PRIVATE EQUITY

Management and Cyber Liability Q1 2024 Market Outlook

Unlike other areas of commercial insurance, the overall management liability marketplace continues to experience insured-favorable conditions. Driven by considerable capacity, rates amongst management liability products in the Public, Financial Institution, Private/Nonprofit, and Cyber Liability markets have dramatically improved since the height of the previous hard market period. For Private Equity firms and their investment portfolios, now is the right time to take advantage of these conditions by way of improved coverage opportunities, cheap excess limits, and better portfolio program aggregation opportunities. While underwriters will surely be monitoring evolving regulatory, geopolitical, and economic concerns in the year to come, it is our expectation that relatively favorable conditions will persist throughout 2024.

State of the Financial Institution Market

New entrants to the GPL/D&O marketplace helped drive down premiums and provide viable options, which had been lacking in recent years. As a result, insurers have been agreeable to broader terms to remain competitive and retain clients. It is likely that reductions in premium will slow in 2024 as firms face continued SEC scrutiny and new compliance rules and regulations.

In 2023, the SEC filed a total of 784 enforcement actions, a 3% increase over 2022. Actions relating to crypto jumped from 18 cases in 2022 to 44 cases in 2023. Misconduct allegations in these actions include fraud, unregistered offerings, and unregistered exchanges. Such actions directly impacted asset managers with regulatory investigations, fluctuating crypto currency pricing, and portfolio valuations. 2023 also introduced new Private Fund Adviser rules, which will take effect in the latter half of 2024 and early 2025. We expect underwriters to closely watch any upticks in claims due to non-compliance and adjust their terms accordingly.

Market Trends

Premium:

- Private Equity firms and similar asset managers are seeing on average flat to -10% premium decrease over prior year, assuming no change/growth in assets under management (AUM), portfolio companies are compliant with debt covenants/no defaults or bankruptcies, and a clean loss history.
- Private Equity firms with controlling positions may face increased underwriter scrutiny, with premiums -5% to +5% as insurers experience an increase in claim activity/bankruptcies.
- Excess rates range from 60-70% of the prior layer.

Retentions:

- Retentions for mid-size Private Equity firms with under $1B in AUM are generally around $250K.
- For firms with AUM between $1B to $5B, we are seeing retentions range between $250K to $500K. For broader manuscript forms, many insurers are requiring higher retentions of $1M or more.

Insurer Capacity/Trends:

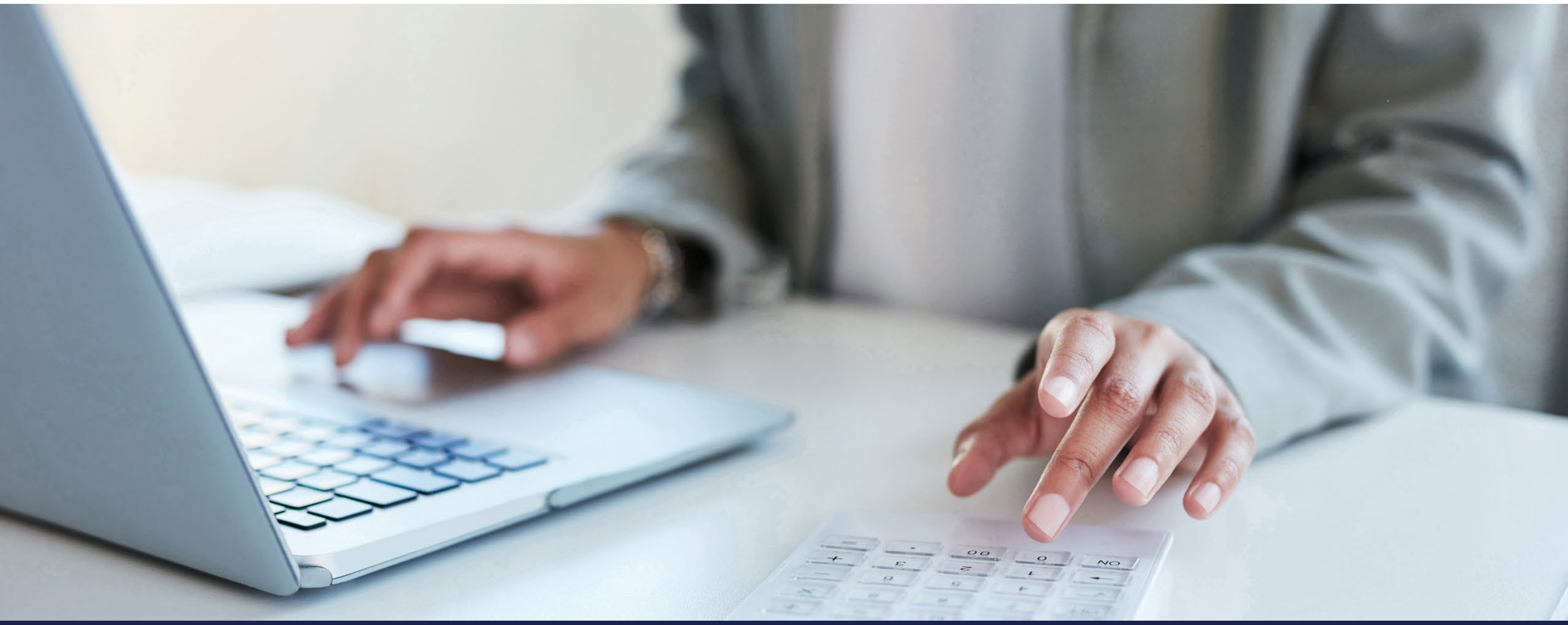
- Primary insurer options are expanding as many insurers are searching for growth.
- Excess capacity is more plentiful and less expensive than past years.
- Many Private Equity firms are adding excess limits as defense expenses continue to rise. According to The American Lawyer, standard attorney billing rate increases in 2024 could be between 6% to 8%.
- Many insurers offer additional limits for fines and penalties assessed against Chief Compliance Officers.
- Firms with Crypto, Cannabis, Alcohol, and Firearms exposures will continue to have a limited number of insurers willing to entertain the risk.

State of the Public Company D&O Market

To the chagrin of many public company underwriters, the softened market environment in the public company D&O space continues to persist. Heading into 2024, we expect the D&O market to remain competitive with favorable pricing. The emergence of new insurance capacity looking to capitalize on the former hard market period, and the decline in the number of companies going public with significantly fewer IPO's, SPACs, and de-SPAC opportunities in 2023, forced carriers to seek new opportunities for their capacity elsewhere, namely on non-incumbent renewals. This resulted in rates continuing to decline throughout 2023 for most public companies. Companies that recently went public through an IPO transaction experienced larger premium and retention decreases, as they were most affected during the hard market cycle's premium impact compared to mature public companies.

Uncertainty surrounding new regulatory guidance such as ESG, Cybersecurity, and Artificial Intelligence as well as geopolitical conflict will surely test the patience of the underwriting community. However, while there may be headwinds to public company D&O profitability ahead, the Federal Reserve's signaling of interest rate decreases throughout 2024 has provided promise for stable economic conditions. Ultimately, while we do not anticipate reductions in pricing and retentions to remain at the aggressive levels seen throughout the second half of 2022 and 2023, it is likely that moderate reductions in pricing will persist due to sustained underwriting capacity.

Securities class action lawsuits represent the most significant severity risk for public company D&O insurers; therefore, underwriters closely watch these filings as an indicator of their loss experience and profitability. After a four-year decline, the number of new federal securities class action suits increased from 206 in 2022 to 228 in 2023. Excluding merger objection and crypto related cases, the technology sector accounted for 22% of new filings in 2023, followed by the healthcare technology and services sector at 19%, and the finance sector at 18%. In 2023, the average settlement value was approximately $46M, a 17% increase over the 2022 inflation-adjusted average settlement value of $39M and the second consecutive year that this value has increased according to the National Economic Research Associates (NERA). In 2023, there were also several shareholder derivative settlements with significant cash components as evidenced by 2023's mega-settlements in Tesla ($735MM) and CBC/Viacom ($167.5M). D&O carriers will continue to watch the number of filings as well as the potential impact of rising settlement values in securities class actions and derivative litigation, as they evaluate their loss experience and pricing models in the coming year.



RISK strategies

Market Trends

Premium:

- Premium trends continue to differ between mature and newly-IPO'd public companies, with the latter receiving the most significant premium relief.
- For mature public companies, we are currently anticipating premium reductions in the flat to 10% range. Newly IPO'd companies, especially those that IPO'd at the top of the hard market, continue to secure larger premium decreases in the 5-15% range.
- D&O insurers are increasing the number of ancillary lines they offer – such as Crime, Employment Practices Liability, and Fiduciary Liability – as they look to generate additional income and secure lines on the D&O program.

Retentions:

- While retentions generally fell across the board in 2023, we are anticipating less of an impact to mature public companies in 2024.
- For newly IPO'd companies, we anticipate self-insured retention levels to continue to fall closer to historic levels in the $2M to $5M range, depending on market cap and industry (vs. $5M-$10M in the hard market)

Insurer Capacity/Trends:

- Competition amongst primary capacity providers continues to be strong – especially for those companies with strong balance sheets and leadership.
- We continue to see higher limits offered on a primary basis, with most primary insurers offering $5M and $10M primary limits. While not preferred, for distressed, high hazard classes (such as biotech), or recently IPO'd risks, it may remain more cost efficient to take advantage of extremely favorable excess rates and build in $2.5M limits.
- In similar fashion to other segments of management liability coverage, insureds are taking advantage of cheaper excess rates and increasing limits year-over-year.
- Opportunities for enhanced coverage continue to be available as underwriters rely on non-pricing and retention selling points to retain and/or win business.

SPACs

The booming SPAC market from 2020 and 2021 fell out of favor when the SEC's enforcement division stepped up scrutiny in March 2022 coupled with rising interest-rates, which further dampened demand for SPAC investments. The number of SPAC transactions declined significantly from the height in 2021 when there were 613 SPAC IPO's to just 86 in 2022 and 31 in 2023.[1]

In a move that could further reduce insurer interest, on 1/24/24 the SEC adopted new rules to enhance disclosures and provide additional investor presentation in SPAC IPO's and in subsequent business combinations between SPACs and target companies, referred to as de-SPAC transactions. The new rules are intended to make the disclosure and legal requirements for de-SPACs similar to those of traditional IPOs. It would, for example, make the target company legally liable for disclosures around forward-looking projections. SPAC sponsors, which are frequently hedge funds, private equity firms, and venture capital investors, would also have to reveal more information about their identities, conflicts of interest, dilution, and compensation. The net result is that these rules will drive up legal risks and costs for the SPAC, Sponsors, and target company. As such, we expect the D&O market for SPACs will continue to slow down as the rules are expected to go into effect in May 2024.

SEC Oversight

The SEC adopted new cybersecurity disclosure guidelines in July 2023, which require all publicly listed companies to disclose any material cyber incidents within four days of discovery. In addition companies will be required to disclose in their annual 10-K filing their processes for assessing their cybersecurity risk and board oversight of such risk. With numerous laws in effect and in queue, many companies have a heightened risk of claims resulting from non-compliance.

[1] *Spacinsider.com*

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State of the Private / Nonprofit Market

Private and Nonprofit D&O remains a buyers' market as we enter 2024. The pricing overcorrection that occurred during the 2018-2021 hard market left room for underwriters to offer cost relief in 2022/2023. This softening trend is showing no sign of subsiding in early 2024. Newcomer insurers, legacy excess carriers seeking primary positions, and increasingly tech-based underwriting strategies are all driving factors of the soft market conditions. Carriers are generally willing to offer higher limits, broaden coverage and decrease retentions to win business in this fiercely competitive environment. While we expect the mid-teen rate decreases to continue in the coming months, there is uncertainty as to how long this pattern will last. However, with additional capital and fundraising opportunities anticipated with the Fed's signaled rate reductions, it appears the looming bankruptcy concerns in connection with an anticipated recession may in part be alleviated. In the meantime, insureds will continue to reap the benefits of surplus capacity and aggressive underwriting.

Market Trends

Premium:

- Companies with strong balance sheets and clean claim histories are seeing average premium decreases between flat to -10% year over year, assuming no change in exposures.
- The Healthcare, Technology and Consumer Discretionary industries are seeing more conservative rate decreases, as increased litigation has led to deeper underwriting probes. Rates are typically -10% to +5% for risks with strong financials, clean claim history and no recent/upcoming reductions in workforce.
- Excess rates are generally reflecting 60-65% Increased Limit Factors, a decrease from the 75-85% (at times 100%) routinely seen during the hard market.

Coverage Trends:

- D&O – Coverage is generally broader as many Insurers are adding "bells and whistles" to increase their draw power, with the exception of added Biometric ("BIPA") exclusions. BIPA exclusions continue to be prevalent as there is no uniform consensus from the market on how this unique exposure should be underwritten and how claim activity will evolve.
- EPL – Market conditions are allowing underwriters to be more generous with sublimits in states experiencing decreased litigation, such as Wage & Hour Defense Costs coverage. We are also seeing more creativity in coverage terms as Insurers try to mitigate increased losses without raising rates, as follows:
  - Separate/higher retentions for high wage earners (typically $150K+ annually)
  - Separate/higher retentions for class action lawsuits
  - Separate/Higher retentions in high-risk states
  - California continues to be problematic for EPL underwriters and higher rates and more restrictive coverage will prevail in 2024.

Insurer Capacity:

- Primary insurer options remain bountiful as competition intensifies.
- Excess capacity continues to grow, causing rates to drop roughly -5% to -10% year over year.
- Many Insureds are taking advantage of the rate cuts to add additional layers of protection in response to rising defense costs and the unpredictable 2024 litigation landscape.
- Tougher classes of business, such as Crypto, Blockchain, Cannabis, and Healthcare companies, continue to have less options in the marketplace.

State of the Cyber Market

After a tumultuous two year hard market, the Cyber market stabilized in 2023 with insureds generally experiencing a flat to slight decrease in renewal premium. While premiums shifted downward in large part due to more sophisticated cyber controls implemented by companies in recent years and the lull in ransomware claims in 2022, many insurers reported that claims frequency and severity were on the rise in 2023. Coalition's Cyber Claims 2023 mid-year report shows ransomware claims frequency increased 27% and severity increased 61% compared to the second half of 2022. In that same period, funds transfer fraud losses showed a 15% increase in frequency and a 39% increase in severity. Due to the rise in ransomware attacks, increased claims severity and new state privacy laws, we expect to see premiums trend slightly higher in 2024.

Market Trends

Premium:

- Expectations in 2024 are a 0% to -10% decrease for Insureds with good internal controls and +5 to +15% for Insureds with poor internal controls.
- Excess rates are ranging from 60-70% of the prior layer, which marks a decrease from 2022 and earlier.

Retention:

- Retentions remain low, starting around $2,500 and increasing based on revenue, industry and other exposures.
- Retentions for funds transfer fraud/social engineering can be higher than other coverages on the same policy form.

Insurer Capacity/Trends:

- Traditional and InsurTech markets provide ample capacity for firms with up-to-date cybersecurity controls and business recovery plans.
- Blockchain, cryptocurrency, and gambling offerings remain limited.
- War exclusions are becoming more restrictive by barring coverage for acts of war, whether or not declared.
- Many insurers are including wrongful data collection exclusions – including claims for violations of the Biometric Information Privacy Act.
- Directors & Officers Liability policies commonly add exclusions for cyber claims, necessitating a standalone cyber liability insurance policy.

Impact of AI on Cyber Insurance

Artificial intelligence (AI) has become increasingly integrated into insurtechs for risk assessment and underwriting. In 2024, these technologies are expected to become more sophisticated, offering more personalized and accurate insurance products. Using AI, chatbots, and other interactive tools, insurtechs will likely continue improving the customer experience, making insurance more accessible, particularly for smaller middle market companies.

AI powered cyberattacks are feared to be one of the key threats in 2024. Hackers are increasingly using AI powered language models to increase the speed and scope of ransomware attacks and to create new malware, phishing emails, and deepfakes which allow cybercriminals to manipulate audio/video content to create highly convincing fake media to spread misinformation, deceive individuals and blackmail victims. Additionally, there is an increasing overlap of operational technology and information technology. Industry segments such as critical national infrastructure, autonomous vehicles, and manufacturing are emerging as segments with potential vulnerabilities.

Cloud Computing

The adoption of cloud computing continues to accelerate, offering benefits such as scalability, cost-efficiency and flexibility. However, as companies increasingly rely on the cloud, the need for robust security measures becomes critical. With the increasing sophistication of cyberattacks, a zero-trust approach is gaining prominence. This model requires authentication for every user and device.

Remote Workers

Since the pandemic and many companies' switch to remote or hybrid work models, we have seen a significant increase in the number of cyberattacks on businesses. With employees accessing company networks from various locations and using personal devices, companies face increased exposure to unauthorized access, data breach, social engineering/phishing attacks, and malware infections. Strong security measures such as multi-factor authentication, virtual private networks (VPN), and employee cyber awareness training are critical cyber best practices.

Third Party Vendor Management

Third party data breaches may force companies to respond to incidents that are outside of their control or originate from an indirect source. Third parties include suppliers, vendors, service providers and contractors with access to privileged information like customer data or internal company systems data. Although there might not be an obligation to respond or provide notification under current cyber privacy breach regulations, companies could still suffer significant reputational damage as a result of a breach. We recommend mapping your data flow, including both digital and physical data, to ensure those third parties entrusted with your data are properly enforcing security policies and procedures. We are seeing more insureds implement third party cyber diligence/risk assessments to understand and mitigate their risk.

State Privacy Laws

In 2019, the U.S. privacy framework changed with the emergence of the California Consumer Privacy Act, which created a significant compliance burden for most businesses collecting personal information about California residents. Since then, we have seen additional states enact similar privacy laws in the absence of a comprehensive data privacy law at the federal level. Currently, 13 states have passed comprehensive data privacy laws in the U.S. – including California, Virginia, Colorado, Connecticut, Utah, Iowa, Indiana, Tennessee, Texas, Florida, Montana, Oregon, and Delaware – and we expect more states to follow in 2024. Companies conducting business in these states must nimbly create cybersecurity/privacy programs to comply with multiple states' privacy laws or risk financial and legal consequences.

If you have questions regarding this article or your current coverage, please contact our Private Equity Group:

Stephanie Needham
Senior Managing Director
160 Federal St, 4th Floor
Boston, MA 02110
617-877-0691
sneedham@risk-strategies.com

Kevin Flasch
Managing Director
750 Third Avenue, Suite 1500
New York, NY 10017
646-234-5846
kflasch@risk-strategies.com

Adam Peterson
Senior Vice President
750 Third Avenue, Suite 1500
New York, NY 10017
610-442-1765
apeterson@risk-strategies.com

Heather Munz
Vice President
7 Great Valley Parkway
Malvern, PA 19355
484-324-2858
hmunz@risk-strategies.com

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