SPECIAL FEATURE
INSURANCE TRENDS FOR INVESTMENT MANAGERS

WHAT DOES THE BANKING ROYAL COMMISSION MEAN FOR CORPORATE INSURANCE AND FUND MANAGERS?

Welcome to our special feature on the corporate insurance market implications of the Hayne Royal Commission and the fallout for the funds management industry. The final report of the of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry included 76 recommendations across these industries as well as the insurance industry.

RYAN NEARY
Manager
Professional Risks
GSA Insurance Brokers

Here, we take a closer look through the lens of our special guest contributor Ryan Neary (Manager Professional Risks) from GSA Insurance Brokers as he explores market trends, what you can do to minimise the impact, and some tips for dealing with your insurer.

IMPACT ON THE MARKET AND INSURER RESPONSE

This string of activities and findings sparked a reaction from insurers already stung by the impact of the increase in securities class actions (Directors and Officers (D&O) securities class action claims and reported circumstances currently exceed the total insurance market premium pool by a significant margin). Insurers are now looking to take corrective action on their portfolios and limit their capacity to these exposures if possible.

One way insurers are looking to limit their exposure to potential losses arising from the Royal Commission is by applying Royal Commission exclusions under professional indemnity (PI) and D&O liability policies. Where an exclusion like this is applied, it is important to understand the implications and what it means to the coverage available moving forward. It is likely those impacted directly by the Royal Commission will have these exclusions applied. However, we are seeing a trend where insurers are looking to apply this limitation to all our clients practising in the financial services sector.

If a Royal Commission exclusion is applied to a client's PI and/or D&O policy, there is a chance the policies will provide minimal coverage for any future or past claims and, in a worst case scenario, the claim could be excluded in its entirety. Therefore, it is GSA's strong recommendation these exclusions should be avoided.

In addition to limiting exposure, insurers are also looking to correct their portfolios in several other ways, including:

- Reducing the levels of capacity insurers are deploying in the market. As a result of increased claims activity and rising loss ratios, insurers are looking to reduce the amount of limit they have out on one client.
- Increasing deductible structures. Insurers want clients to have "skin in the game". Therefore, in the event of a claim, the first amount payable by a client needs to be higher. For listed clients with securities entity exposure we have seen increases in excess of up to 300 percent.
- Increasing premium rates. Insurers are increasing their underwriting rates on clients in the financial services sector. The minimum increase we are seeing for private clients is approximately 15 percent and for listed clients the average premium increase is approximately 50 percent, although we have seen increases of up to 200 percent.
- Increasing attachment points from insurers on towers of coverage predominantly on D&O. Insurers are not willing to deploy new capacity unless they are attaching at a point in excess of the primary $50 million when coverage for the entity is included.

Due to the impacts of the ever-growing shareholder class action environment, together with the implications of the Royal Commission, the state of Australia's financial and professional lines market remain in a state of flux. We are currently in a hardening market and GSA predicts this will be the case for several years to come.

In London, Lloyds has undertaken a strategic review of all syndicates with a view to shutting down under-performing syndicates and reducing the amount of capacity being deployed to poor performing classes of insurance, including PI.

Syndicates that have been unprofitable for the past three years will need to submit a business plan demonstrating how they will correct this and return to profit. As a result, eight syndicates have been shut down and a number of others, in line with their business plans, forced to tighten their appetite and reduce lines of capacity.

This has put further pressure on Australian clients as Lloyds were a big provider of security for PI and D&O in the financial services sector.

WHAT CAN YOU DO TO MINIMISE THE IMPACT?

Whilst the market is in a state of flux and insurers are looking to claw back premiums, a good outcome can be achieved, and coverage secured, if the process is handled correctly and lines of communication are kept open between all parties.

The key to achieving the optimum outcome on an insurance renewal is to start the process early and provide an extremely detailed underwriting submission. We recommend starting the process four months out from renewal, and whilst there are proposal forms and standard documents insurers require in order to provide quotations, we recommend going that one step further.

One of the main concerns of insurers is the lessons learned from the Royal Commission, for example, systemic items such as "fee for no service". We advise our clients to demonstrate to insurers that an internal review, audit and analysis has been performed on the business/portfolio to ensure none of the issues identified in the Royal Commission are present in the business and, if they are present, what corrective action has been taken to help mitigate any future issues that may arise.

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MERGERS & ACQUISITIONS INSURANCE

We try to insure against lots of things these days—home and contents damage, public liability, negligence, and even surgery for pets. Of course, some fund managers have found professional indemnity coverage almost prohibitive in recent years and, as our feature article in this edition of *Fundamental* shows, insurance in the advent of the Royal Commission is likely to get harder for some industry sectors.

LANGTON CLARKE

Partner
Funds Management

In the world of mergers and acquisitions, there are any number of risks and liabilities against which parties are (or should) be covered. But contractual rights only go so far. In this article, partner Langton Clarke explores some of the bespoke insurance products designed to indemnify parties in sale and purchase transactions and the cost for this protection.

WARRANTY AND INDEMNITY INSURANCE

This product indemnifies parties for breaches of representations and warranties given in the sale of a company or business and can be bought by the buyer or the seller.

A buyer policy covers the buyer for losses caused by breaches of warranty given by the seller in a sale contract. It enables the buyer to claim directly from the insurer without first pursuing the seller.

A seller policy covers the seller for losses resulting from claims made by the buyer for breaches of warranty under the sale agreement.

Sellers use the insurance as a strategic tool to prevent sale proceeds being tied up in retention or escrow accounts; while buyers can use the product to increase their financial protection and certainty if recovery from the seller under a warranty claim is in doubt.

TAX INDEMNITY INSURANCE

When a buyer or seller involved in a merger and acquisition transaction identifies a tax exposure, then a tax indemnity policy may be considered to mitigate future financial losses should the ATO successfully challenge the underlying legal conclusion that originally formed the basis of a tax position. These policies reimburse the tax-payer for additional taxes, interest, penalties, and defence costs.

LITIGATION BUYOUT INSURANCE

This type of insurance enables a client to ringfence liabilities which may arise from any current or anticipated litigation. Having such a liability hanging over the parties' heads distracts from negotiations, so this insurance product can take away the uncertainty such a liability brings.

COST

There is of course a cost for the protection these insurances bring:

- For warranty and indemnity insurance, premiums are around 1 to 2.5 percent of the limit provided.
- Taxation indemnities are understandably higher at 3 to 12 percent of the limit.
- Litigation buyout insurance is higher again and can be up to 50 percent of the limit purchased, depending on the strength of the legal opinion in relation to the litigation.

In all cases, a robust due diligence process will be looked upon favourably by underwriters who may otherwise be reluctant to write insurance without it.

HOW CAN WE HELP?

The incentives for taking out these types of cover may differ from party to party. However, like any insurance, it can provide protection and indemnity from specific risks and remove uncertainty in what is often already a complex transaction.

McMahon Clarke is regularly involved in corporate and business mergers and acquisitions and a member of our team can help you understand the legal implications of the various insurance options.

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In addition to a detailed submission, we recommend meeting with the insurer. In a challenging market this is an important step – it allows the insurer to gain comfort with a client and build trust through asking questions and gathering information which may not be available in the written submission. If the insurer is forced to make an assumption in their risk analysis, they will assume the worst, so this interaction allows assumptions to be removed which will only benefit the client.

Whilst we recommend building a relationship with your current insurer, in this market there may be some benefit in undertaking a marketing exercise and engaging with other insurers. This allows you to benchmark your current insurer across items such as capacity, deductible, coverage and premium. We have seen clients secure significant savings in premium and an increased scope of coverage through engaging alternate insurers. We would not recommend this be done every year, as you need to protect your brand within the contracting PI and D&O market.

HOW CAN GSA HELP?

With the market in a state of flux, you should expect some turbulence when renewing your professional liability insurance program. It is no longer a buyer's market nor a given that insurers will be able to offer the same coverage, limit or premium, as seen in previous years.

This is the time when the benefits of using an experienced broker will be felt the most. GSA is an independent broker, with a focus on providing insurance solutions for clients in the financial services sector. GSA holds strong relationships both locally and in London with all insurers deploying capacity and is in a strong position to achieve the best results in this challenging and volatile market.