UK asset management market update

Half year - 2020

Executive summary

We are pleased to present FINEX's UK Asset Management Insurance Market Update as at 1st July 2020. In this issue, we explore the current state of the Professional Indemnity (PI), Crime and Directors' & Officers' (D&O) liability insurance (collectively known as investment management insurance - IMI) market for non-publicly traded asset managers and the funds they manage. In this addition, we identify new and emerging issues within the asset management industry and discuss what impact those issues may have on IMI policies.

As Q1 2020 came to a close, the entire world was responding to the unique and unexpected personal and professional challenges presented by the COVID-19 pandemic. Unprecedented in its scope, the virus itself, along with the market volatility that followed, has already had tremendous consequences for virtually all industries and all lines of coverage across the globe. It has been the most significant issue affecting both asset managers and the PI, Crime and D&O liability insurance market across all sectors this quarter and will likely continue to do so for the foreseeable future.

Though the full extent of the virus' impact on IMI insurance for asset managers is yet unknown, we do know that the pandemic has added a new layer of volatility on top of an already challenged insurance environment. As a result, insurers are taking a far more cautious approach to the renewal process and are expected to be far more invasive in their underwriting protocols than in years' past. Renewals will be challenging so beginning the renewal process early is critical, as insurers are likely to seek increases in both premiums and retentions, while carefully managing the limits they will provide and scope of coverage they will afford.

Although the COVID-19 pandemic is the most prominent issue currently, we have not lost sight of the fact that other new and emerging issues are also affecting the asset management industry. Noteworthy items addressed within this edition include the rise of various accountability regimes, such as the Senior Managers and Certification Regime (SM&CR), the increased focus on "greenwashing", cybersecurity and the rising concerns relating to fund liquidity. We discuss these issues and identify the potential implications they may have on an asset manager's risk profile, as well as their IMI insurance policies.

There have been many challenges facing asset managers thus far this year. However, we hope this publication offers valuable insights to help you successfully navigate through these turbulent times. Should you have any questions or wish to discuss any of these issues in greater detail, please engage myself or a member of your Willis Towers Watson team.

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PI, Crime and D&O (IMI) market update

Cost retentions

Cost and retentions

- **Overall:** Willis Towers Watson has found premiums are generally increasing by 10-30%, while retentions are largely remaining flat for larger asset managers, small to medium size firms are seeing their retentions increase from historic lows.
- **Exceptions:** Asset managers with material changes in assets under management (AUM), merger and acquisition (M&A) activity, challenged risk profiles and/or significant claims activity will experience greater upward adjustments to premium and/or retentions.

Capacity

- **Reducing capacity:** Although insurers are still keen to deploy capacity for the majority of asset managers, they are looking to adjust the amount of capacity exposed to any one asset manager. Typically, we have seen primary insurers reduce their capacity from GBP10m to GBP7.5m or even GBP5m for more distressed asset managers. This leads to new capacity being sought which often results in programs having to be restructured to accommodate new insurers.

Markets

- Primary layer insurers continue to aggressively push rate increases.
- Excess layer insurers have largely aligned behind primary insurers on pricing and terms, with some excess insurers seeking greater increases than the underlying, depending on existing pricing.
- Some insurers are voluntarily exiting programs they deem under-priced, possibly creating a more challenging renewal process.
- Consideration given to breaking relationships with long-term primary and/or excess insurer partners may be required to mitigate significant premium increases.

Coverage

- **Stable to narrowing coverage:** Broad coverage is generally still available, though some insurers are reassessing their portfolio and making adjustments to the scope of coverage within IMI policies. Notable coverage developments include:
  - **"Silent Cyber":** Lloyd's of London and some insurers are looking to eliminate ambiguity regarding cover for cyber-related events by adding language clarifying the breadth and scope of what is (and what is not) covered under IMI policies going forward.
  - **Exclusions:** Introduction of insolvency or COVID-19 related exclusions for distressed private equity firms.

Targeted segments

- **Insurer appetite:** Asset management is still the area that most insurers are looking to grow.
- **Private equity:** One of the most challenged and least desired by insurers currently due to poor claims experience over the past several years globally and the consequential impact of COVID-19 on some investee companies.

Impact of COVID-19

The impact of the pandemic on Asset Management IMI renewals is still yet to be fully determined and is evolving daily.

Generally, insurers are not taking broad negative actions across their book of business but are assessing each renewal on its own merits.

- **Allow for more time** in the renewal process and expect more questions relating to both the impact of, and response to, the pandemic. Insurers will focus on, among other things, regulator/investor interactions, exposure to stressed industries/products, liquidity, valuation practices and the effectiveness of Business Continuity Plans at both your organisation and your key service providers.

Asset Management industry trends

Key issues to watch

COVID-19: Market Volatility

Observation:

The pandemic has created intense global volatility resulting in extreme measures being taken to stabilise capital markets, including new measures taken by central banks, as well as relief being given by the regulators with respect to regulatory lending restrictions, short selling and the timing of regulatory filings.

Concern:

Historically, periods of extreme market volatility result in greater claims activity, usually beginning with errors made during the associated spike in trading activity, followed by litigation brought by unhappy investors (often by alleging a breach of mandate) and, potentially, regulatory activity against the adviser and/or funds.

Suggestion:

Asset managers should ensure that their trade error manuals require immediate notification of such errors to the internal contact responsible for insurance. Cover for correcting such trade errors often imposes strict insurer notification requirements that must be met in order to preserve coverage under the policy. Reviewing the scope of regulatory coverage, as well as the applicability of certain exclusions, such as the Bodily Injury/Property Damage and Pollution exclusions, are also recommended.

COVID-19: Impact on Business

Observation:

As the pandemic works its way through the global economy, the near-term outlook is bleak: the risk of bankruptcy for some firms is almost certain, investors are nervous, key person succession plans are being questioned, portfolio valuation and liquidation are being scrutinised and Business Continuity Plans (of both asset managers and their service providers) are being tested and challenged in unprecedented ways.

Concern:

The insurance market was already in a challenged state going into 2020. The global pandemic now adds a new layer of uncertainty to the renewal process, with insurers applying greater scrutiny to all aspects of an insured's business and the underwriting process expected to be far more invasive than in recent years' past.

Suggestion:

Beginning the renewal process well in advance of the renewal date, approximately 4 months in advance, is highly recommended. For larger firms, conducting underwriter meetings is critical and engaging the appropriate individuals within the organisation to speak thoroughly to each of the insurer's concerns will be imperative in order to mitigate the 'hardening market's' impact on renewal terms.

Asset Management industry trends

Key issues to watch (continued)

Global Culture & Accountability

Observation:

The regulatory environment globally has given rise to multiple accountability regimes, including the Senior Managers & Certification Regime (SM&CR) in the UK (applicable to asset managers as of December 2019), the Manager-in-Charge regime in Hong Kong and similar proposed regimes in Ireland and Singapore. The focus on accountability will continue throughout 2020 and beyond, as the FCA recently issued 'Dear CEO' letters[1] aimed at asset managers and alternative investment firms, stating that the standards of governance in both types of firms are below expectations and progress is needed in order to protect customers' best interest.

Concern:

Increased regulatory requirements and the potential for follow-on civil litigation, creates a heightened exposure for asset managers.

Suggestion:

Investigations coverage, definition of "Insured Person", consideration of a WTW Legal Expenses Additional Protection (LEAP) policy[2] (available for UK entities only) and overseas local insurance requirements should be reviewed accordingly.

1. https://www.willistowerswatson.com/en-GB/Insights/2020/03/dear-ceo-beware-the-sustainable-label

2. https://www.willistowerswatson.com/en-GB/Solutions/products/legal-expenses-additional-protection

Cybersecurity

Observation:

The focus on cybersecurity for all industries, including asset management is now stronger than ever, with scrutiny coming from regulators, business counterparties and investors.

Concern:

Global regulators are focussed on creating new regulations to address cybersecurity. Further cybersecurity scrutiny by the FCA is expected to increase going forward, particularly in light of the increased exposures arising out of the COVID-19 pandemic.

Insurers are also assessing their exposure to "Silent Cyber Coverage" under traditional insurance policies going forward with a view to ensuring cover is either affirmed or not accordingly. Lloyds of London has asked its Syndicates to affirm cyber cover or not to all Crime policy renewals as of 1 July.

Suggestion:

Regulators continue to voice their concerns about cybersecurity and resiliency. The common theme is that regulators expect all financial institutions to be resilient upfront rather than thinking about it as an afterthought when reviewing existing technology or introducing new technology when managing cyber risks.

Existing IMI insurance should be reviewed, including the scope and limitations of such cover and how it interacts with other insurances. If little exists, explore stand-alone options or Cyber extensions to the IMI policy.

Asset Management industry trends

Key issues to watch (continued)

"Greenwashing"

Observation:

Responsible investing mandates and environmental, social and governance (ESG) products are a top priority for many investors, while shareholders are increasingly focused on the incorporation of ESG factors into an organisation's own operations.

Concern:

As asset managers try to keep up with investor demand, the risks associated with this trend must be managed, including the risk of misrepresenting the characteristics of an ESG product and/or the extent to which ESG factors are incorporated into an asset manager's own operations (i.e."greenwashing").

Suggestion:

Several regulators, noticeably the SEC, have included this topic within their 2020 Examination Priorities[3]. Expect insurers to enquire about, among other things, the extent of ESG training asset managers are conducting for their sales and marketing staff and the process in place to mitigate the risk of greenwashing. Asset managers should examine and understand the breadth and limitations of coverage under their IMI policies, including cover for investigations and investor related disputes.

3. https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf

Fund Liquidity

Observation:

Liquidity has been a hot topic ever since the financial crisis and more recently last year, the liquidity issues encountered by Neil Woodford's flagship LF Woodford Equity Income fund which initially saw gates being imposed on investor withdrawals, then subsequently all cash being returned to investors (subject to regulatory approval).

In its recent analysis of fund liquidity, MSCI found that at least 7 UCITS had the potential to be in a liquidity situation similar to Woodford[4], while the Bank of England stated in its July 2019 Financial Stability Report and Record that it "continues to judge that the mismatch between redemption terms and the liquidity of some funds' assets has the potential to become a systemic issue[5]."

Concern:

Continued noise surrounding liquidity and therefore how much illiquid assets certain types of funds can hold at a given time is still subject to much debate. Ultimately, the authorities want to protect investors from being mistreated but also to minimise any liquidity shortfall from becoming a systemic issue to the wider global economy. Systemic issues and the protection of individuals' finances has become a major concern more than ever in light of the impact of COVID-19.

Suggestion:

Asset managers should be prepared to address liquidity-related questions from insurers, especially if performance has been negative or there have been an increase in redemption requests. Fund managers and senior management should review and understand the breadth of coverage under their IMI policies, particularly with respect to formal and informal investigations.

4. https://www.msci.com/www/blog-posts/is-there-another-woodford/01539700184
5. https://www.bankofengland.co.uk/financial-stability-report/2019/july-2019

FCA: Notable activity

In addition to the FCA's recent 'Dear CEO' letters to Asset Managers, the FCA gave a speech on 4 June 2020 on 'The FCA's response to COVID-19 and expectations for 2020' by Megan Butler, Executive Director of Supervision – Investment, Wholesale and Specialists[6]. It highlighted the following:

- FCA acknowledges that in operational terms the industry has responded well to COVID-19 and that it is now moving away from incident response to focus on longer term issues.
- Operational and financial resilience and acting with integrity are core focus areas going forward.
  - Operational – the FCA expects all firms to continue to have robust contingency plan in place which are regularly tested. This should include operational risk assessments and transfer/mitigation of risks where possible with a view to protecting the consumer.
  - Financial – pressures financially for some firms and the temptation by those firms to "cut corners" on governance, or their systems and controls to the detriment of customers.
- The FCA reconfirmed its role as regulator and that it would act where it sees bad practice. An example of is where firms close companies in order to avoid liabilities to their customers to then set up new ones.
- With regards to the future, the FCA acknowledged that although regulation will still be based on Principles, it was aware of the difficulties faced by firms on interpreting the complexities and number of rules. Instead the FCA is looking to move away from a rules based system and focus more on the customer experience.

6. https://www.fca.org.uk/news/speeches/fca-response-COVID-19-and-expectations-2020

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