



A Changing D&O Environment in EMEA: More Volatility Ahead?



The D&O insurance market over the past decade experienced rate reductions, broadening coverage and increasing claims frequency and severity. This meant that losses outpaced premiums and the industry needed to respond. The magnitude and speed of the response that followed surprised many market participants. Significant capacity shortage led to sharp price increases and in many cases to reduced limits purchased by companies. The outlook for the D&O market remains challenging as the risk environment is more uncertain than ever.

External factors are expected to be the driving force for D&O claims, potentially putting pressure on the sustainability of the market. We have chosen to look closely at four topics which we believe will have an influence on the D&O claims landscape in Europe, the Middle East, and Africa (EMEA).

“Awareness and appreciation of the risk landscape by all market participants will be critical in avoiding extreme market reactions like we have seen during the past couple of renewals. A sustainable D&O market is in the best interest of all stakeholders, especially our clients.”

Nepomuk Loesti

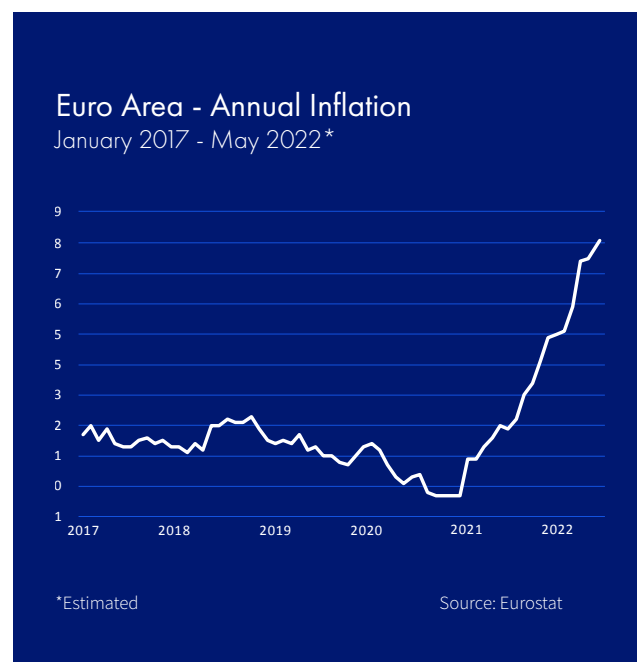
1. Inflation

Inflation is on the rise across the globe and fueled by the current geopolitical situation. In the world of D&O insurance, inflation can be broadly divided into two categories and their effects vary.

Economic Inflation

Economic inflation occurs when prices of goods and services are rising while the purchasing power is decreasing. One year ago, the inflation in the Eurozone was low single digits, today however the inflation has tripled or quadrupled in most countries, with the annual inflation rate in the Eurozone estimated at 8.1% for May 2022. The biggest drivers behind the rapid increase in inflation are soaring energy costs, as well as the increase in costs for food, alcohol, industrial goods, and services. Inflation is now more than four times above the ECB target of 2%.

Soaring inflation could put some companies into financial trouble, potentially leading to an increased rate of insolvencies. Insolvencies are commonly known as one of the most frequent drivers of D&O claims. High rates of inflation mean that unless income increases at the same rate, people are financially worse off. This can lead to lower levels of consumer spending and a fall in sales for companies, especially companies focusing on non-essential products and services. While companies could remain relatively unaffected by inflation through transferring all costs to consumers, in reality, some companies will absorb part, if not the majority, of the increased cost to avoid losing customers. In addition to this potential increase in insolvency related D&O claims, for D&O insurers increasing inflation can have a sensitive effect on the claims cost over time due to a greater compounding effect, as a result of the long tail nature of many claims.



Social Inflation

Third party litigation funding, erosion in the public's trust of large corporations, increased focus on social responsibility and large jury awards in the U.S. (relevant for EMEA companies exposed to the U.S.) are some of the factors that have led to higher loss costs for companies and insurers. Litigation funding and the focus on social responsibility are growing rapidly in EMEA. Litigation funding refers to the concept whereby a third party agrees to assume all, or part of, litigation costs. In return the litigation funder would receive a certain percentage of any settlement or judgment.

Litigation funding has grown in the EMEA region and is a popular tool for plaintiffs taking on large companies that have vast amounts of funds and insurance to defend claims. Stakeholders are putting pressure on companies to meet high Corporate Social Responsibility standards and are increasingly holding them responsible to such standards. This growing sentiment will likely lead to an increase in claims related to diversity, human rights violations, antitrust, and climate change.

The combination of economic and social inflation will likely lead to claims inflation. Since both economic and social inflation are increasing, we can expect that D&O insurers will feel a double effect on the claims cost. This may be mitigated by the fact that investment income could increase in lieu of higher interest rates, but it is unlikely to increase enough to offset any claims inflation. In addition to this, the number of D&O claims we see has increased during the past 10 years.

“Rising claims inflation will have a direct impact on the profitability of the D&O market, and therefore an open dialogue and common understanding between insurers, clients and brokers on this topic remains more critical than ever.”

Nepomuk Loesti

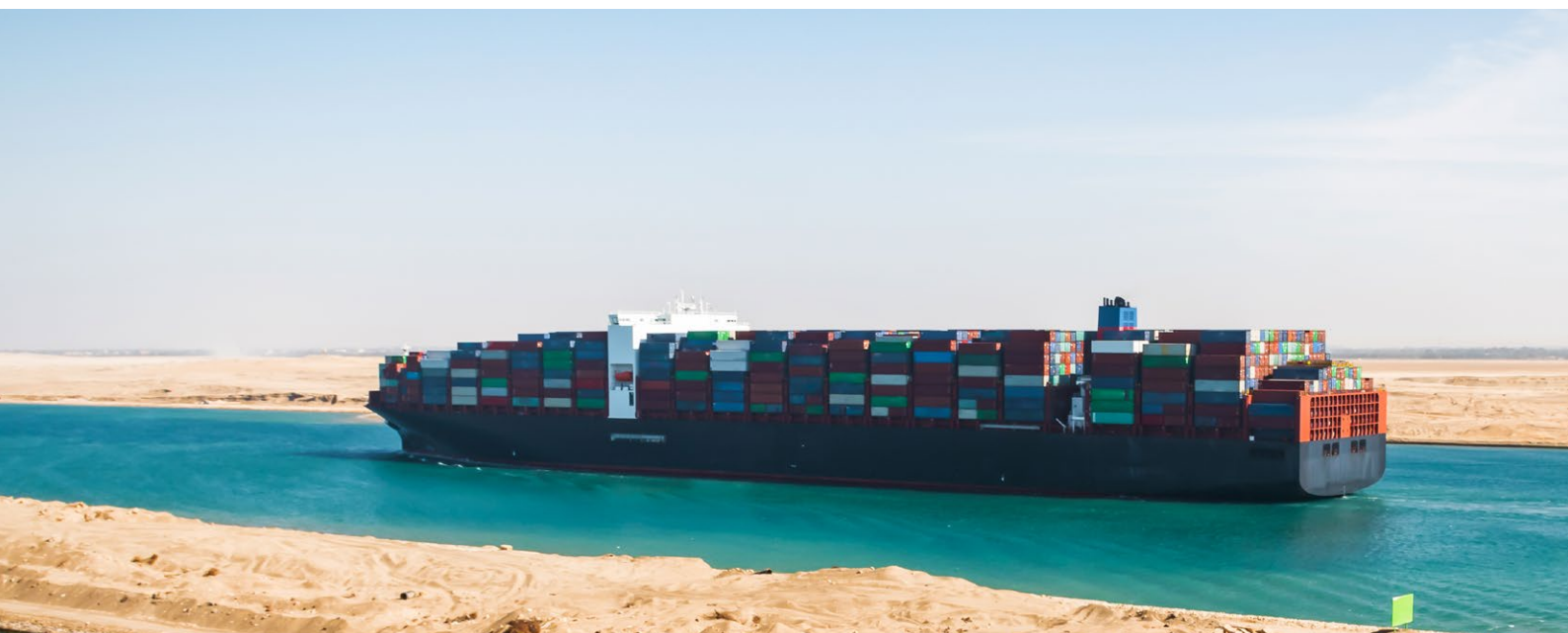
2. Supply Chain Disruptions

Resulting from the pandemic and fueled by the current geopolitical situation, supply chain disruptions have quickly evolved as a major concern for companies. Blocked transportation routes, labour shortages, and soaring energy prices are all contributing to the disruptions. The ultimate effect for companies could be loss of revenue, increased costs, and thus impact on already constrained liquidity positions.

Some companies are moving away from a “Just in Time” inventory model approach by greater stockpiling of inventory. This change in approach can put pressure on working capital needs and liquidity which, in combination with the effects of increasing inflation and the appetite of lenders, could lead to more financial pressure for companies.

In addition, with the increasing digitalization of the transportation sector, vulnerability to cyber-attacks has increased. With the growing number of cyber-attacks worldwide¹, this is an area which could pile the pressure on supply chains which are already experiencing numerous challenges.

Corporate decision makers are being forced to quickly adapt and react to disruptions and changes in the supply chain exposing them to potentially questionable decision making. The situation is a tough test for the decision-making governance within companies.



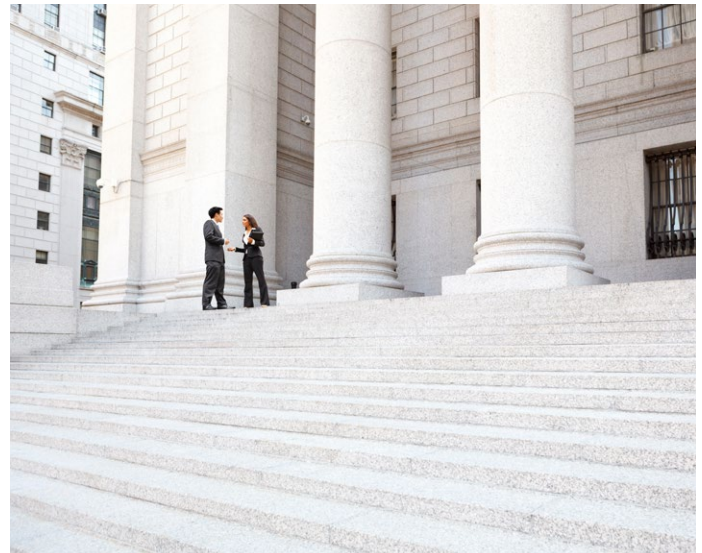
1. <https://fortune.com/2022/02/17/ransomware-attacks-surge-2021-report/#:~:text=Governments%20worldwide%20saw%20a%201%2C885,SonicWall%2C%20an%20internet%20cybersecurity%20company.>

3. Increased Regulatory and Criminal Enforcement Activity

For many years, a big driver of D&O claims has been linked to regulatory investigations and criminal enforcement alleging bribery, corruption, accounting fraud and human rights violations. These claims have seen increased frequency, likely as a result of more regulatory and criminal enforcement focus, and cross-border collaboration between regulators. The severity of these types of D&O claims has also increased with costs, in some cases, amounting to tens of millions of dollars, and sometimes only to defend these cases. We have seen regulators and criminal enforcement authorities in EMEA being more active in pursuing companies for alleged wrongdoings. In addition to this, it is expected that the active U.S. regulators will increase their cross-border collaboration with non-U.S. regulators and enforcement agencies as part of an initiative under the Biden Administration². We have already seen companies in EMEA be subject to criminal enforcement investigations where multiple regulators from different countries collaborate, sometimes with follow-on shareholder actions brought in one or multiple markets.

Furthermore, the European Commission has put forward a proposal for a Directive on Corporate Sustainability Due Diligence to tackle human rights and environmental impacts across global value chains³. If this Directive comes into effect, it will set a standard for EU companies on certain minimum requirements and harmonize the rules across member states. It will help make sure that companies will be held liable if they fail to prevent or mitigate potential adverse impacts on human rights and the environment not only in their own operations, but also within their suppliers.

In addition to the more traditional types of regulatory and criminal enforcement activity mentioned, it is expected that companies in



EMEA, and their directors and officers, will face more scrutiny around cyber security breaches and climate change issues such as carbon emission targets and biodiversity. Parallel to investigations commenced by criminal enforcement authorities, we have started seeing non-governmental organizations holding companies responsible for their actions, or inactions, in European courts.

“Longstanding global claims handling experience and expertise is essential to support clients in complex global regulatory and criminal enforcement activity. At AIG, with more than 80 Financial Lines claims specialists in EMEA, we have been able to provide that support successfully in numerous cases around the world.”

Jose Martinez



4. EU Collective Redress Directive

While there are mechanisms for bringing collective actions in many of the member states of the EU, they differ a lot between the member states, and activity has historically been limited. Recognizing this situation, the EU passed the Collective Redress Directive in 2020 with a deadline of implementation by member states in 2023⁴. According to the EU the intention of the Directive is to protect consumers being harmed by unlawful practices. “Without effective means to bring unlawful practices to an end and to obtain redress for consumers, consumer confidence in the internal market is reduced”, the Directive states. Under the Directive, so called “qualified entities,” such as consumer organizations and public bodies may bring representative lawsuits on behalf of consumers against companies for violations of different EU laws e.g. relating to general consumer laws, data privacy, energy, financial services, telecommunications, travel and tourism, and environment and health.

2. www.nortonrosefulbright.com/en-gb/knowledge/publications/36eccd8be/cross-border-implications-of-the-new-us-strategy-on-counteracting-corruption

3. www.whitecase.com/publications/alert/european-commission-issues-major-proposal-due-diligence-obligations-protect

4. <https://eur-lex.europa.eu/legal-content/en/TXT/PDF/?uri=CELEX:32020L1828&from=DE>

The “qualified entities” are entitled to seek two kinds of measures.

- Redress measures in the form of compensation, repair, replacement, price reduction, contract termination, or reimbursement of prices paid, or
- Injunctive measures aimed at stopping or prohibiting a practice deemed to constitute an infringement

The Directive enables “qualified entities” to represent groups of consumers from several EU member states in a single lawsuit. While the alignment and focus on collective redress possibilities across the member states in the EU might lead to more consumer class action litigation, there are a few safeguards in place that aim to prevent the litigation system from being abused:

- The Directive implements a “loser pays” principle which will lead “qualified entities” and the consumers to think twice before filing a lawsuit
- To further prevent representative actions under the Directive from being misused, punitive damages should be avoided. Qualified entities should also establish procedures to avoid conflict of interest and external influence, namely if they are funded by a third party
- While the Directive does not prohibit third-party funding, it instead restricts its use. It is the responsibility of the member states to make sure that conflicts of interest between funders and claimants are prevented. The member states must ensure that any third-party funding does not impact the protection of the consumers’ interests.

“The impact of the EU Collective Redress Directive is still unsure, but we have seen before in other regions how quickly changes in legislation and legal judgments can translate into an uptick in D&O litigation.”

Nepomuk Loesti

The new EU Consumer Redress Directive may lead to heightened awareness and activity around consumer class action litigation in Europe. In combination with existing and evolving risks such as inflation, supply chain disruption and regulatory investigations, directors and officers of companies in EMEA are likely to have more responsibility on their shoulders than ever before.

Conclusion

Until 2018, the D&O insurance market experienced consistent rate reductions since 2003⁵, with broad terms and conditions and large capacity deployed. However, during the past few years (and especially over the last two), purchasers of D&O insurance have experienced premium increases, coverage restrictions, and sometimes a shortage of capacity available. This was a result of surging loss costs as D&O claims have increased both in frequency and severity. The long-tail nature of D&O insurance in combination with growing claims inflation have led to many D&O insurers posting losses in the past few years⁶.

There are no signs that loss costs will improve in the near to mid-term. With traditional types of D&O claims likely to remain and the addition of macroeconomic uncertainty, enhanced regulatory activity, society’s heightened focus on corporate social responsibility, and the passing of new legislation to support consumers, exposures remain elevated for the foreseeable future.

It is within this changing market environment that we continue to support our clients by building long-term partnerships during the insurance market cycle to help them have the right protection for their D&O’s.

5. www.aon.com/getmedia/a3b89e94-1af1-4eb6-9b6a-e7634d70e150/Q4-2020-DO-Pricing-Index.aspx

6. www.fitchratings.com/research/insurance/us-d-o-insurers-post-underwriting-losses-despite-record-premiums-28-04-2021

Author

Nima Rafiee
Underwriting Manager
AIG Financial Lines EMEA
M: +49 174 602 7680
nima.rafiee@aig.com

Nepomuk Loesti LL.M., Dipl.-Kfm. (Univ.)
Head of Financial Lines EMEA
T: +49 69 97113 271
T: +49 151 220 538 94
nepomuk.loesti@aig.com

José Martinez
International Head of
Financial Lines Claims
T: +34 91 5677 431
jose.martinez@aig.com



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AIG Europe S.A. has its head office at 35D Avenue John F. Kennedy, L-1855, Luxembourg. AIG Europe S.A. is authorised by the Luxembourg Ministère des Finances and supervised by the Commissariat aux Assurances 7, boulevard Joseph II, L-1840 Luxembourg, GD de Luxembourg, Tel.: (+352) 22 69 11 - 1, caa@caa.lu, www.caa.lu/.