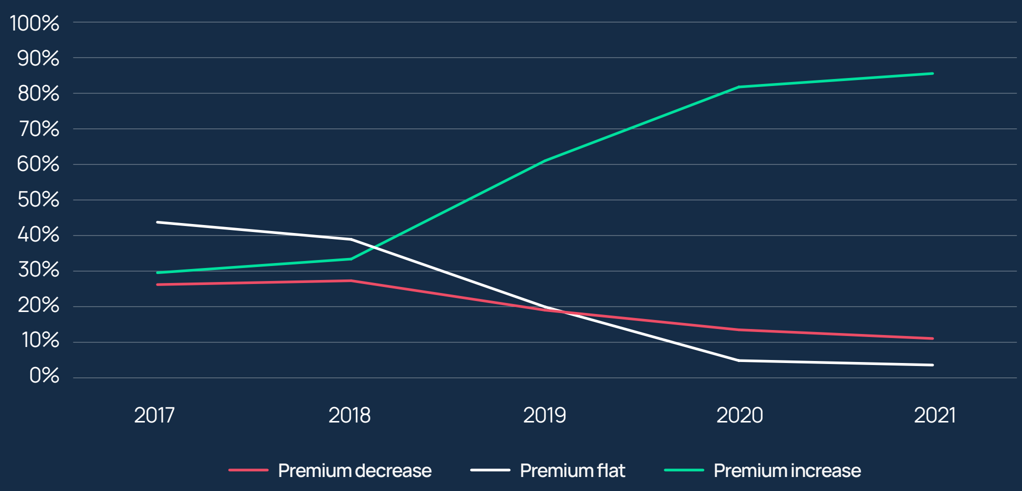
From 2021 and moving into 2022, premiums have started to stabilise. Our data shows a 15% rate increase across our portfolio between 2020 and 2021, a fraction of the year before

Figure 1: Percentage rate change for our D&O clients renewing with the same limit – 2017-2021 (Source: Data collected by Howden's Financial Lines Group)



As Figure 2 shows, the percentage of our clients experiencing a premium increase grew dramatically between 2018 and 2019 but the curve flattened between 2020 and 2021. Despite the huge difficulties in placing D&O programmes which left many buyers unable to obtain cover, Howden ensured clients were protected through innovative policy structures and extensive market engagement. Our success in maintaining D&O cover for our clients during the tough 2019 and 2020 years is reflected in our strong client retention rate and growing market share.

Figure 2: Number of clients experiencing premium increase, decrease or no change (2017-2021) (Source: Data collected by Howden Financial Lines Group)



What we've seen in 2022 so far

The start of 2022 heralded a positive change in the D&O market environment, with insurer sentiment very much geared towards growth. This will serve to drive competition and move the market from its hard position to one of transition. This is good news for D&O buyers. We are already seeing some meaningful rate reductions, especially where sectors were heavily penalised by insurers given their Covid exposure.

We expect to see the percentage of clients renewing with a premium increase drop dramatically. More clients should experience a flat renewal or decrease in premium as competition and appetite increases. Indeed, we know of underwriters that are looking to offer insureds large savings on some renewals and on favoured clients, are willing to significantly undercut 2021 premiums.

Even as early as January 2022, we saw insurers uncharacteristically slashing premium rates on those policies that had gone through two years of dramatic premium hikes. These same insurers would have declined the risk the previous year based on lack of appetite.

But, the transitional nature of the market and rating differential across sectors does mean that this is not the norm. Initial data for the first quarter of 2022 is showing premium rate change tracking at 1.5%.

We expect insurers will be viewing well-priced placements as new business opportunities, in turn creating an opportunity for clients to reassess their programme structures and limits and remove any overpriced capacity from the market.

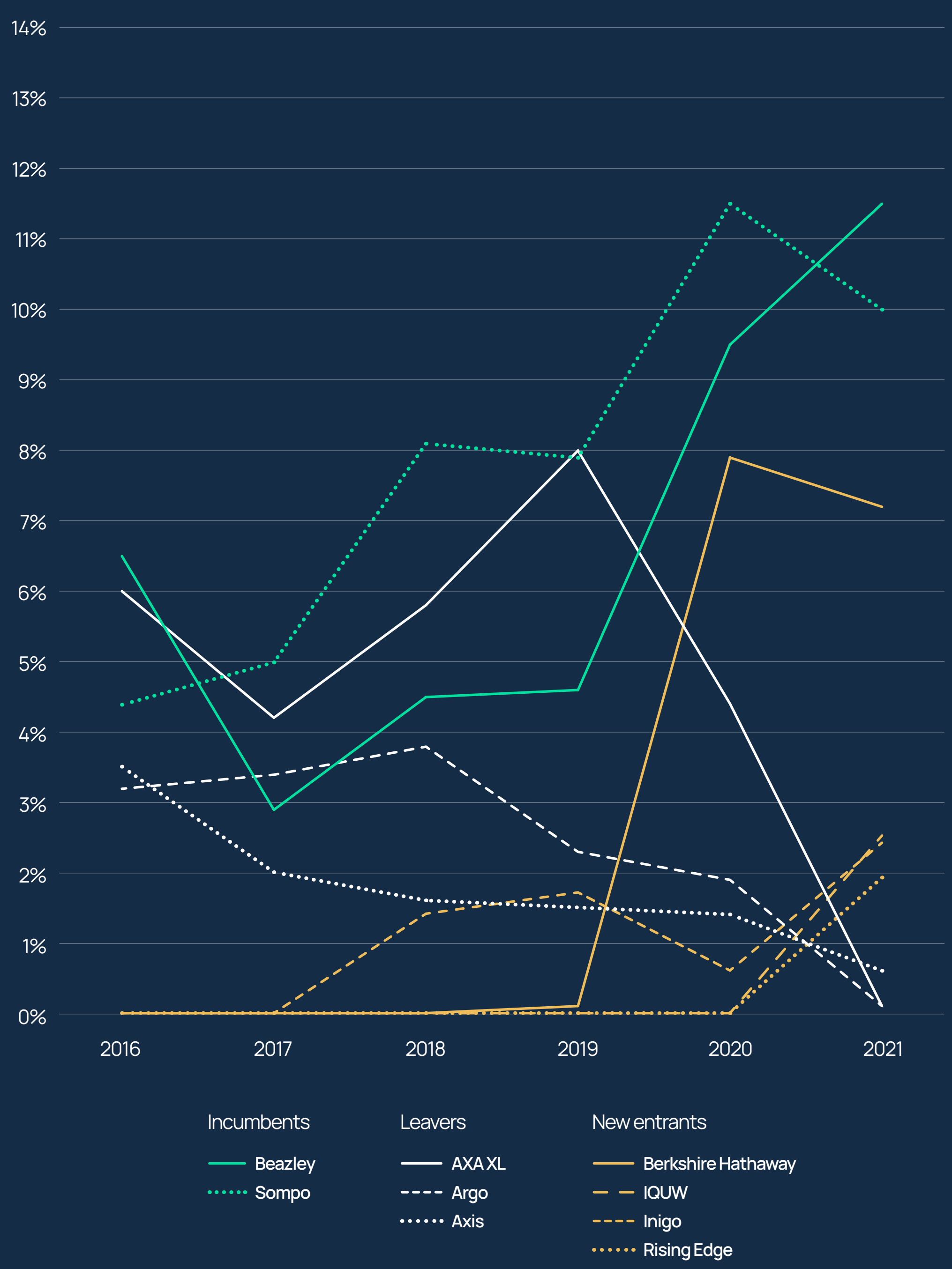
Line size restrictions are also showing signs of lifting. This again will create competition. As rates begin to fall, insurers will no doubt look to put out more capacity to balance the loss of premium. As a result of prohibitive pricing, many clients bought less D&O limit during 2019-2021. Premium rate improvements and bigger insurer line sizes will allow clients to increase or restore their policy limits. Clients often bought more limit than was perhaps necessary during the soft market because rates were so low. The 2022/23 renewal would be a good opportunity for clients to review policy limits and consider more innovative solutions such as additional Side A only cover and ring-fencing limit for the main board directors.

Expanding insurer appetite

New entrants such as IQUW, Rising Edge and Inigo all show a jump in the market share of Gross Written Premium placed by Howden during 2021. Berkshire Hathaway targeted large, multinational US traded clients which carry higher premiums, giving them significant market share and a high ranking position in our top 20 D&O insurers by GWP – see graph in Figure 3 below.

Interestingly, this graph also shows how some D&O insurers increased their appetite during the hard market whilst others pulled out of the class altogether. AXA XL, Argo and Axis all show declining market share. Sompo Japan increased their share of our D&O portfolio by nearly 50% between 2019 and 2020 and Beazley have more than doubled their market share since 2019.

Figure 3: Share of Gross Written Premium for Howden Placed D&O Insurance in 2021
(Source: Data collected by Howden's Financial Lines Group based on client placements)



Developing risk trends and the evolving demands of insurers

Environmental, Social and Governance

We have seen a sharp focus on ESG issues by insurers over the last two years. Lloyd's issued their first ESG report in 2020 and more recently set out their 'roadmap for climate action'. As of January 2022, Lloyds no longer offer new insurance cover for thermal coal-fired power plants, thermal coal mines, oil sands, or new arctic energy exploration activities, and are planning to phase out existing policies in these areas by 2030. Instead, the focus is on pioneering new risk transfer solutions for green innovations as part of their ambitious manifesto to transition the global insurance industry's investment into sustainable and climate-positive industries.

Other insurers setting up ESG-focused operations include Beazley's ESG consortium, Aspen's 'Project Leaf' initiative and the world's first fully sustainable insurer, Parhelion. These insurers will use data and technology to apply rating scores against a set of ESG criteria to assess the suitability of a risk for ESG underwriting in future.

ESG reporting is thought by many commentators to be an area that will drive litigation as we move through 2022. Over-optimistic ESG commitments and reporting, or active 'greenwashing', are expected to become areas of focus. 30% of Howden's current ESG-related claims involve failure to disclose the extent of environmental liabilities.

Companies with good ESG scores will be able to differentiate themselves in the market, attract favourable premiums and access additional capacity. Beazley (a leading Lloyds insurer), for example, will automatically offer up to an additional USD 2million limit via their new consortium stamp to companies that have top ESG scores.

Q Does this mean that policyholders with lower ESG scores will face higher premiums, larger retentions and restricted cover?

A We believe that insurers will focus on providing additional capacity, auxiliary advisory services and preferential premium rates to insureds with the best ESG scores. In the short term, we don't envisage insurers penalising lower-rated companies with punitive premium rates although additional underwriting information may be requested. We expect insurers' emphasis will be on the 'carrot' rather than the 'stick' unless there is a major deterioration in claims activity correlated to low ESG scores.

Regulatory pressure

Regulators are also ramping up their fight against climate change. In October 2021, the UK Government set out proposals for economy-wide Sustainability Disclosure Requirements (SDR), with the first step being to ensure 'the information exists to enable every financial decision to factor in climate change and the environment'.

The European Commission has issued guidelines on how climate and environmental risks should be managed by financial institutions, and the US Securities and Exchange Commission set up a new task force last year focusing on the ESG disclosures of public companies. Other countries also imposing requirements on companies for ESG disclosure include Japan, China, Australia and Brazil, and the list is growing.

Within the 'Social' and 'Governance' elements of ESG, the UK's Financial Conduct Authority published its policy decision on diversity and inclusion on company boards and executive committees last month. It now requires all companies subject to UK Listing Rules to disclose in their Annual Reports for financial years starting on or after 1 April 2022 whether their boards are meeting specific diversity targets set on a 'comply or explain' basis. Targets for the representation of woman and people from minority ethnic backgrounds are expected to be a starting point for boards to consider wider diversity characteristics.

Insolvencies

There is concern that insolvencies and corporate restructures could spike significantly, with most government support schemes at an end or in the process of being phased out. Additionally, uncertainty remains around the overall macroeconomic outlook and any future pandemic-related impact. Growing inflationary forces generated by rebounding economies, shortages in both materials and labour and spiralling energy costs may also create issues.

Covid

The ability to navigate Covid-induced supply chain issues and the move to more flexible working arrangements are now taken as a given. As a result, we are seeing far less focus on Covid working arrangements and the impact on businesses. Insurers are rarely asking insureds for 'Covid questionnaires' which were once a requirement at the height of the pandemic. What is anticipated is that more claims against directors are likely to arise from employment practices as companies and employees clash on flexible working arrangements. With government financial support schemes ending, many D&O insurers are expecting a rise in bankruptcy and insolvency claims.

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Russia

The recent events in Ukraine have of course added complexity as insureds and insurers look to establish the level of exposure to Russia and sanctions and adapt to the new environment. This places an additional compliance burden on companies and it is another area where directors will be held to account. It is a criminal offence to breach or facilitate a contravention of the trade, aircraft, shipping and financial sanctions imposed on Russian organisations and individuals. The penalty for breaching sanctions is a fine or up to 7 years in prison, but there are other ramifications for directors: reputational harm, loss of confidence in the ability of the board to manage its risks, loss of revenues, and increasing difficulty of servicing debt as a result of declining business.

In the insurance market, most insurers are relying on sanctions laws and sanctions exclusions to deal with the additional exposure to the Russian situation but a few insurers are seeking to impose blanket Russia exclusions on their D&O policies. Some of these exclusions are enhanced sanctions endorsements, which most insureds will be familiar with, but others go further and exclude cover for any entity, person, property (including money and computer systems) or claims in Russia or Belarus.

The LMA Territorial Exclusion for Belarus, Russia and Ukraine is particularly far-reaching and very onerous for insureds. We are continually working to create amended language where the scope of the proposed exclusions is not acceptable.

Cyber

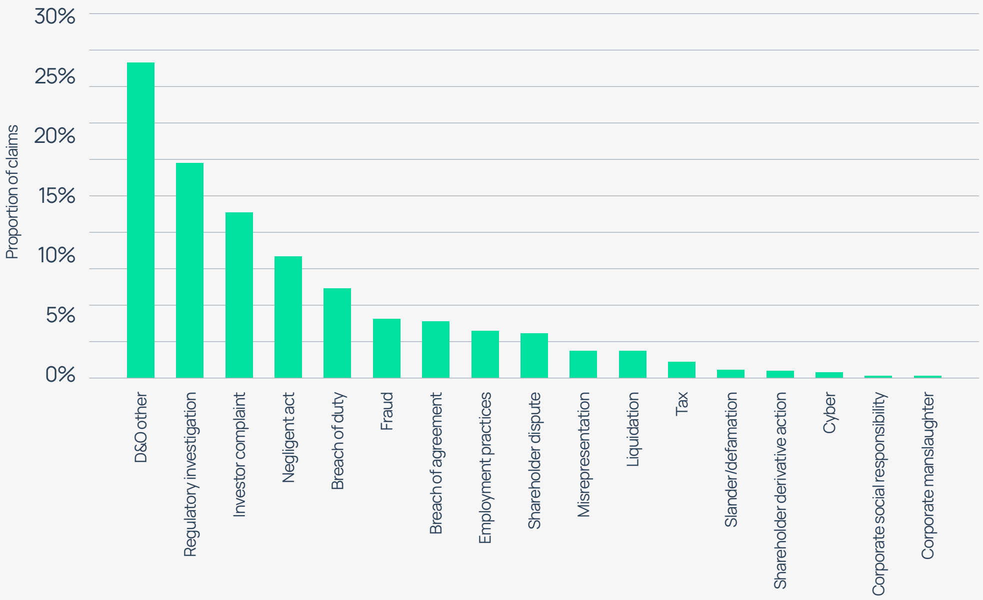
The ongoing impact of cyber-attacks on companies remains a major concern. The current distress in the cyber market is a direct reflection of this. Ransomware and denial of service incidents – whilst not a direct D&O risk – can lead to board exposure, either due to data breach issues or failure to implement adequate protections against attack, as well as the subsequent impact on the business if there is a denial of access type attack.

How are claims shaping the market?

We have seen a marked rise in the number of D&O claims that we have managed over the last couple of years. In 2020, the figure increased by 120%, and we received a similar number of claim notifications from clients in 2021.

We are seeing claims for a wide range of allegations as shown in the graph in Figure 4 below.

Figure 4: Percentage of Claims by Loss Type in 2021



D&O other

These are claims against directors and officers involving a large variety of claimants, situations or events that do not fall into the more common categories of D&O claims.

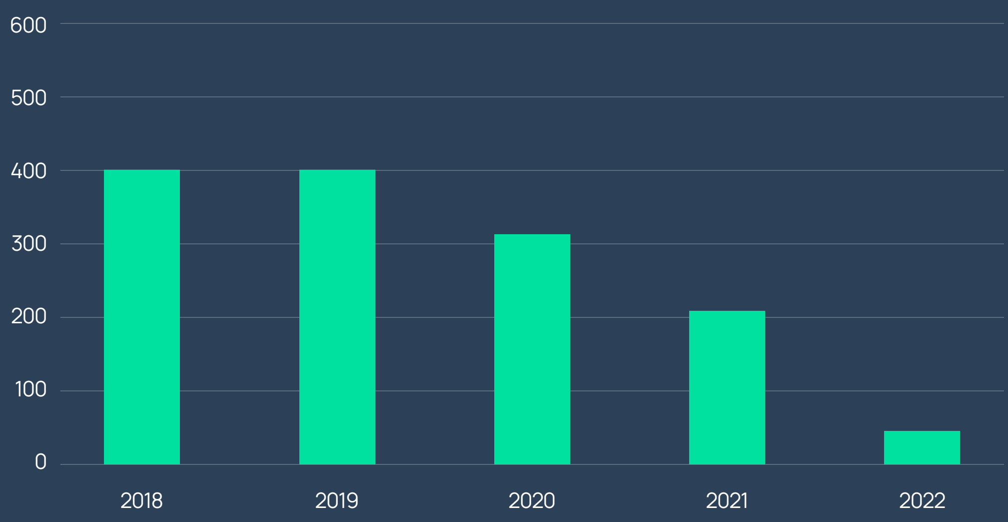
Ignoring the 'D&O Other' denomination, the most common cause of D&O claims in 2021 was Regulatory Investigations, making up 18% of our total D&O claim notifications. Regulatory Investigations also made up the largest proportion of claims collected by us in the same year (53%).

In the aftermath of the global pandemic, we are expecting there to be an increase in regulatory investigations and enforcement actions as regulators clear back-logs and reset their sights on board room culpability. New legislation holding directors to account such as the Senior Managers and Certification Regime in the UK will start to bite. In the USA, the Securities Exchange Commission are proposing to bring in new disclosure rules in 2022 for ESG and SPACs and are expected to continue their tight grip on cryptocurrency regulation. In this gold-fish bowl environment, the value to directors and officers of having appropriate cover in place cannot be over emphasised.

US Securities Class Actions

The annual number of US securities class action filings is a major indicator in the D&O claims environment. Following two years of record filings in 2018 and 2019, the number of filings fell dramatically in 2021 to 218, the lowest level in 7 years.

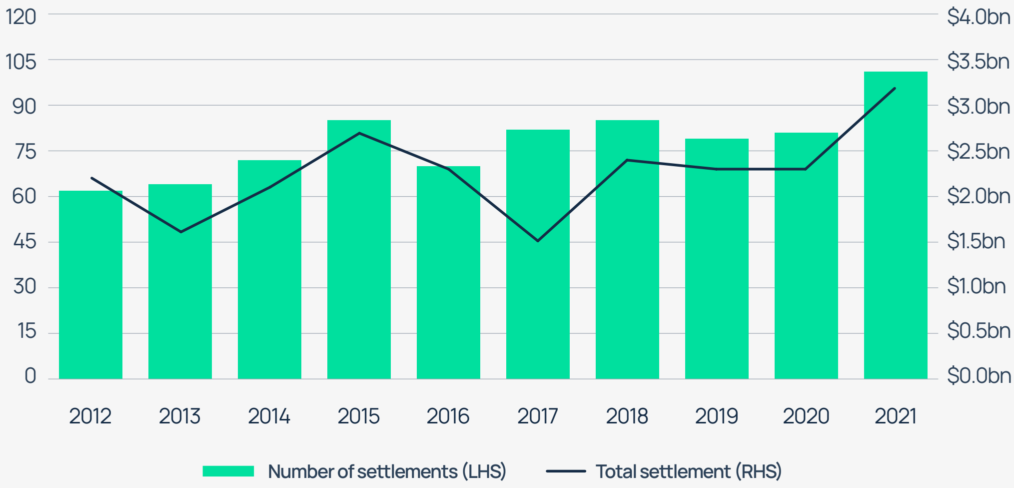
Figure 5: Number of Federal Securities Class Actions, Last Five Years
(Source: Stanford Law School, Securities Class Action Clearinghouse)



This is driven by a drop in M&A and Rule 10b-5 filings (which allege misleading statements and omissions in connection with the sale or purchase of a security) which fell 82% and 17% respectively. Whilst this is good news for the D&O market, insurers are waiting to see if this is a true trend or due in part to the backlog of trials built up during successive lockdowns. In 2020, there were more than 550 cases yet to be heard. According to Law360's January report "COVID's Impact On Litigation To Persist In 2022", the pandemic is expected to continue to impact both the types of claims and the mechanics of how those cases are dealt with. Remote court proceedings and depositions are likely to stay.

In contrast with the drop in filing numbers, 2021 saw the largest ever number of settlements reached at 101 and the largest aggregate settled at USD 3.2billion. This trend will be prominent in the minds of D&O insurers when underwriting new and renewal business during 2022.

Figure 6: 2021 Had Largest Number of Settlements and Dollars Paid Out in Past 10 Years (Source: Woodruff Sawyer, Securities Class Actions Report: Filings Against Public Companies Down for Second Year in a Row)

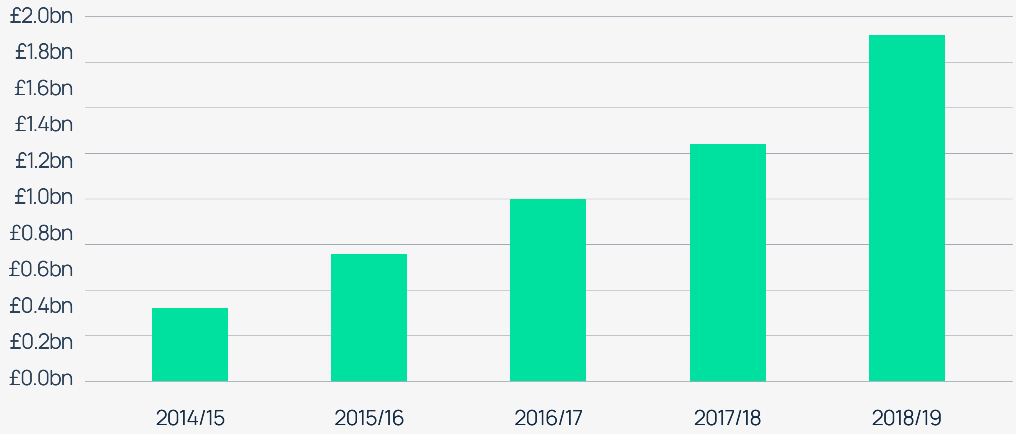


One area that has seen securities class action filings increase is **Special Purpose Acquisition Companies (SPACs)**. Here filings involving allegations against SPACs have increased from just 5 in 2020 to 32 in 2021. D&O policies for SPACs were mainly written in the US and Bermudan insurance markets and those insurers will be watching this trend closely.

Third party litigation funding

Litigation funding has increased exponentially in the UK since 2014 with the value of court cases and cash directly held by UK litigation funders hitting a record high of £1.9bn in 2019. This increases again to £2bn in 2020 despite the difficulty in trying cases during successive lockdowns.

Figure 7: Total assets at UK litigation funders reached a record £1.9bn last year (Source: RPC)



The growth in this marketplace means that there is strong competition for suitable claims and, as a result, funders are looking to initiate cases from scratch. Economic downturns tend to see a rise in litigation which will be a new source of claims for funders. D&O insurers believe litigation funding will be a significant driver of claims in the next few years.

Final thoughts

The outlook for the D&O insurance market is looking brighter in 2022. Our pricing and market data from 2021 shows the market is in the early stages of transitioning to a softer one, bringing with it more favourable conditions for insureds.

Contributing factors for this include new capacity entering the market in 2021 which is driving greater competition amongst insurers and pricing decreases. Whilst we are still in a challenging D&O market, which includes an evolving claims landscape with a stronger focus on ESG and Covid-related issues, we believe there is indeed 'Light on the Horizon' for D&O purchasers in 2022.

Howden's D&O Team

At Howden, our role is to challenge the market on behalf of clients and be prepared to be challenged by them. Our D&O team has already delivered strong results in early 2022, and with the positive outlook for the year ahead, we are confident of being able to continue to achieve the best terms in the market for our clients.

Howden's D&O team offers the market leverage and expertise to deliver for clients, providing solutions to what can seem to be insurmountable issues. Our team advises on the specific coverage limitations and implications and then engages with insurers who are willing to specifically underwrite policies we present.

If you are looking to discuss your D&O requirements, or for competitive prices and expert advice, please get in contact with one of the authors.

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