D&O + E&O MARKET UPDATE - FOR FIs

The Executive Risks world today is a tale of two insurance marketplaces: one for financial institutions (FIs) and another for everybody else. Typical commercial risks will find a soft market, albeit a little less so these days, but FIs should brace themselves. Increases are ranging dramatically from 10-20% to 400%. The best risks may be lucky to experience a flat renewal and the very best a small decrease.

No one should be too surprised. The credit crisis has put up some terrifying numbers: Write downs and losses reaching approximately $400 billion, extensive credit/subprime litigation to the tune of 448 overall suits\(^1\), including 98 class actions\(^2\), of which more than 90% involve FIs. Industry analysts expect D&O and E&O losses from FIs will approach $4 billion\(^3\). Losses outside the FI sector could be almost as high. A marketplace reaction is unavoidable.

The FI world is no stranger to crises, but two factors differentiate the current situation. First is the time it is taking for the crisis to develop. The subprime crisis broke in April 2007. In July of 2008 the news media were featuring customers lined up at failing banks. Predictions that the worst is over have appeared and disappeared over the past year, and meanwhile, the spread of the crisis has been steady. What began with subprime loans and CDOs spread to mortgage-collateralized investments and credit default swaps and then to auction-rate securities. The losses and the ensuing pursuit of legal remedies go on. Even the savings and loan crisis of 20 years ago was shorter lived than today’s events indicate this crisis will be.

Second is the breadth of this crisis. Recent financial upheavals have been mostly limited to one or two subsectors. The dot-com meltdown of 2001 hit investment banks; the mutual funds scandals of 2003 hit mutual funds and some hedge funds. This crisis is impacting a wider cross section in the FI sector. For instance, in addition to banks and mortgage banks, insurers with real estate investments and even conservative credit unions are feeling some pain from the turmoil.

GUilty UNTIL PROVEN INNOCENT

Last year, you were innocent until proven guilty – underwriters looked for signs of exposure to subprime or credit exposures, and if they found them, they acted accordingly. Now, financial institutions are guilty until proven innocent. If exposures are found in the underwriting process the penalty is especially harsh: we have seen increases of 100% to 400%.

It may be important to note that insurance carriers are **themselves** financial institutions, which makes them
understandably cautious. While they potentially need cash to pay out large subprime-related
claims they may simultaneously find themselves heavily invested in mortgage-backed securities
whose value is plummeting.

**DOUBLE JEOPARDY**

These multiple exposures raise the issue of professional liability or E&O losses combining with
D&O losses. In these cases, shareholder matters generally hit the D&O contract, while suits from
clients hit the E&O. While the originators of subprime mortgages that laid the foundation for the
current crisis are the most obvious group exposed to such a double hit, they are not the only
ones. Financial institutions that packaged the mortgages and sold them as securities may also
see a double load.

Additionally, because of the potential for entanglement of their E&O and D&O risks, many FIs
buy combined coverage, or tie their D&O and D&O limits to each other. They may also have to
face combined losses and combined premium increases.

**HARD BUT NOT HOPELESS**

The situation is not hopeless. No carriers have left the market. A few of the initial class action
suits related to the current crisis have been dismissed, indicating that proving outright fraud in
many of these cases may be difficult.

There is no doubt, however, that the marketplace is a tough one. Some underwriters are refusing
to renew certain risks, but more often, carriers are reducing their limits of coverage to reduce
their exposure. Increased deductibles or retentions are also being imposed. Policy terms and
conditions are becoming more restrictive. Non-rescindable provisions may now be limited or
more difficult to obtain. Carriers are reluctant to provide difference-in-condition provisions on
A-Side placements. Credit and subprime loss exclusions are starting to appear.

What can you do? Prepare for the difficult task of differentiating your risk in the marketplace.
The best way to do that is to anticipate what the underwriters will ask and give them the
information before they ask for it. Proactivity is critical when dealing with underwriters who are
being very careful about how and where they put their limits at risk.

Here are red flags underwriters will focus on.

- **Public disclosure**
  - What does the street know and what was the reaction?
  - What is the company’s track record on disclosure?

- **Investments**
  - Are there subprime or other credit-related exposures?
  - Have there been write-downs?
  - What is the valuation basis of the investments?

- **Solvency concerns**
  - Are there long-term financial issues?
  - Has the firm raised capital recently? From whom?
• Regulatory review
  – Has the SEC gotten involved?
  – If so, how has the company responded?
  – Has the SEC issued any determinations or findings?
  – Has the bank settled, or discussed settlements, with any state attorney general?

• Board issues
  – How active is the board in terms of oversight?
  – How independent is the board?

Expect tough renewal negotiations. Ironically, some of the institutions hardest hit may find the worst behind them. While carriers holding large claims will want to recoup some of their payments in the form of higher premiums, their competitors in the insurance marketplace may see an opportunist play if they believe the claims already filed will capture the majority of the risk under the prior policies.

The tale is a complex one, but one aspect is clear: any financial institution looking for D&O and E&O coverage has its work cut out for it in the foreseeable future. Hard work and a close cooperation among all parties is critical to ensuring that an effective insuring agreement will be consummated.


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