# Growing complexities over ESG risk add to D&O insurers' pricing woes

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The increasing focus on environmental, social and governance (ESG) initiatives by regulators and investors presents a complex problems for insurers covering directors and officers liability. Uncertainty is clouding risk assessment at a time when pricing powers are reined in and a challenging economic environment looms.

D&O insurance rates began to slow in 2022, after three years in which insurers wielded significant pricing power, with lower coverage limits, higher retention terms and more coverage exclusions. Fitch said premium volumes were likely to remain flat or drop further, after sliding 2.7 percent in the first half of 2022 from a year ago. This is partly a result of newer entrants offering coverage, lured by a 130 percent surge in D&O premium volume from 2018 to 2021.

The complex nature of ESG risk adds pressure amid a D&O coverage market in which insurers' pricing now needs to keep pace with losses, experts said. ESG issues have varying levels of risk, and there are no commonly accepted parameters that measure the ESG performance of a company or industry.

"In my view, the only way you can really protect yourself from that kind of risk situation is through premium that reflects the uncertainty," said Kevin La Croix, attorney and executive vice president at RT ProExec, an insurance broker focused on management liability issues. "Unfortunately for the industry right now . . . there are not going to be many opportunities for the insurers to be able to command the pricing authority to extract that uncertainty premium."

So far, D&O insurers' actuarial assessments of a company's ESG exposure have largely remained limited to underwriting questions rather than impact on pricing, but that could soon change as the regulatory spotlight intensifies on company disclosures. This could translate into higher retention or pricing terms during policy renewals.

"As this risk evolves and as we assess the risk, I think we are going have to take it into consideration at some point into our overall underwriting - which would include our pricing and coverage and everything else," said Joe Caruso, head of North America financial lines at Allianz Global Corporate & Specialty, a commercial property and casualty insurer.

Underwriters will wait to see the litigation, fines or other implications arising from the increasing regulatory scrutiny and board commitments to transparency and disclosures to decide on further action, Caruso added.

Regulatory scrutiny around ESG has increased significantly. The U.S. Securities and Exchange Commission is preparing a series of climate-related disclosure requirements and the Department of Justice is stepping up enforcement of environmental laws. Beyond regulation and rulemaking, lawmakers began to efforts to curtail the growth of fossil-fuels use into law in the Inflation Reduction Act passed in August.

Though the act mainly ties climate action to incentives such as tax credits to spur growth in wind and solar production and electric cars, it signals that government action on ESG, particularly climate change, is something that insurers need to build into their assumptions about their client's operating environment, as it will impact their business risk, experts said.

**Uncertainty risk assessment & backlash**

ESG presents a risk on environmental social and governance issues that companies and investors are uncertain about and divided on. ESG policies have become a political flashpoint in which conservatives and the jurisdictions they control have been pushing back against corporate ESG initiatives, while progressives have been implementing tougher ESG policies. Companies which are showcasing and promoting ESG policies might expect premium discounts or better terms and conditions from their insurers, but litigation trends show otherwise.

"If you look at the claims that are actually being filed, particularly recently, they aren't being filed against the companies that are ESG laggards, that are not being proactive. In fact, they are being filed against companies that have been proactive or have taken controversial positions or have shown poor execution and follow through," La Croix said. "It is a muddier picture to try and figure out where the claims might be coming from in the future."

In a backlash against ESG efforts, some lawsuits allege boards prioritized ESG factors at the cost of their fiduciary duty of profit-making. A group of 19 attorneys general started investigating world's largest asset manager BlackRock in August over its efforts to push towards net zero carbon emissions in its portfolio holdings. In September, Starbucks was sued for its diversity policy and hiring practices that were alleged to discriminate against White applicants.

Though these lawsuits are relatively rare, experts expect this to be a new course to watch heading into 2023.

“There's a lot of competing pressures on businesses, and they have to walk this thin line. When you're in a posture doing that, you are going to slip up one way or the other, and there are going to be advocacy groups and shareholders and lawyers eager to represent them. And so I do predict that we are going to see more of these claims, as these issues continue to be hot-button matters politically,” said Bradley Nash, partner at law firm Hoguet Newman Regal & Kenney.

Lawmakers' ideological divide has worsened the problem. While the SEC has proposed a set of rules on climate disclosures that run almost 500 pages, about 17 states – most recently Florida – have proposed or adopted legislation that would limit the ability of the government, especially public retirement plans, to make investments based on ESG criteria or do business with entities that boycott others based on ESG factors, according to law firm Morgan Lewis.

“The ESG backlash... also reflects the fact that ESG risk can come from many directions and can look very different,” LaCroix said. “It also suggests that the environment can unfold in unexpected ways if this ESG backlash continues to unfold and affects legislative and regulatory approaches and could translate into what type of litigation risks a company might face.”

With the midterm elections drawing close, insurers will be closely watching to see if Democrats, known for their ESG focus, can make gains in the Senate or if power shifts to the Republican party which is more divided on ESG matters.

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