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Financial Lines rates have been hardening, but how much longer will this last?

Charles Boorman takes a look at the factors that have led to the current financial lines market environment, and what the future may hold.

Recent headlines tell us about shrinking capacity and large rate rises in D&O as a result of increased claims activity on the back of a long and protracted soft pricing cycle. In the London Market these rate rises started in 2018 and have continued gaining some considerable momentum since then.

So just how long is this likely to last?

Firstly I think we need to put this into the context of the wider Financial Lines space, because most D&O Underwriters are also responsible for writing a number of other products often bundled into Financial Lines including Commercial Crime and Employment Practices Liability, either written on a standalone basis or blended into SME D&O policies.

Whilst a lot of recent noise has been rightly aimed at D&O, and specifically about US and Australian listed Class Action exposures, the problem is that Financial Lines Underwriters have been seeing losses from just about everywhere. Severity dominated US Class Action losses have been plaguing the London D&O market for years, but in recent times the ability to balance out the likely occasional loss in that area with a book of Commercial Crime or SME D&O has disappeared.

On the SME D&O front, years of low loss activity meant that underwriters have thrown in additional coverage to make their offering more appealing. However, retention levels were set too low, as were the premiums, and along with an increasing amount of D&O loss frequency, underwriters were hit by a myriad of social engineering and #MeToo claims.

Financial Lines books are traditionally low frequency, high severity and long tail, but when you include high frequency, low severity, short tail losses into the mix, you've got problems. For D&O, it normally takes 4 to 5 years of development to have even the first idea whether any underwriting year has been good or bad. Worryingly, in the last few years it has only taken two years to know that some of the more recent years have performed very badly.

So, will the capacity squeeze and increasing rate environment last? Most of the main Insurers with legacy books have so far decided to keep going, but they have radically reduced their average line size, amended their appetite to varying degrees, have less authority to quote individual risks than ever before, and are seeing far more Actuarial and management oversight.

New capacity is beginning to appear, but it is no way near enough to replace the capacity lost and won't be for some time, if ever. The risk environment is not getting any better, in fact it's getting much worse. I haven't even dwelled on COVID, the unfolding financial crisis, social inflation, the rise of event driven litigation, increased regulatory actions and prevalence of third-party litigation funders and the development of emerging risks such as Cyber and environmental issues.

The premium rates of today need to reflect the worse than expected results of prior years and be enough to pay for the claims notified this year and paid going forward. And if that isn't enough, underwriters are continuing to deliver bad news to senior management on a quarter by quarter basis. Until this stops and they can see the turnaround reflected in financial year results, they will have little motivation to tell their Financial Lines team to turn the taps on. In fact the exact opposite may well be the case and one or two may withdraw completely. All these factors point to premium rates continuing to increase until at least 2022 and probably beyond.

CONTACT

Charles Boorman

Head of Management Liability & Financial Institutions

E: charles.boorman@hdi-specialty.com