



 Insurance
Reinsurance

Underwriting Directors & Officers Insurance...



...what's the right price?
D&O White Paper

Produced by the Management Liability team at AXA XL, a division of AXA.

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Introduction

The international D&O claims environment has become more difficult for both insurers and insureds over the past five years, and there is a clear gap between current pricing and the heightened level of risk that has emerged.

This white paper is a continuation of a series of white papers focusing on directors & officers (D&O) insurance. The two previous white papers specifically examined the history, legislative evolution and pricing sustainability of the Australian D&O insurance market. The theme of pricing sustainability they outlined is a sentiment that now echoes throughout the current global D&O marketplace and is the context for this white paper, in which we:

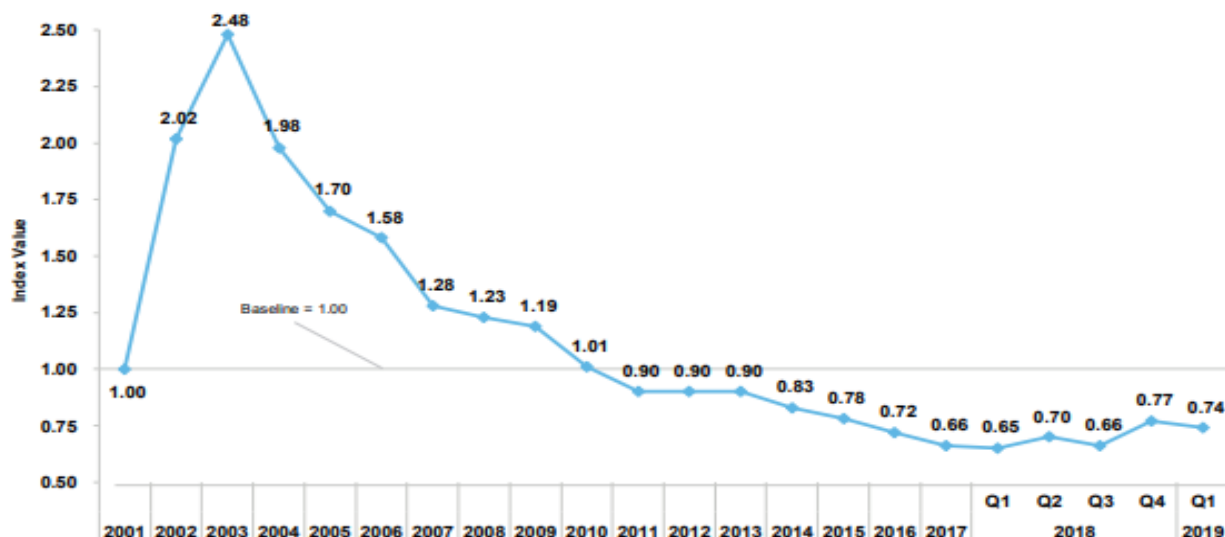
- (i) explore the known issue of the **US landscape**;
- (ii) acknowledge the continuation of the **Australian market** class action and regulatory culture;
- (iii) point to the effects of **social inflation** and a general market-wide uptick in governance actions against companies and their directors; and
- (iv) focus on the identifiable intermittent volatility present in the risk exposure of **global institutions**.

Within this paper, we openly share some of our own experiences and perspectives on market trends and consider what the future might hold.

Pricing deterioration

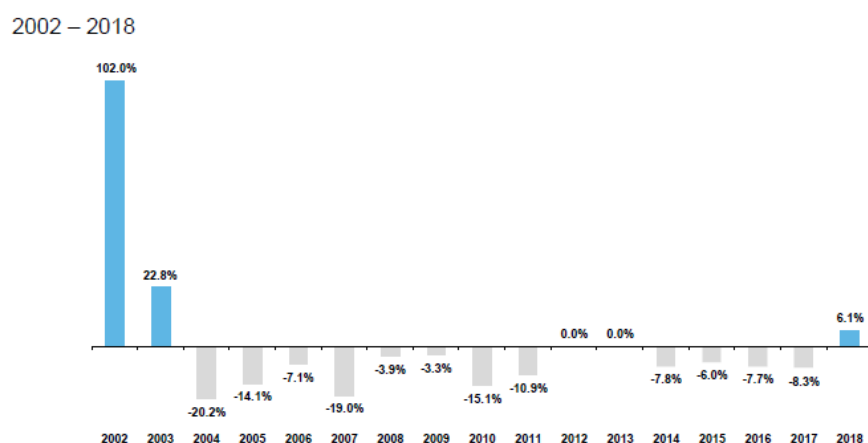
As illustrated in Aon's *Quarterly D&O Pricing Index*, until relatively recently, global D&O pricing showed a consistent and prolonged decline and compound rate reduction, except for Australia, which has experienced a notable increase in rate in recent years. The rise in 2002 can be considered a one-off year, coming off the back of a very low base prior to this.

Table 1 : Quarterly D&O Pricing Index 2001-2019



Source: Aon - Quarterly D&O Pricing Index Q2 2019

Table 2 : Annual year-on-year price changes



Source: Aon - Quarterly D&O Pricing Index Q2 2019

Other market commentaries, such as Marsh's regional indexing, indicate that this decline in the D&O pricing environment was more severe in the international marketplace than it was in the US – and this does indeed correlate with our own experience. With this in mind, we undertook a deep-dive exercise into our own international portfolio in 2017.

The results of this exercise, overlaid with the dynamics of the macro environment, indicated that two particular profiles were requiring significant remediation:

- Australian-listed D&O (particularly Side-C coverage); and
- international companies with all or part of their securities issued/listed in the US.

Through further profiling and segmentation of our portfolio by size, we also noticed claims deterioration relating to global and large institutions with multibillion-dollar or euro revenues.

Since this 2017 deep-dive exercise, our continued risk profiling and analysis has brought us to the conclusion that there has been a global D&O claims deterioration, across all profiles of client. This has been compounded by:

- prolonged pricing deterioration;
- broadening regulatory and social inflation effects;
- the fragility of the global economy;
- new and emerging risks transitioning into D&O claims; and
- policy coverage expansion.

While this general deterioration has occurred, we have made the following notable observations:

- US exposures remain a key contributor to large and frequent D&O settlements;
- Australia exposures continue unabated; and
- there is a trend towards pronounced volatility in the large or global institutions client profile, which is not sufficiently offset by an adequate premium pool.

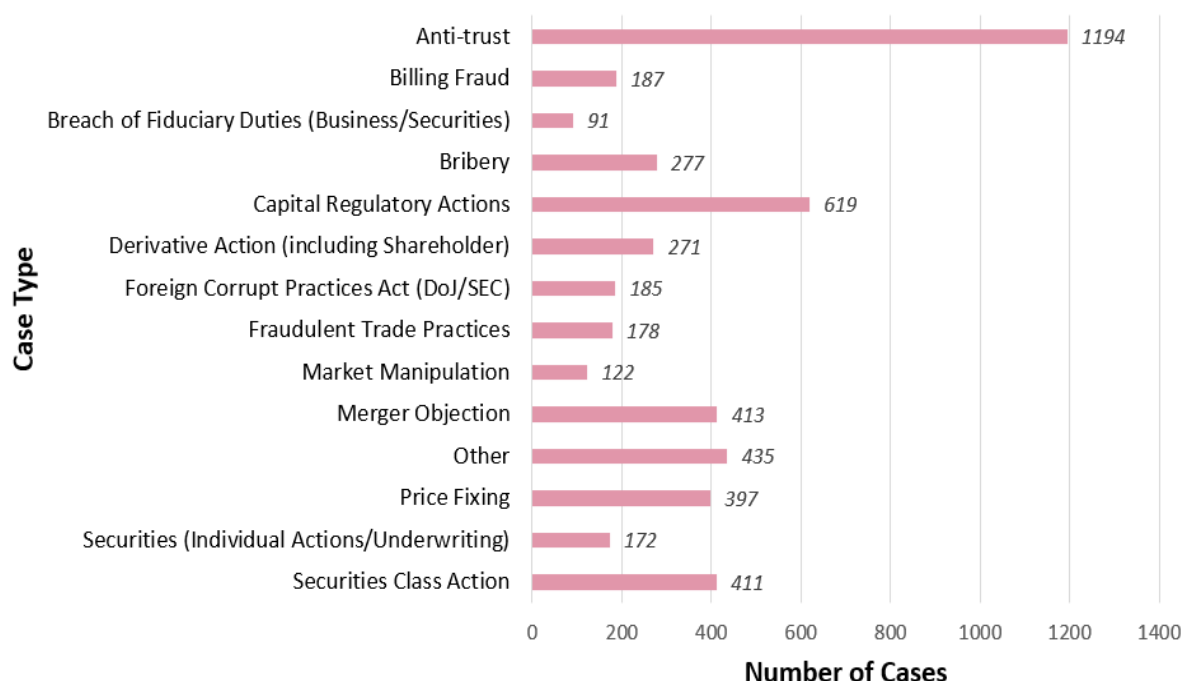
All the above have led to the net effect of a wave of consecutive deterioration and unsustainable insurer returns.

We will now examine each of these observations in more detail.

Social inflation – international D&O claims deterioration

What's driving international D&O claims deterioration?

Table 3 : Number of cases (2000-2018)



Source: AXA XL and Advisen: Our analysis on this question incorporated a blend of: a) internal AXA XL data; and b) an external (UK and European) dataset provided by Advisen. The latter records 'litigation cases' against companies. It is important to note that not all litigation cases are necessarily actual D&O claims, but on inspection of the specific litigation cases and the trend of case type, it was clearly evident to see the prominent involvement and probable reliance on D&O insurance¹.

As Table 3 illustrates, our analysis found that there is a broad blanket of D&O litigation to which directors are now exposed, dispelling the historical misconception that directors are only truly exposed to US securities claims.

Monopolising markets and restricting competition have been common themes surrounding many industries; therefore it is no surprise to see anti-trust cases still prevalent some time after the global financial crisis.

Anti-trust, bribery and price-fixing were found to be widespread. There was a wide range of investigations and fines relating to foreign exchange price-fixing investigations, drug companies' settlements relating to the inappropriate acquisition of rights to the development of a competing drug, and many other cases. Security class actions (SCAs) against UK and European companies were frequent, having increased in recent years, with significant implications for the international D&O market.

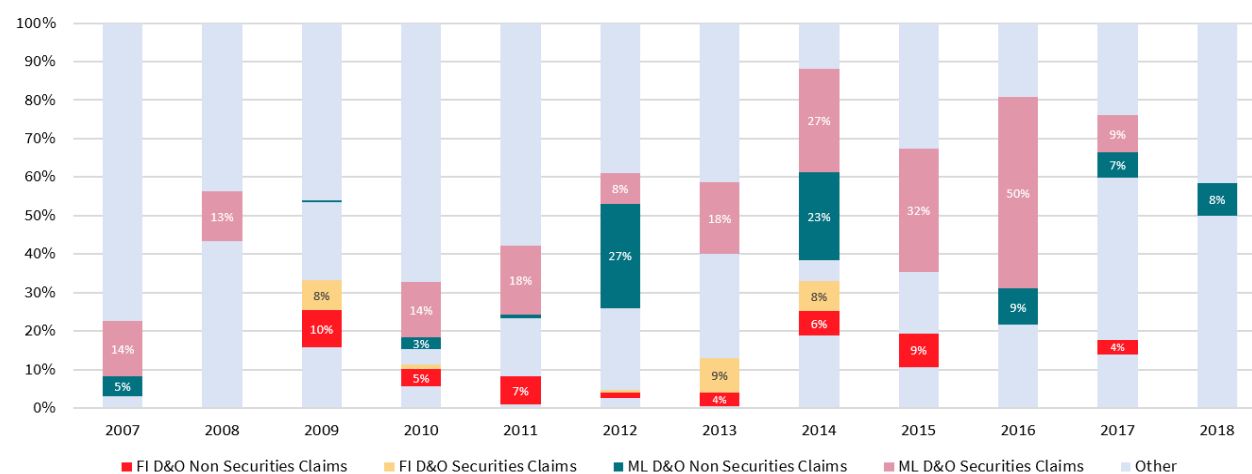
The AXA XL portfolio's historical claims data is reflective of this trend, with a notable shift across our entire Financial Lines² portfolio towards a prominence of D&O volume and frequency, as indicated in Table 4. It is important to note that it takes notified D&O claims a minimum of three years, and often longer, to develop into incurred reserves on an insurer's balance sheet. So, we would consider that, for 2017 and 2018 at least,

¹ For the majority of these cases, it would only take the naming of a director or officer of the company for coverage under a D&O policy to be triggered.

² AXA XL International Financial Lines writes Management Liability (Directors & Officers/Employment Practice/Pension Trustee/Crime); Professional Indemnity; Cyber; Financial Institutions and Warranty & Indemnity Insurance.

it is still possible for the notified claims to develop the appropriate reserves.

Table 4 : Segment incurred as a proportion (%) of total financial lines incurred by year (highlighting D&O)



Source: AXA XL

Regulatory activity

The US Department of Justice, the US Securities and Exchange Commission (SEC) and the UK Serious Fraud Office (SFO) have all been highly active in enforcing regulation – such as the Foreign Corrupt Practices Act (FCPA) – and investigating companies for potential breaches of bribery or anti-competition laws. The SEC regularly publishes its enforcement data³, and many international companies appear on the list of enforcement actions for 2017, 2018 and 2019, including Telefonica Brasil S.A. (Brazil); Barclays (UK); Credit Suisse Group AG (Switzerland), Mobile Telesystems PJSC (Russia); Fresenius Medical Care AG & Co (Germany); Petroleo Brasileiro S.A (Brazil); Elbit Imaging (Israel); Panasonic (Japan); Sanofi (France); Kinross Gold (Canada); and Telia (Sweden). Some of these FCPA actions include significant violation settlements, sometimes worth hundreds of millions of dollars. While the fine may not necessarily be picked up by the D&O policy, the associated securities claim, the derivative claim and legal defence costs might well be.

The length of the investigation, as well as the global scope and number of insured persons being interviewed and investigated, has certainly had a bearing on the quantum of losses experienced. At least half a dozen companies have recently suffered losses to the D&O tower in excess of US\$75 million for investigation costs alone. This is before any subsequent derivative claims or other civil or criminal actions have been filed.

The increased funding levels of regulators has provided them with added resources and determination to enforce regulations. The SEC established the Division of Enforcement to further enhance its enforcement of the FCPA. Additionally, one of the outputs of the Royal Commission in Australia was a more robustly funded regulatory enforcement regime.

Regulators may next turn their focus to climate change accountability. Through the Senior Managers and Certification Regime, which is applicable to certain financial institutions, the Prudential Regulation Authority in the UK imposed a deadline of 15 October 2019 for reporting how climate change risks are identified and managed by directors.

Our analysis of the Advisen dataset shows a clear upward trend in the numbers of regulatory and investigative actions taken against companies in Europe and the UK – in particular, against larger organisations.

³ U.S. Securities and Exchange Commission: SEC Enforcement Actions. <https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml>

Third-party litigation funding

Litigation funding is a practice that provides financing to a litigant or group of litigants along with law firms to pursue a lawsuit, in exchange for a portion of any settlement or judgement award. The practice of litigation funding started in Australia and continues to grow, primarily in Australia, the UK and the US. In the US, there is growing pressure for increased transparency and disclosure in court cases. Primary concerns of this practice for defendants and their insurers are:

- increased litigation and claims costs;
- prolonged litigation;
- lack of control of litigation; and
- potential conflicts of interest.

Funders and their motives vary. Increasingly, funding companies operate in a similar way to venture capitalists – seeking and vetting lawsuits with the highest potential return and sometimes in creative ways. The US federal judiciary continues to assess whether courts should require civil cases to disclose third-party financing deals. Pending that resolution, courts remain divided on the disclosure of these arrangements in the US. In Australia, the involvement of third-party litigation funders has had a direct correlation with the rise of SCAs. In response, Australian regulators are looking into class actions, investigating the role of litigation funding and potential considerations for any changes in the rules affecting securities litigation⁴. Interestingly, we have now also started to see this litigation funding trend in the Netherlands.

Collective redress actions in the European Union

The development of class action capability and culture is well publicised. The diesel emissions saga may well have accelerated the class or collective action capability throughout Europe.

While its impact is related to breaches in competition law, the implementation of the Consumer Rights Act (CRA) in 2015, is evidence of a growing appetite for collective action mechanisms in UK law, which allows for collective proceedings and collective actions to be brought by someone who “will fairly and adequately act in the interests of class members” rather than just specified bodies. Furthermore, the previous restriction that a collective action must be a “consumer claim” was removed, therefore allowing businesses to be part of a collective action⁵.

Similarly, German law – for example, by virtue of the 2018 Model Declaratory Action – allows for class or collective actions to a limited extent in certain circumstances. For example, following the emissions saga, German consumer rights group myRight is using its existing platform (which was previously used to claim back compensation for delayed flights) to bundle claims through fiduciary assignment of multiple Volkswagen customers. The users register their vehicle on the myRight website and, if eligible, complete a form to participate. Each single claim myRight handles should, technically, be ruled on by the court individually. In this way, myRight has accumulated the claims of tens of thousands of car owners⁶, and the combined sum in question for both actions now exceeds €1 billion. There are several benefits to filing claims in this way, one of which is reduced costs. Thousands of individual claims would incur millions of euros in court fees, whereas one complaint costs a fraction of that.

The Netherlands has one of the most prominent class or collective settlements proceedings forums in Europe. So far, nine class settlement agreements have been successfully declared binding since the Act on

⁴ Australian Law Reform Commission. *Integrity, Fairness and Efficiency—An Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (ALRC Report 134), January 2019, available at <https://www.alrc.gov.au/publication/integrity-fairness-and-efficiency-an-inquiry-into-class-action-proceedings-and-third-party-litigation-funders-alrc-report-134/>

⁵ Legislation.gov.uk. Consumer Rights Act. <http://www.legislation.gov.uk/ukpga/2015/15/contents/enacted>

⁶ Bälz, H. ‘Recent class actions law developments in Germany’, October 2019, available at https://www.google.co.uk/search?newwindow=1&safe=active&sxsrf=ACYBGNT9gip7jUb6ezyf1bFTH9kwUJzg5g%3A1572789597746&ei=Xd2-XemdLdCU1fAP0cGyUA&q=german+class+action+myright&oq=german+class+action+myright&gs_l=psy-ab.3...377316.378793..379733...0.0..0.417.1823.0j6j0j1j1.....0....1..gws-wiz.....0i22i30j33i22i29i30j33i160.hUGfVJ7G04&ved=0ahUKEwipwJ7qmc7lAhVQShUIHdGgDAoQ4dUDCAo&uact=5#spf=1572789979648

the Collective Settlement of Mass Damage (Wet Collectieve Afwikkeling Massaschade, or WCAM) came into effect in July 2005 with billions of dollars of compensation awards being made as a result. On 19 March 2019, the Dutch Senate approved a bill that will allow representative entities to seek damages in a collective action, with the expectation that the number of representative collective actions will increase.

The EU has also expressed a growing interest in collective actions, issuing a draft directive on representative actions for the protection of the collective interests of consumers (COM (2018) 184 final). The European Parliament adopted an amended proposal at its first reading on 26 March 2019. The adoption of the draft directive would, after implementation, create a national legal basis for collective redress within the EU. This could lead to an increase in collective actions⁷.

#MeToo

While this white paper does not specifically consider employment practice matters, the #MeToo movement has caused harassment claims to be extended into D&O liability insurance. Employment practices liability (EPL) insurance covers claims brought against an organisation that arise from issues of discrimination and harassment, but recently the claims have gone beyond EPL insurance transcending into D&O insurance. This can occur when the board of an organisation has allegedly acted inappropriately upon harassment allegations. #MeToo and other movements have given individuals greater courage and confidence to challenge unacceptable behaviour within organisations, which is increasing the number of discrimination and harassment claims.

Recessionary threat

Alongside the lingering uncertainty of Brexit remains the fragility of the macro global economy. In its October 2019 forecast, the International Monetary Fund describes the world economic outlook as ‘precarious’, with the potential for a ‘global manufacturing downturn [and] rising trade barriers...’⁸

The correlated effect, as seen in the wake of the 2008 global financial crisis, is the parallel increase in claims against directors and officers. This likely increase in claims could arise from a variety of sources – corporate or financial restructuring, job losses and inevitably insolvency can transcend into D&O claims, sometimes with an associated cost. An example of increased costs is the requirement to post bonds under Spanish legislation, with no guarantee the bond will be recouped. The construction sector has been particularly affected by the economic conditions, with examples including Abengoa in Spain and Carillon in the UK. The retail sector has also been negatively affected by reduced consumer spending, coupled with changing purchasing habits and long leases on costly premises resulting in more than 40,000 staff redundancies in the UK⁹ at UK companies such as House of Fraser, Debenhams and BHS. As Thomas Cook recently learnt, more than 100 years of operational heritage and brand is no protection against creditor demands. The fragility of the economy and the impact on industry groups, the property market and investment portfolios is likely to be increasingly high on the agenda of both company directors and their insurers.

Reserving adequacy

Finally, we should also touch upon reserving adequacy. In a recent letter¹⁰ to chief executives of general insurance firms, Gareth Truran, Acting Director, Insurance Supervision at the Prudential Regulation Authority (PRA), outlined the regulator’s priorities for the forthcoming year, citing concerns about reserve adequacy, reserving governance and controls, and even “anecdotal concern that commercial pressure from management to deliver improved results”. The letter also made reference to financial and professional lines, where they are seeing “increasing areas of emerging risk”.

⁷ Knigge, A & Wijnberg, I. *Class/collective actions in The Netherlands: overview*, June 2019., available at [https://uk.practicallaw.thomsonreuters.com/6-618-0285?transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/6-618-0285?transitionType=Default&contextData=(sc.Default)).

⁸ International Monetary Fund, *World Economic Outlook Reports*, available at <https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019>.

⁹ Centre for Retail Research. ‘Who’s Gone Bust in Retail?’ available at <https://www.retailresearch.org/whos-gone-bust-retail.html>.

¹⁰ Truran, G. Bank of England, ‘Prudential Regulation Authority letter dated 5 November 2019, available at <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms.pdf?la=en&hash=8E5ED1FB3B6AD154D8E76504C4C6579A42015396>.

The conclusions to the letter imply that the general insurance industry did not always make realistic reserving assumptions in business planning; was not always quick enough to identify key trends and communicate about them; and neglected to understand the importance of data. Whether the industry got it wrong is a discussion the PRA needs to have with the chief executives, but it shows the importance of future reserving considerations for insurers to deliver sustainable relationships with their policyholders and the desired return on equity for shareholders.

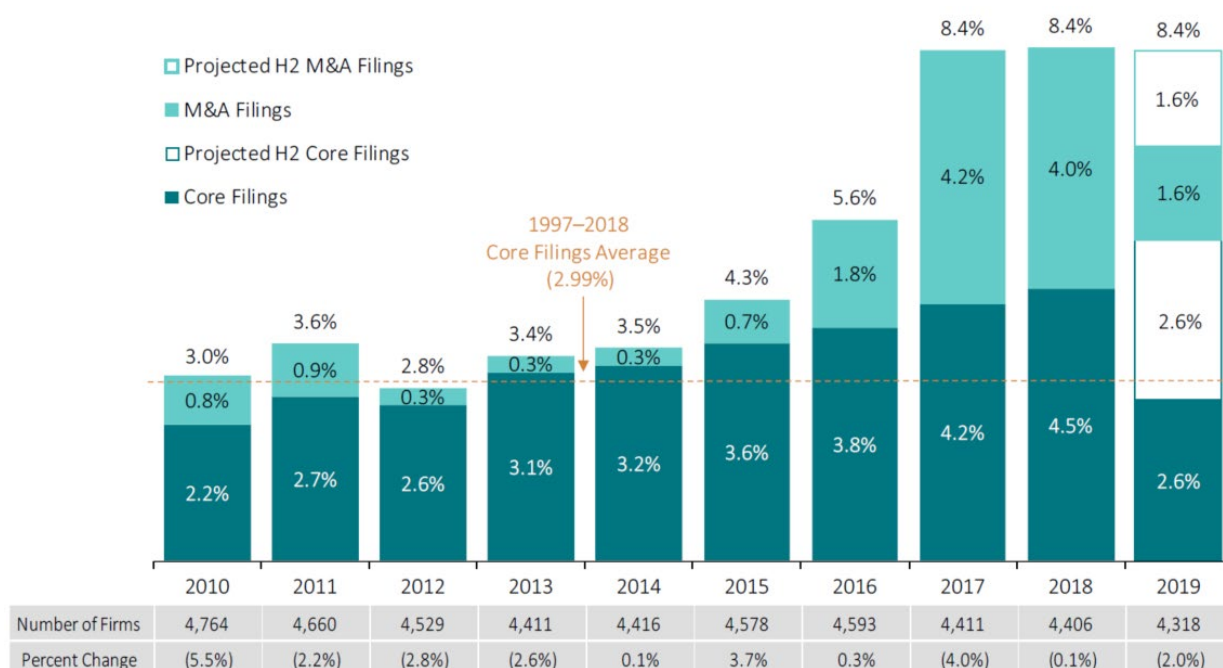
US exposures remain a key contributor to the D&O claims landscape

D&O claims arising from US exposures, particularly SCAs, have for a long time been a major source of exposure for companies and their directors. Below, we briefly review the current US exposures:

State jurisdiction is changing the landscape

Aside from 2001, US Federal and State SCAs are at an all-time high and are likely to remain at an elevated level in the coming years. This has been driven by several factors, including the fact that merger objection suits – which had until recently been brought in the Delaware Court of Chancery – have moved to the federal courts (mainly 2nd and 3rd circuit) due to several negative rulings against plaintiffs. These merger objection suits now account for around half of all federal class action lawsuits between 2016 and 2018¹¹. It is fair to say that almost all mergers or acquisitions involving at least one US-traded entity, will result in a federal SCA being filed. Although they tend to resolve in disclosure only settlements, these cases can come at a cost to the primary D&O layer through legal costs alone, if the self-insured retentions are not set at appropriate levels. Taking merger objection suits to one side, the number of core SCA filings are around 55% higher than the 10-year average¹². There were 4,406 US-traded companies in 2018. The frequency of federal SCA lawsuits doubled from 4.2% in 2014 to 8.4% in 2017 and has remained at a similar level in 2019. Even if merger objection suits are removed, the core filings still represent over 5.6%, a trend expected to continue for the rest of 2019. Prevailing rates for primary D&O in the international financial lines markets as at Q4 2017 were roughly one eighth of this on average, or one tenth of the total, including merger objection activity. The fact that class action dismissal rates are at record highs (46% for 2017 and 49% during H1 2018) does mitigate this to some extent. However, defence costs for a successful motion to dismiss average US\$1 million, which typically exceeded self-insured retention levels in 2017¹³.

Table 5 : Percentage of US listed companies subject to a filing 2010 – 2019 H1



Source: Cornerstone Research: Securities Class Action Filings: 2019 Midyear Assessment.

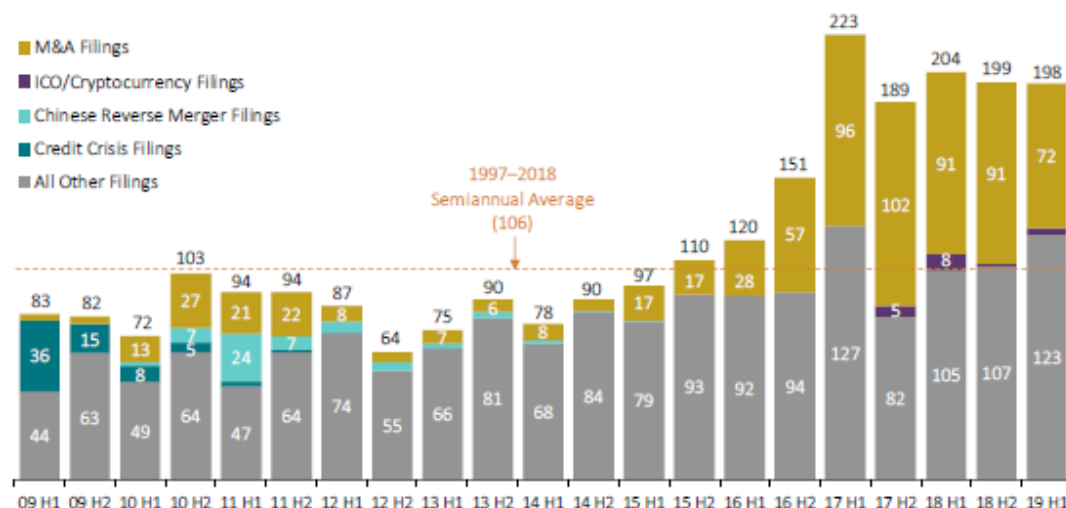
¹¹ Cornerstone Research: Securities Class Action Filings: 2019 Midyear Assessment, available at <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2019-Midyear-Assessment>.

¹² Ibid.

¹³ Ibid.

Plaintiffs continued the rapid pace of securities fraud case filings in the first half of 2019, with 198 new federal class actions. According to the report, *Securities Class Action Filings - 2019 Midyear Assessment*, released by Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, plaintiffs have filed more than 1,000 SCAs in the last two and a half years, accounting for more than 20% of the total number of cases filed since 1997.

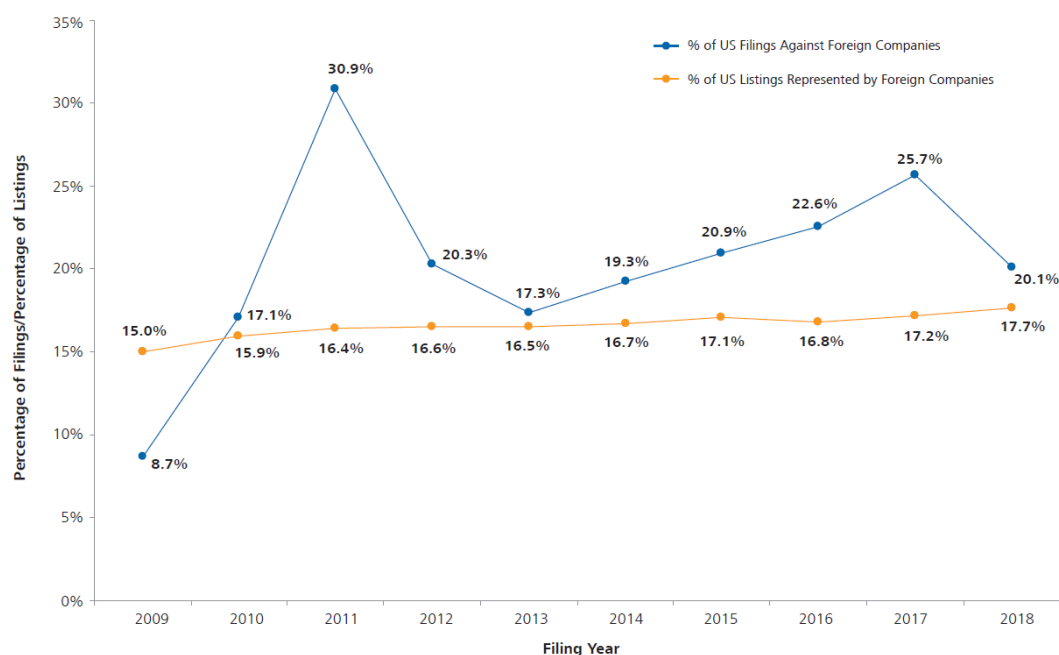
Table 6 : Biannual number of class action filings 2009 H1 – 2019 H1



Source: Cornerstone Research: *Securities Class Action Filings: 2019 Midyear Assessment*.

Since 2016, the historical trend for a lower frequency of US SCA lawsuits being filed against foreign issuers compared to domestic issuers has also reversed. While 17.1% of the companies listed on US exchanges were registered outside the US in 2017, they accounted for 25.5% of the SCA activity that year¹⁴.

Table 7: Annual number of class action filings by location of headquarters – core filings 2010-2019 H1

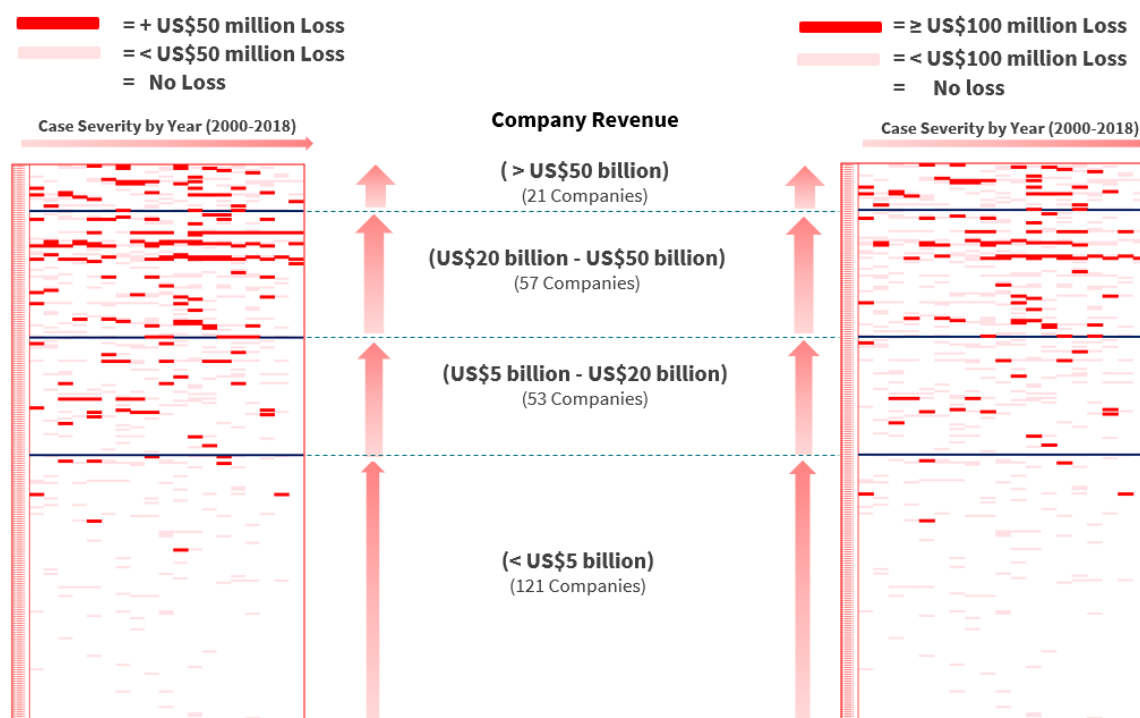


Source: NERA. *Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review*, by Boettrich, S. and Straykh, S. January 2019.

¹⁴ Ibid.

The financial severity that is seen in the Stanford Securities data is mirrored in our analysis of the Advisen dataset. This can be seen in Table 8 below, which analyses loss cases with settlements in excess of US\$50 million, and US\$100 million for foreign entities that have incurred US securities cases.

Table 8 : Severity of US loss cases



Source: AXA XL and Advisen

China

In recent years, filings against Chinese companies have been of particular concern. These claims arose from reverse takeover transactions or structures, where a Chinese company would take over a dormant or moribund listed company to obtain a listing without going through the IPO process. After a brief lull in the number of actions in 2016 (4), they were back up to highs of 13 shareholder class actions in 2017, suggesting a 10% frequency of SCA for Chinese companies.

Emergent law firms

Another factor affecting the frequency of SCAs is the emergence of a second and third tier of US plaintiff firms. These came about following the global financial crisis, when some of the major white shoe firms were heavily occupied with larger cases, which created a bottleneck of cases for new entrant firms to litigate. As the glut of cases dried up, these emergent law firms started to compete for a smaller pool of strong cases. They now work tirelessly to put together class actions on sight of a stock drop, or any hint of misstatement in company disclosures. This has led to a higher frequency of SCAs, but also a deterioration in the quality of cases being brought, which has also contributed to the historically high rates of dismissal (49% in H1 2018 compared to 47% in 2019).

It has had a marked effect on the US securities litigation environment for smaller companies. Historically, the plaintiff bar has been generally preoccupied with filing claims against companies with higher US-traded market capitalisations perceived to have deep pockets, and where a payout would be sufficient to warrant litigation. The frequency of SCAs against small and micro-cap companies has risen drastically, which has caused a misalignment between the costs of defending and settling these claims and the premiums

associated with this segment. The fact that class actions against these companies are disproportionately dismissed does little to mitigate the impact on primary insurers. This is because prevailing soft market conditions have eroded self-insured retentions to a level where defence costs, even to the point of motion to dismiss, are being borne by the D&O insurance programme.

Foreign companies are not immune to this environment, and it is worth noting that filings against European firms increased by 63% in the second half of 2019, relative to the same period in 2018.

Rising defence costs

It is worth noting that as the frequency of class action lawsuits has increased, so too have US defence attorney rates, further eroding D&O policy limits and increasing the burden on insurers' margins for this class. Hourly rates, which only a few years ago tended to average around US\$700 per hour, are now frequently in excess of US\$1,500 per hour, with a few exceptional examples at US\$2,000 per hour. Circumstances that would have previously been contained within the retentions have significantly impacted the primary layer limits, leading to further questions around the adequacy of both pricing and retention levels.

Cyan

Of more recent concern is a ruling in the US Supreme Court in the case of Cyan Inc vs Beaver County Employees Retirement Fund (20 March 2018) that complaints alleging breaches of sections 11 and 12(a) of the 1933 Securities Act cannot be removed from state court jurisdiction. Historically, these could be brought in either federal or state courts, but defence lawyers were often successful in removing these from state courts to federal courts by consolidating the complaints, especially where there was also a 10(b) claim under the 1934 Securities Act.

This complicates the securities litigation process in several ways and has the potential to significantly impact D&O policies. The outcomes of complaints litigated in federal courts have become more predictable over time as case law has developed and judges have many more years of experience in dealing with securities claims. State courts add a new dimension of uncertainty, as the judges will not have dealt with anything like the volume of securities litigation seen in federal courts and may be moved to hear cases which would otherwise be summarily dismissed by the federal judiciary, or award significantly higher damages than those awarded by circuit judges. This could result in additional pressure on defendants to make early settlement of claims which might otherwise have been dismissed, or the risk of bearing high legal costs. The defence of these cases in state courts is likely to be challenging and costly, with low dismissal rates for California state court cases, for example, and less favourable outcomes for defendants generally. A re-evaluation of risk is therefore required for companies about to undertake initial public offerings, or for those that regularly raise capital from the issuance of shares on US exchanges.

American depositary receipts: case study - Morrison vs National Australia Bank (June 2010)

Another complication with regards to US jurisdiction has arisen around SCAs involving companies with shares traded over-the-counter in the form of American depositary receipts. These sponsored ADR1 programmes were expected to be beyond the reach of US securities laws due to the US Supreme Court's judgement in Morrison vs National Australia Bank (June 2010), which ruled that US securities laws only apply to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities". However, several recent high-profile SCA complaints against such companies have survived motion to dismiss and found jurisdiction in US courts on the grounds that the companies filed an F6 registration (a requirement of sponsored ADR programmes). Having complied with other SEC regulatory requirements, the ADRs were found to have sufficient connection to the US. This brings into question the prevailing underwriting considerations and insurance rates for such companies, as historically they have attracted fractions of the premiums associated with companies with exposure to US securities laws. Insurers continue to watch court judgements as this area evolves.

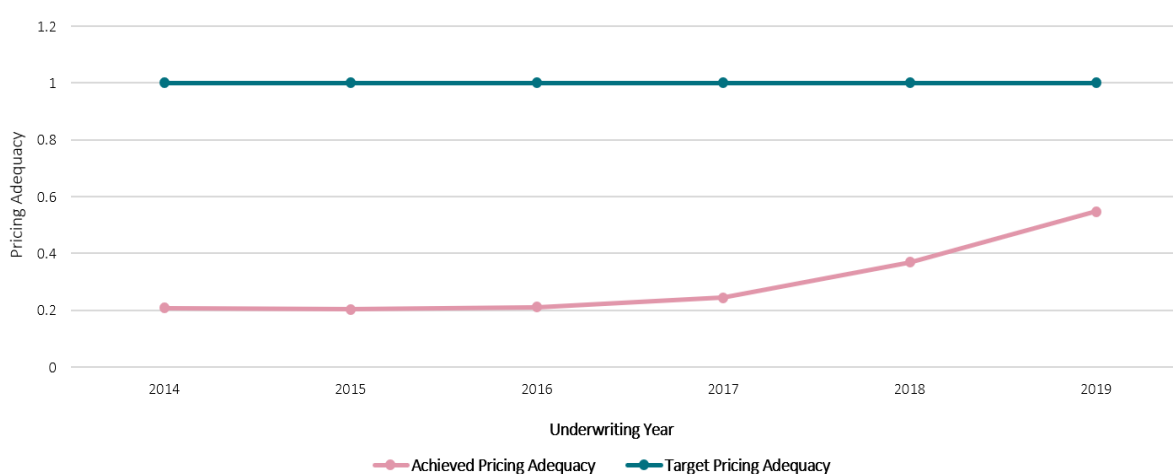
US pricing environment

It is now broadly understood that the international D&O market, in writing D&O US risks:

- underestimated the exposures due to an underrepresentation of foreign filers in overall filings historically;
- underestimated the rapid evolution of costs associated; and
- had a significant pricing gap compared to US D&O carriers, even though the exposures were ostensibly the same.

AXA XL's own international D&O portfolio experience is testament to this thesis. If we chart the actual adequacy of D&O pricing across our US-listed D&O portfolio, we can clearly see that the premium charged for these risks is clearly below the required "adequate" pricing required for a sustainable return.

Table 9 : AXA XL US-listed pricing adequacy



Source: AXA XL. Definition of Pricing Adequacy: Pricing adequacy of 100% demonstrates the pricing required of a piece of business to achieve its required return on equity, a Pricing Adequacy of less than 100% highlights that the piece of business isn't achieving its required return on equity.

To ensure sustainability and commitment as a primary insurer carrier, since 2016/17 we have clearly communicated to our brokers and clients the need for corrective remedial action specifically to ensure pricing parity with US markets for this type of risk exposure.

We are strongly advocating that the following two elements are required for us to maintain our continued commitment to foreign entities with US securities exposures:

- The management of policy limits to levels of less than US\$15 million on any one risk, and averaging US\$ 10 million over the whole portfolio segment (this will manage the volatility inherent in this portfolio segment); and
- The ensuring of pricing adequacy, on a sustainable basis.

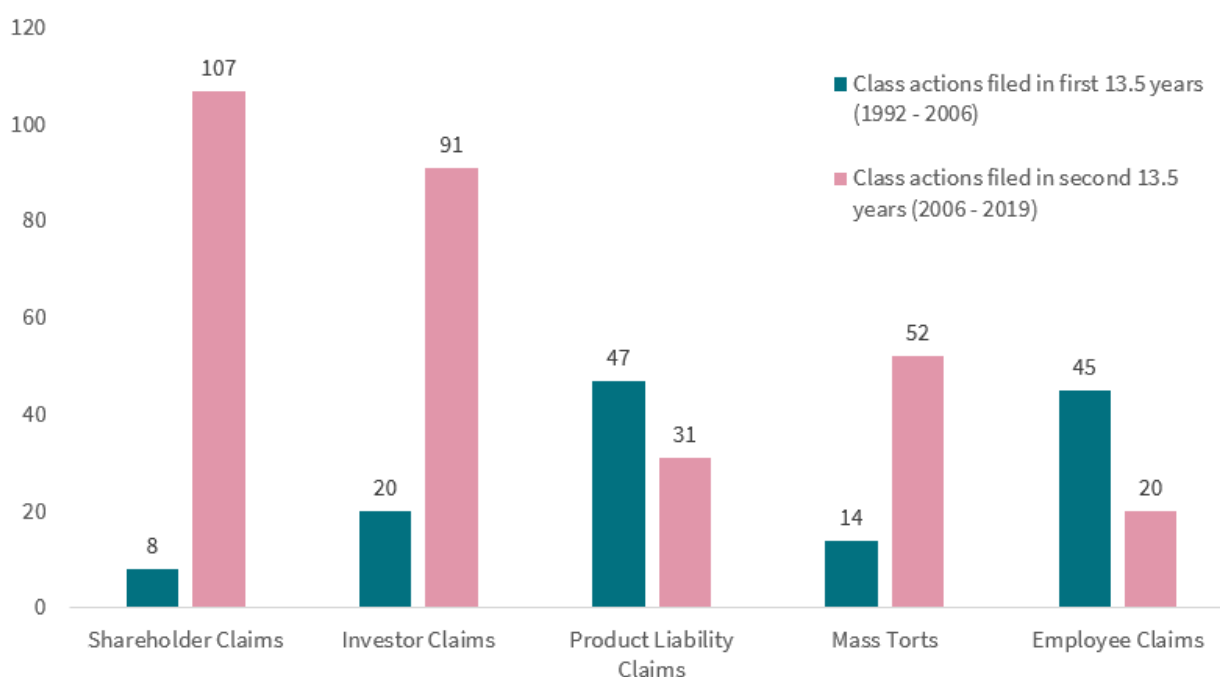
Both are elements we collectively refer to as "right price" underwriting.

Australian exposures continue unabated

In the previous white papers in this series, we explored the impact of SCAs on the Australian D&O liability insurance market. Major insurance carriers – both locally or through London wholesale capacity – have either withdrawn or significantly retrenched their capacity for Australian risks. The Australian D&O environment has fundamentally shifted in the past 15 years, with the result that:

The total value of D&O insurer contributions to SCA settlements since 1999 [to 2016] is estimated to be more than AU\$1 billion¹⁵.

Table 10 : Australian class actions 1992-2019



Source: Prof. Vince Morabito, *Empirical Perspectives on 27 Years of Class actions in Australia*

Our analysis indicates that the estimated total historical settlements for SCAs in Australia have totalled AU\$1.8 billion plus defence costs.

The increasing trend in the number of SCAs continued in 2018 and 2019, putting them under the spotlight of the Australian Law Reform Commission (ALRC). AMP, BHP, Brambles, Commonwealth Bank of Australia, GetSwift, Lendlease, Quintis, RCR Tomlinson, Vocus Group and Woolworths have all been the recipients of shareholder claims in 2017 and 2018.

Although not a SCA, we can see the global reach of litigation in the Volkswagen case, in which a ‘without admission of liability’ settlement has been reached for AU\$87 million, to be made available to Australian motorists. This figure could rise to AU\$127 million plus costs, depending on the size of the claimant group¹⁶.

Why are the results so bad? The increasing trend in frequency of SCAs is clearly illustrated in Table 11 below. The historical average settlement for SCAs is AU\$48 million, plus defence costs.

¹⁵ XL Catlin. ‘Show me the money! The impact of securities class actions on the Australian D&O Liability insurance market’ by McKay, E, 2017, available at <https://axaxl.com/fast-fast-forward/articles/show-me-the-money-the-impact-of-securities-class-actions-on-the-australian-d-and-o-liability-insurance-market>.

¹⁶ Maurice Brown Lawyers. ‘Volkswagen, Audi, Skoda class actions’, available at <https://www.mauriceblackburn.com.au/class-actions/current-class-actions/volkswagen-class-action/>.

Table 11 : Frequency of SCAs in Australia 1999-2018

Source: AXA XL

This has meant that the average frequency of SCAs has notably increased.

Table 12 : Average frequency of SCAs in Australia between 1999-2018

Period	Average Frequency
Overall – since 1999	4.0
Pre 2011	1.8
2011 onwards	7.3
2013 onwards	8.3
Last 3 years	10.7

Source: AXA XL

Our observations are that:

- the average consolidated frequency of SCAs in the past three years (2016- 18) is;
 - 29% higher than the previous three years (2013-15),
 - well over double the long-term average (1999 onwards), and
 - more than five times the pre-2011 average,
- the proportion of matters discontinued or struck out has reduced to fewer than 10%.

The next layer fuelling the Australian D&O claims environment has been the Royal Commission Inquiry. In December 2017, the Australian Governor General established a long-awaited *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*. This highest form of public inquiry was a response to the mounting public and political pressure following a decade of scandals surrounding Australian financial institutions and *ad hoc* regulatory interventions. As a result of falls in share prices following the Commission's revelations, multiple SCAs have been launched against various financial institutions, and some consolidated.

Market vectors

So, where to now? We anticipate that the current market dynamics will continue to drive up rates. Our latest analysis suggests that:

- the Australian D&O market premium pool needs to quadruple on 2016 levels to ensure reasonable profitability for insurers;
- rates are not there yet, especially for larger market capitalised companies;
- the future drivers of deteriorating risk environment for D&O include;
 - the introduction of contingency fees as recommended by the ALRC, which is likely to change the economics of SCA litigation against smaller market cap companies,
 - more aggressive regulators following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, and
 - increased exposure to cyber and climate risk and consumer and shareholder activism, among others.

There is little evidence to suggest that the developing SCA environment is a claims spike. It is also very likely that the current hard market conditions will continue for some time.

Globalisation and global institutions

Intermittent volatility

A global or large institution with a multibillion-dollar or euro turnover typically has:

- a complex organisational structure;
- a multi-jurisdictional presence; and
- a prominent public profile.

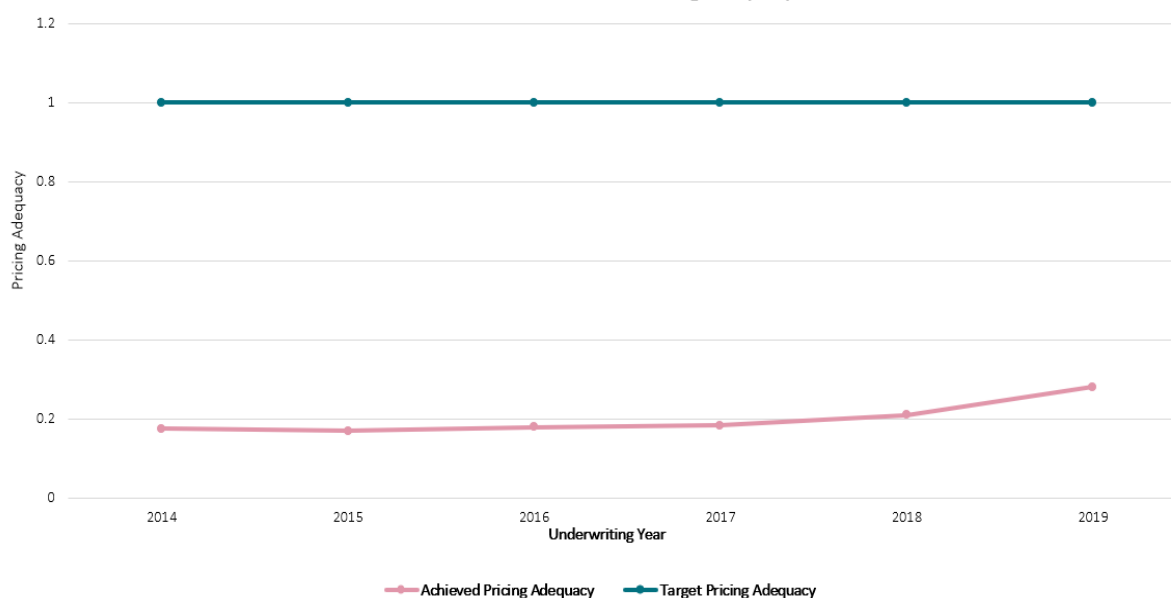
These traits typically escalate with size and scale.

While there should always be an appreciation of the individual risk characteristics, it remains clear from our analysis that a large or global institution is more exposed than a smaller organisation. There is an enhanced risk associated with size, scale, complexity and profile that can be mitigated – but not eradicated – through individual account underwriting.

The result is that we can identify a trend of intermittent volatility to this segment of the D&O market, where years of profitable and sometimes claims-free performance (especially on an excess layer placement participation) could be followed by a severe loss. This is evident in the early period of our study, but not quite as pronounced in the latter period, which is less intermittent and more consistent.

If we examine AXA XL's large and global institutions from our international D&O portfolio and chart the adequacy of D&O pricing across these institutions, the premium charged for these risks is well below the "adequate" pricing required for a sustainable return. Indeed, the gap between the "adequate" price and the market price is greater than for the US-listed entities.

Table 13 : AXA XL global institutions' pricing adequacy



Source: AXA XL

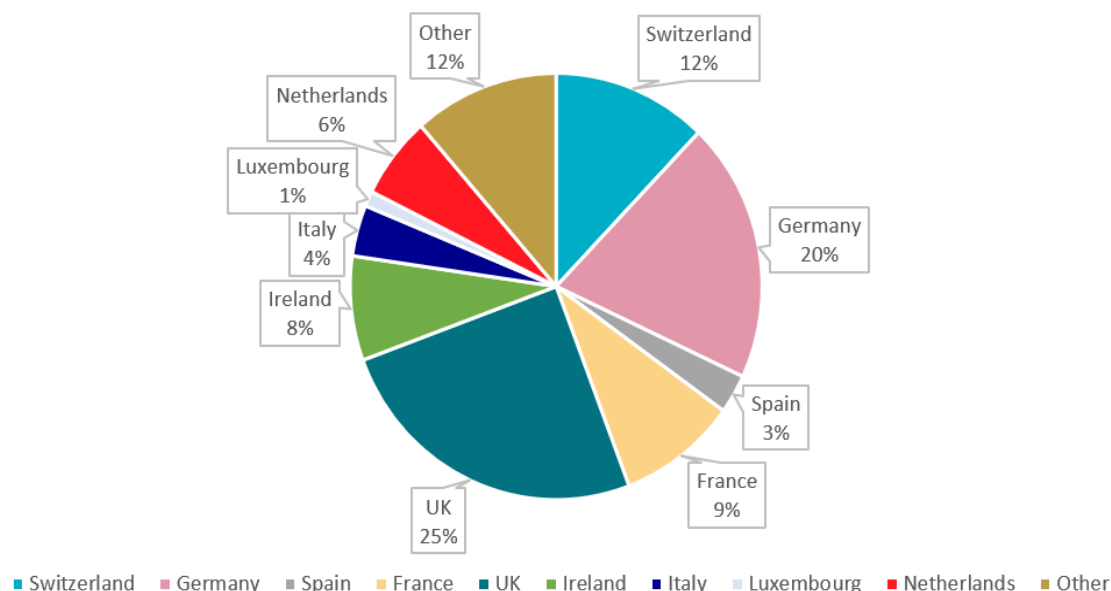
Country and industry agnostic

From our analysis of the AXA XL portfolio and Advisen dataset, we concluded that:

- the intermittent volatility gravitates to more developed international economies, but the issue is **country agnostic**; and
- the intermittent volatility gravitates toward certain industries, but the issue is **industry agnostic**.

The chart below reveals the countries worst affected and shows that parent companies from the UK and Germany were subject to almost half of the loss cases in the Advisen dataset over the 2000-2018 period. However, no correlation was found between particular industries and an increased likelihood of cases.

Table 14 : Total loss cases for UK and European parent companies



Source: Advisen

This is also reflected in industry statistical data. For example, according to the German Insurance Association, the predicted loss ratios in Germany were 99.1%, 85.3% and 112.9% respectively, for the 2016, 2017 and 2018 years of account¹⁷.

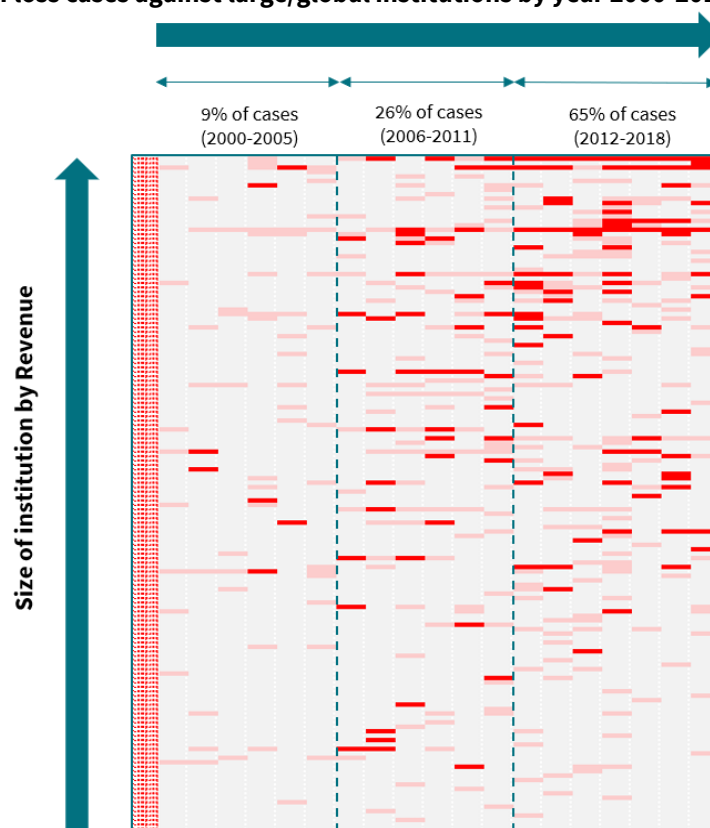
Size and time correlation

There is, however, a notable correlation between the size of a company and the increased likelihood of a case being brought against it. Our analysis of the Advisen dataset shows that the majority of these cases have been against larger companies, demonstrating a strong correlation between company size and the number of loss cases.

In the infancy of D&O insurance, the barometer for risk analysis centred around US exposures, specifically US securities. As we saw in the section *Social inflation – and international D&O claims deterioration*, this is no longer the sole measure, and the trends described are now appearing in the global company segment. Regulators are increasingly holding large and global organisations to higher levels of account.

¹⁷ German Insurance Association. *Directors and Officers (D&O): Contributions, benefits and loss ratios*, available at <https://www.gdv.de/de/zahlen-und-fakten/versicherungsbereiche/directors-and-officers--d-o--36526#BeitraegeLeistung>.

Table 15 : Number of loss cases against large/global institutions by year 2000-2018



Source: Advisen. To test the thesis that larger companies experience a higher frequency of loss cases, we mapped out all UK and European litigation cases recorded by Advisen against institutions with a turnover of >US\$10 billion. Size of institution is mapped along the y-axis with time across the x-axis and our analysis points to a significant increase in the number of cases in recent years, with two thirds of the sample occurring in the past six years. This is a notable trend for these large and global organisations.

The increase in loss cases against large or global organisations in recent years is evident in most European countries. Table 15 above shows how the majority of the 21st century cases have occurred in the past six years, and the table below highlights that this trend is country agnostic.

Table 16 : Percentage of loss cases by country

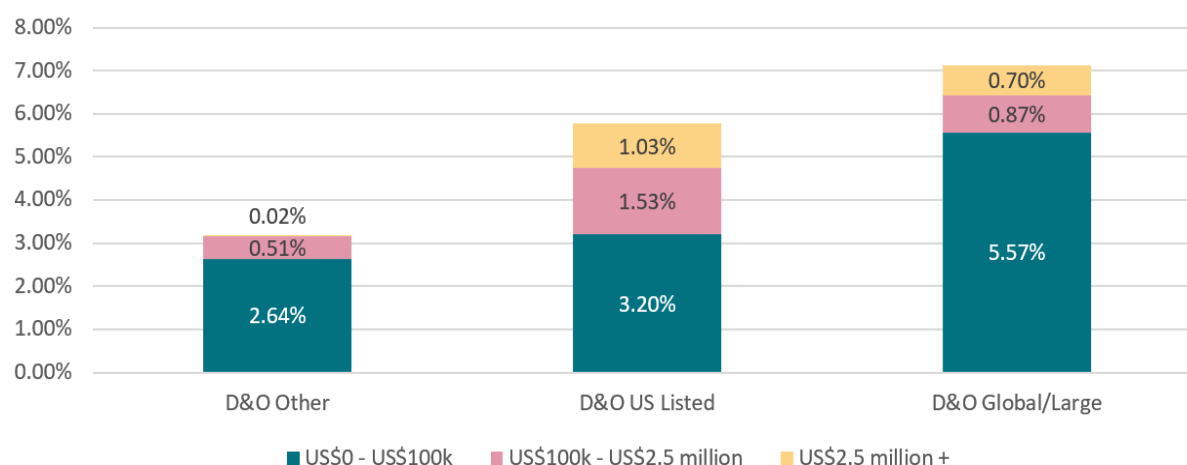
Country	2000-2005	2006-2011	2012-2018	Total Number of Cases
Other	14%	35%	51%	65
Switzerland	18%	26%	56%	34
Germany	6%	17%	76%	383
Spain	0%	26%	74%	23
France	11%	29%	60%	176
UK	9%	46%	45%	74
Italy	21%	25%	54%	28
Netherlands	11%	31%	58%	71

* Other is made up of 29 European Countries.

Source: Advisen

The trend seen in the Advisen dataset is also reflected in our own portfolio claims frequency data, where the global institutions exhibit a much higher frequency of claims notified per policy, even in comparison with the US securities profile.

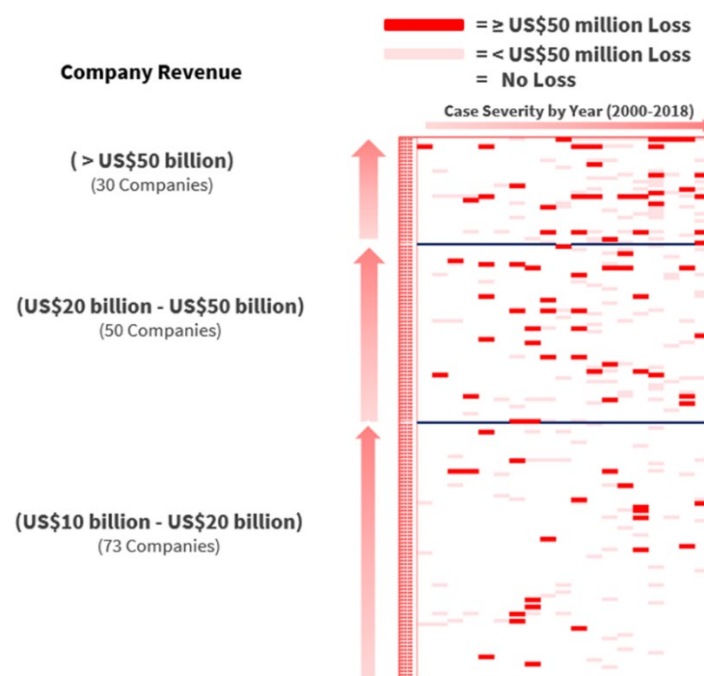
Table 17 : Average historical claim frequency by incurred banding 2008-2017



Source: AXA XL

There is a similar trend when we look at the severity of the cases from the Advisen dataset for UK and European global institutions with large revenues that are not US-listed. As seen in Table 18 on page 26, the frequency of large losses above US\$50 million is higher for companies with more revenue. One significant issue arising from large global institutions is the intermittent volatility of the large claims. There is no consistency in when the claims occur or who experiences them, which creates an element of unpredictability in this market segment. Many of these losses are financially disastrous for most organisations, meaning that providing cover for these risks at the right price is becoming more difficult.

Table 18 : Global institutions loss case severity 2000-2018



Source: Advisen

Based on the increased frequency and severity in large or global institutions, we believe that a considerable correction is required for the multibillion-dollar or euro turnover segment in order to maintain a realistic long-term and sustainable partnership in this segment.

International D&O pricing environment

We've been in a underpriced market for a prolonged period, which, coupled with social inflation - a heightened legal, regulatory and compliance environment - has exposed the inadequacies of the pricing of D&O insurance for global and large institutions. The length of time it takes for claims notifications to develop into fully reserved (or paid) claims – the “long-tail” nature of D&O liabilities – combined with the marked change in the risk environment that directors of large/global institutions find themselves in, has created a “perfect storm” , which has brought into focus the losses applicable to this segment.

The proliferation of claim types including merger objections, anti-trust, bribery, and securities claims has resulted in both an increase in the frequency and an unforeseen severity of loss. This severity has taken the excess market, in particular, by surprise. D&O rates for companies without US traded securities are at an all-time low, following 13 years of softening market conditions and the sheer over-abundance of insurance capacity saturating what was historically perceived to be a benign segment. Naively perhaps, average market rates for non-US traded companies have roughly priced the exposure based on the suggestion of between a one-in-500-year to a one-in-1,000-year catastrophic loss event. However, the international D&O market has seen several total programme losses for non-US-traded companies in the past 10 years. Therefore, we can realistically expect insurers to seek rebalance and premium correction in this space.

The market is now showing greater awareness¹⁸ and communication to clients is improving, but as insurers we need to educate and communicate, while also relying on our broking partners to help convey the right messaging in a timely way.

¹⁸ Commercial Risk Online. 'D&O market set to harden further with concerns over capacity shortfall', by Norris, B., 28 October 2019, available at <https://www.commercialriskonline.com/do-market-set-harden-further-concerns-capacity-shortfall/>.

The future and our approach

Macro influencers, such as the degree of litigation within a territory, statutory enforcements and broad economic cycles, significantly impact the financial lines insurance market. The financial lines insurance product is heavily focused on providing the legal defence of companies and individuals so it follows that the more developed a territory, the greater the likelihood of a stronger litigious attitude. Emerging statutory regulations often lead to insurance opportunities because parties prefer to transfer the risk that has been statutorily enforced upon them. The EU General Data Protection Regulation (GDPR) is another current example of this. In periods of economic health, the motivation behind litigating for financial gains is diminished. In contrast, when the economy shows fragility or takes a downturn, parties (both individuals and companies) will look more keenly for additional opportunities for income to compensate for this.

The International D&O market has experienced a perfect storm: a prolonged rate decline in parallel with a fundamental shift in the legal and regulatory environment, with no sign of abatement. Trends indicate the greater likelihood of heightened claims settlements and a tendency for plaintiff lawyers to turn straight to the D&O policy in the drafting of their lawsuits. We are experiencing a proliferation in the types of proceedings against directors, ranging from anti-trust, merger objections, bribery and (not forgetting) SCAs.

Since 2017, we've witnessed a bounce back of rates but with inconsistency and, unfortunately, inadequacy.

The AXA XL approach is to be transparent with all our clients and brokers. We need to apply an underwriting philosophy based on a simple fundamental of 'right price' underwriting. We are actively managing our international portfolio by managing our capacity (proportionate to risk volatility and severity) and driving pricing adequacy – to ensure sustainability. We understand that right price underwriting requires change and may cause some tension in the short term, but in the long term it will show our commitment to providing sustainable insurance protection to our clients.

Our D&O insurance industry is predicated on risk. We can predict and model the direction of some of that risk but there will always be the unknown. Who, for example, could have predicted the collapse of Enron; a major oil leak in the Gulf; the collapse of an Italian bridge; a Brazilian dam bursting; the global financial crisis; or a diesel scandal? What might be next?



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