D&O: Slower headline increases but rate-on-rate keeps indexed rate climbing

As we have highlighted many times in the past, Aon's quarterly D&O report is one of the best in the industry, where pricing disclosures from industry participants are typically limited to just headline numbers and lack further details on changes in the underwriting terms.

This quarter's numbers provide a useful update on the current market hardening in just three points.

First, pricing in public D&O is up somewhere from 22% to 68%, depending on what angle one takes.

Aon gives multiple viewpoints on pricing that control for various things, each with their own advantages and disadvantages, which we get into in the report below.

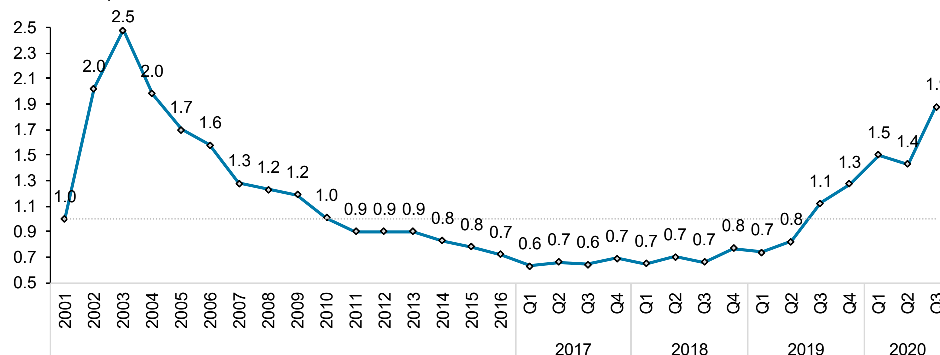
The report provided one data point that suggests a sequential deceleration in D&O rates may be taking place. Price per million of limit purchased for all policies was down to 68% from 74% in Q2. However, the number that caught our attention was the price per million of limit purchased by the same clients that renewed in the prior-year quarter, which increased by only 40% in Q3, versus 61% in Q2.

That said, we highlight two factors that undermine this proposition of decelerating market pricing. First, the price changes in the primary market (for same deductible and same limit), which we find a more meaningful indicator of market conditions, were flattish at 22% versus 23% in Q2. Second, the Q3 prices had a much tougher comparison against Q3:19. For perspective, last year between Q2 and Q3, the headline pricing surged to 70% from 17%, and the primary market prices increased to 12% from 7%.

Despite the slowdown in the rate of change, the compound impact of rate on rate is accelerating the indexed level at faster levels than earlier in the cycle.

Quarterly index of D&O pricing

Source: Aon, Inside P&C



In the report below, we show that, taking into consideration the rate-on-rate adjustment, Aon's pricing data still shows persistency in the hardening rate environment.

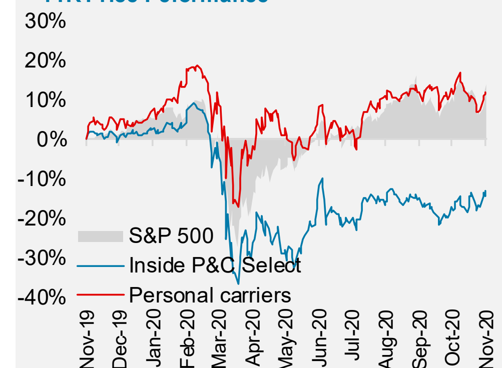
Inside P&C Research

Dan Lukpanov, CFA
Research Analyst
E: dan.lukpanov@insidepandc.com
T: (212) 224 3326

Gianluca Casapietra
Research Analyst
E: gianluca.casapietra@insidepandc.com
T: (212) 224 3495

Composite	YTD px chg.	P/B
Large comm.	(20.3)%	0.8x
Regional	(28.8)%	1.2x
Specialty	(14.0)%	1.5x
Personal	6.7%	1.8x
Bermuda	(22.8)%	1.0x
Florida	(45.6)%	0.7x
Brokers	(2.7)%	-
IPC Select	(14.5)%	1.1x
S&P 500 Fin.	(18.4)%	-
S&P 500	8.7%	-

1YR Price Peformance



Second, Aon shows the level of restructuring by clients intensified in the third quarter.

The restructuring data too suggests that the hardening cycle is not showing signs of abating, with more policyholders facing tougher underwriting terms, as well as simple price increases. In the third quarter, only 49.6% of clients renewed with the same deductible, down from 54.5% last quarter and 64.8% YoY. The level of limit purchased remained more stable at 87%. It is worth noting that because a higher deductible lowers the probability of attaching, this can be a more powerful way to cure an underperforming book than pure rate (especially for excess layers).

Third, and most importantly, in spite of all this, the market appears to remain orderly and rational.

The two-tier D&O market structure implies that whenever first-tier carriers misprice the market, there is a cohort of second-tier players looking for "break in" opportunities to take market share.

However, Aon's report suggests that, despite the pricing and deductible changes noted above, 93% of primary policies in Q3 renewed with the same carrier, within 2 points of the average level since 2016.

In summary, despite the signs of slowing market hardening suggested by some of the headline pricing metrics, the strong YoY price action on top of already high rates in 2019 suggests the resetting of risk appetite goes on, at levels not seen in almost two decades.

However, a primary policy retention level that remained persistent at above 93% level since the hardening market cycle began, in one of the market's hardest pockets, suggests the market remains in a rational and orderly re-pricing mode, balanced between stress and stability to various degrees.

D&O: The high retention hard market

As we highlight every quarter, Aon's D&O report is excellent – one of the best in the industry for those looking to get multiple viewpoints to triangulate around market conditions rather than just headline numbers.

According to Aon, depending on how you look at it, pricing in public D&O is up somewhere from 22% to 68%. This is a sequential decline from Q2, but by some measures a meaningful YoY acceleration from an already high 12%-70% range the broker reported in Q3:19.

(Note, this is for US public companies only. Recall, private company D&O is recording less aggressive price increases as it is not exposed to the same loss trends driven by securities class actions.)

Aon reported D&O price per million of limit purchased as being up 68% compared to the prior-year quarter. This number is typically the most widely reported, in part because it tends to be the largest and most volatile.

However, as we have discussed before, this metric is simply based on price per million of limit purchased in aggregate across Aon's portfolio of publicly traded US companies (we estimate 150-200 clients per quarter for context), and thus should not be taken simply at face value.

Most notably, the figure can be distorted by mix of business in Aon's client base, or by exposure changes from these clients. To control for this, Aon also provides a "same store sales" version that tracks only clients that renewed in the prior-year period. On this basis, pricing was up 40%, a significant deceleration from the 61% in Q2.

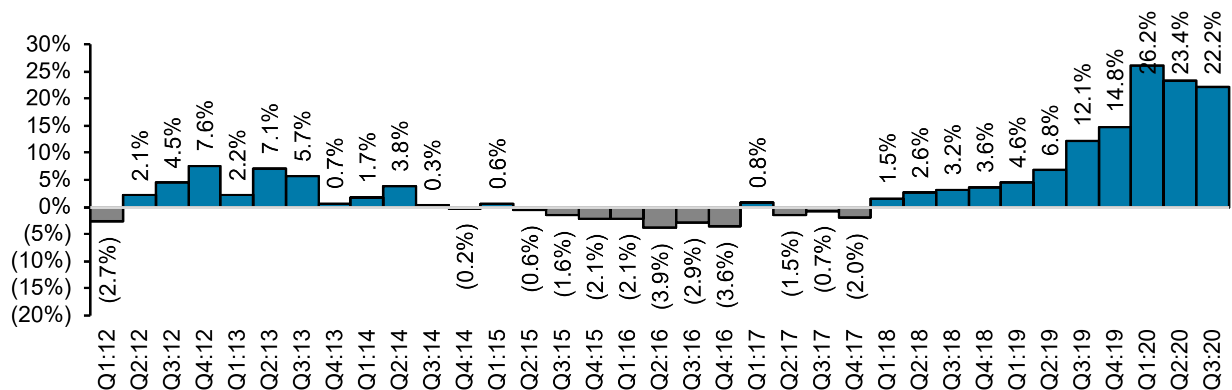
The reason for the significant discrepancy between the all-in and same-client samples is likely a shift in the mix shift due to new IPO programs. Aon reported that eight out of the 20 largest programs by premium were IPO programs that were new to this quarter's sample.

However, this number too can be distorted by client-specific coverage changes, including alterations in limits purchased, deductibles or a shift in the mix of limits between forms of coverage (e.g. ABC limits or Side-A only). To control for this, Aon also offers a pure-price change-only metric for primary policies only renewing with the same limit and deductible.

On this measure, primaries were up 22.2%. For us, this is typically a more meaningful indicator of market conditions than the price per million noted above, and the number most widely cited.

"Same store sales" with same limit & deductible – YoY price changes

Source: Aon, Inside P&C

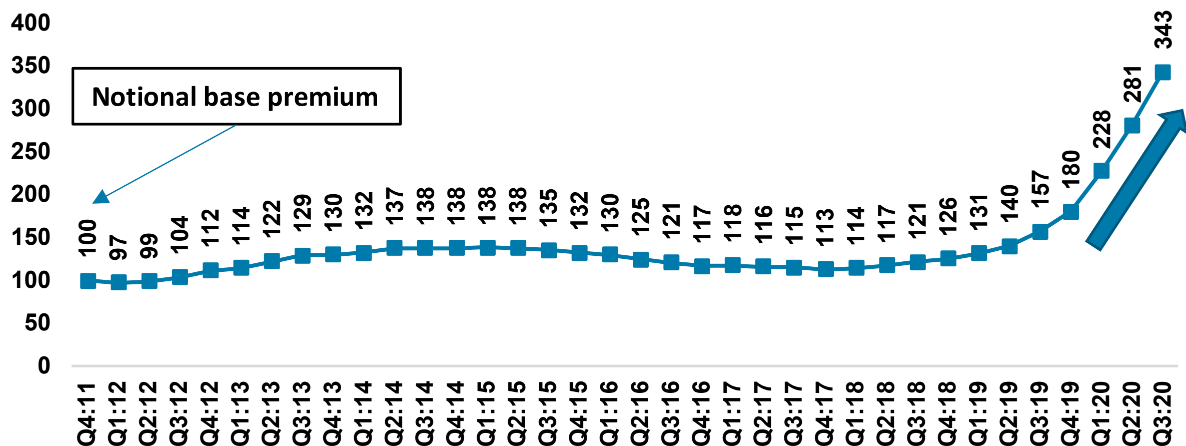


In this way, it is worth noting that **(a)** this number remains well beyond any level seen in recent history – double what it was a couple of quarters ago, and almost 4x what it was in the last market hardening in around 2012-2013, but also that **(b)** it is well below the headline numbers that are commonly cited. You could argue that it is down a point from Q2, but it is worth noting the rate-on-rate adjustment would likely mean Q3 rate increases are more meaningful given the tougher YoY comparison with Q3:19 that had an over 5pt sequential increase from Q2:19. This is better demonstrated by an indexed view, i.e. looking at the curve (premiums) rather than the derivative (price change).

As we show below, despite the sequential deceleration on the headline price change, it still has a substantial impact on the premium.

"Same store sales" with same limit & deductible – the impact of YoY price changes since 2011 on a notional premium of 100

Source: Aon, Inside P&C



Another way to look at it is tracking Aon's proprietary D&O pricing index.

However, the "same store sales" metric has its limitations too. First, it is worth noting that the number of companies renewing with the same limit and deductible has plummeted in recent quarters (more on that later).

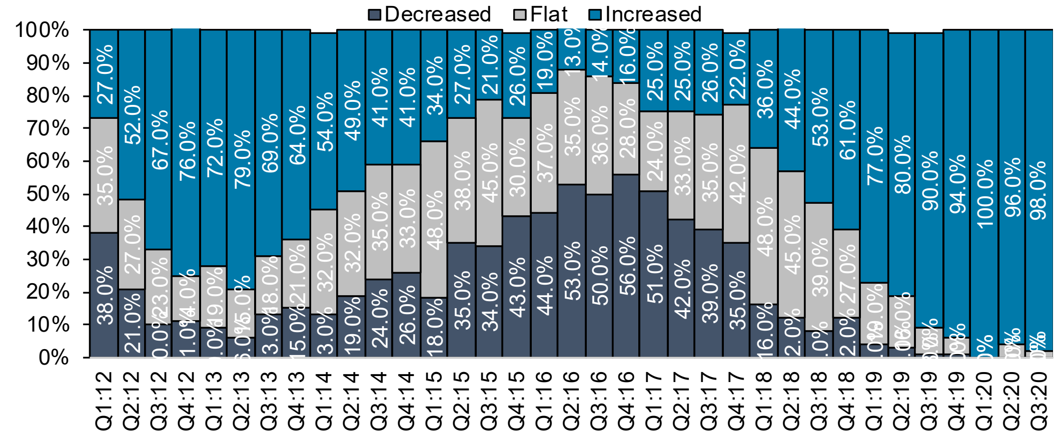
Second, though it controls for the variables mentioned, it also has an inherent sample bias in our view. This is because the sample of clients least likely to change limit and deductible is likely to include a high proportion of loss-free accounts.

Conversely, restructuring coverage with higher deductibles or reducing limits purchased is a classic way to manage the premium dollars spent when price per unit of coverage increases beyond client budgets. Therefore, the true price rises for primaries are likely well above these levels.

That said, another metric showing the market's hardness was that 96% of clients with the same limit and deductible as a year ago recorded price increases – showing the market continues to make few exceptions. This compares to 21% with flat or down pricing in the last market hardening.

Primary price change distribution

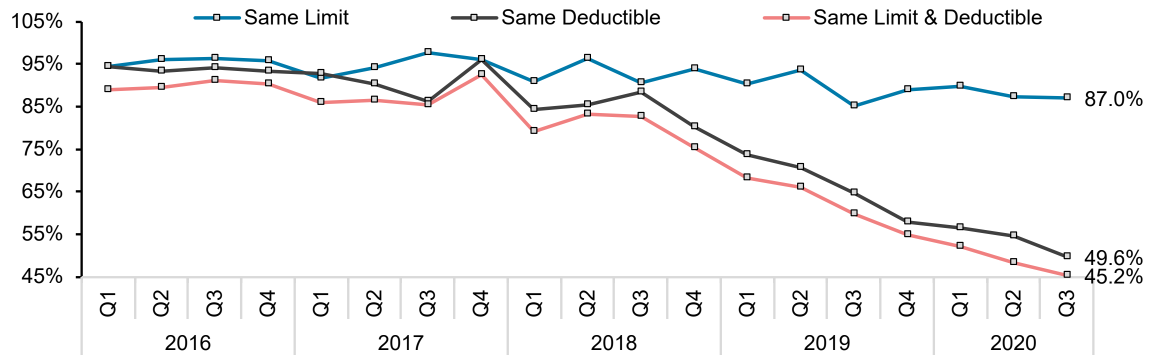
Source: Aon, Inside P&C



Beyond price, we look to the level of structure changes as another decent proxy for the hardness of the market. We note that companies appear to largely be buying the same amount of limit, but with half of the market changing the deductible – undoubtedly higher. Notably, the proportion of policies changing deductibles is increasing sequentially. This is a de facto price increase not captured in the price-per-million metrics.

D&O coverage change

Source: Aon, Inside P&C



Retentions remain strong despite market keeps hardening

The primary D&O market in the US is dominated by AIG, Chubb and Axa XL, with second-tier players including Allianz, Zurich, CNA and Sompo, according to sources. This market structure has historically made sustained underwriting discipline challenging.

As is familiar in most heavily intermediated lines of insurance where capacity is seen as commodity-like, an auction-driven price discovery mechanism tends to lead to a “winner’s curse” outcome, where the least rational and least disciplined participant sets the clearing price.

As such, a second tier of carriers looking to “break in” provides brokers a credible threat of a substitute market, even if the business isn’t shopped or moved.

However, despite this competition, the level of account churn in primary D&O has been low. For context, Aon reports that, even in 2018, the first year of price increases since 2003, 97% of primary policies renewed with the same carrier. The average since 2016 has been around 95%. This is well beyond even high-quality carriers across commercial lines.

However, in Q3, in spite of all the action noted above, the retention level in primary D&O remained in line with long-run trends and stable from Q2 at 94%, having ticked down to 93% in Q3:19.

As noted above, this remains excellent relative to other lines, in spite of the monster pricing movement. However, this will be an area to watch for a sign of any competitive response from second-tier companies deciding to push for share and hoping to get a free ride off the market discipline of the lead players, pushing the overall market towards more sustainable profit levels – potentially including new entrants.

Net take: Impressive numbers, but you can't cure an excess book with price alone

We spent much of last year arguing that market conditions were better than the available pricing data suggested – based on the premise that pricing for restructured accounts is even higher than the headline figures suggest. Essentially, the higher deductible and lower probability of attaching is not being captured in the pure pricing metrics.

However, the recent high headline figures have forced us to add more nuance to this view, as we believe the price-per-million figures are being distorted by huge pricing changes on the low RoL excess layers.

This makes sense given loss trends, with higher-severity, longer claim-payment development patterns, and our understanding of a market where excess players have been persistently late to recognize losses and put up case reserves (= pretend and extend).

Now we have been on the leading edge of calling the hard market in D&O, starting with our prediction of a big market move coming in the market in April last year.

Even so, at this juncture, we continue to urge a little caution around these monster headline numbers. In short, there is a simple truism that informs this skepticism: you can't fix an excess business with pricing – you fix it by not having losses (= attaching out).

With that axiom in mind, our view is to not be too blown away by the headline pricing numbers. There's more to re-underwriting than price.

Further, we note that the price increases come after a substantial period of price reductions, and remain well below levels reached in the last true hard market.

In fact, this may even understate the challenges. As noted above, these pricing metrics are based on price paid per million dollars of limit offered. When you factor in the higher exposure from elevated equity market valuations and increased frequency and severity trends, per unit of risk pricing likely has a long, long way to go.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, and Dan Lukpanov.

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