Financial Institutions 2005
Executive Liability Market Forecast

Pricing and Players

The good news for 2005 is that capacity is largely expected to remain stable for Executive Liability (Directors & Officers, Errors & Omissions, Fiduciary and Fidelity). Some of the carriers who are just starting to cover financial institutions and who largely started out writing excess placements, appear to be seriously considering introducing primary policy forms and looking to compete on selective primary accounts for Directors & Officers (D&O) and Errors & Omissions (E&O). More competition on primary placements, even if only on segments of the business, is a good thing for buyers. The one dark spot in the rosy capacity picture is the potential loss of Fidelity limits previously extended by Gulf and Travelers.

The bad news is that premiums for financial institutions are expected to increase, as they did in 2004 (especially in bond pricing) when rates ran counter to the general market’s downward trends. This may be moderated, however, if heightened competition materializes.

Willis is continually striving to provide you – our clients and future clients – with practical, meaningful information that we hope will be useful as you navigate through the trials that may come. To accomplish this goal as respects financial institutions, we have assembled a team of highly skilled professionals in London and North America that allows us to deliver our thought leadership “glocally” – that is, the skills, knowledge and expertise of a global group are available to each and every one of our clients through their local Willis Client Advocate or Practice leader.

Past issues of our Financial Institutions Alert have covered topics such as Basel II and CyberRisk. This edition will offer you our thoughts on where the marketplace will take you in 2005. Areas of focus include D&O, E&O, Fiduciary and Fidelity, areas we group under the single heading of Executive Risks.

As always, I welcome your comments, suggestions and feedback. I have enjoyed the time we have spent together and look forward to the next opportunity to see you.

– John Bayeux, FI Industry Practice Leader
2005 Renewal Pricing

Terms and conditions are likely to remain points of contention in 2005. As companies are asked to pay more, they want to get more from their Executive Liability coverage. In addition to the usual severability and personal conduct exclusions for D&O, battleground issues will include E&O coverage for investment advisory services and some of the coverage constrictions that appeared last year on a number of policies issued to asset managers.

The Surety Association of America, to which the majority of financial institution bond insurers belong, has rolled out a new financial institution bond form. While conversion to the new form has been slow, a careful review is warranted. There are substantive changes contained within the new form that curtail coverage and, for those institutions adopting it, there are numerous enhancements that should be made to it.

A continued source of loss under financial institution bonds are incidents involving registered representatives, disclosed agents, insurance agents and mortgage fraud. Insurers adding coverage for these classes of agents are limited in their ability to underwrite the internal controls of these outside agents. Although the financial institution bond underwriters continue to add these agents to bonds, the adequacy of deductibles associated with these exposures continues to come under close scrutiny.

Agent and mortgage fraud coverage will continue to be carefully underwritten. Some insureds will find a limited number of insurers willing to underwrite these exposures, significantly reducing the number of markets insureds can negotiate their bond renewal with.

As carriers continue to respond to what they perceive as increased exposures, financial institutions are continuing to consider a variety of program structures. Options include more focused and creative application of retentions, use of captives, finite risk and umbrella strategies. For larger risks, this migration from traditional insurance for some portion of a broader risk transfer strategy is expected to continue through 2005. The value of the new approaches will depend on the program design and its effectiveness as a risk differentiator.

Major Liability Trends for Financial Institutions

In 2004, several trends prompted concern on the part of financial institutions and their Executive Liability underwriters.

- Lenders saw aiding and abetting claims brought in virtually every major corporate scandal along with some record-breaking settlements
- Mutual funds experienced more market-trading investigations and settlements
- The insurance industry found itself in the sights of the New York attorney general and various state insurance departments in their investigations of steering/conflicts of interest.

One positive turn of events for financial institutions is that investment analysts saw their conflict-of-interest investigations/settlements move off the radar in the US (while continuing in certain non-US venues). However, the 300+ IPO laddering cases that struck the investment banking community in 2001 are likely to settle in the coming year and the settlement values could be in the billions of dollars. Although the carriers should be fully reserved for these claims, payouts of this magnitude always hurt. So while the worst is behind us for this class of cases, carriers looking to share the pain may well turn again to the buyers for pricing increases and tightening of terms.
### Securities Class Action Litigation by Type of Suit

<table>
<thead>
<tr>
<th>Type</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual fund</td>
<td>–</td>
<td>–</td>
<td>19</td>
<td>20</td>
</tr>
<tr>
<td>Analyst</td>
<td>5</td>
<td>41</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>IPO laddering</td>
<td>312</td>
<td>1</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Classic</td>
<td>176</td>
<td>226</td>
<td>181</td>
<td>212</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>439</td>
<td>266</td>
<td>216</td>
<td>233</td>
</tr>
</tbody>
</table>

*Source: Stanford Securities Class Action Clearinghouse web site*

### High in Frequency, Higher in Severity

According to Cornerstone Research (Securities Class Action Case Filings, 2004: A Year in Review), financial institutions were one of the top industries in terms of loss frequency (beat out by consumer, technology and communications). Financial institutions were either second or tied for second in severity as measured both by maximum dollar loss and disclosure dollar loss.

### Financial Institutions Filings
*(Excluding IPO Laddering, Analyst and Mutual Fund Claims)*

![Graph showing maximum dollar loss and disclosure dollar loss for financial institutions from 2003 to 2004](image)

Claim against financial institutions are expected to continue to come from non-traditional sources such as institutional investors and bondholders. This first group, on average, racks up securities settlements that are 16 times higher (per attorney Bill Lerach in his presentation *Why Institutional Investors Make a Difference*) and bondholders who are making new law both in the US and Italy in the case of Parmalat.

### Changing Rules of Play

It may be truer for financial institutions than any other industry group that the rules of business are changing. While it is not clear if this is due to their critical role in capital formation or simply because “that’s where the money is,” the industry is under the microscope.

Every publicly traded company in the US is faced with the increased due diligence and reporting requirements under Section 404 of Sarbanes-Oxley (“SOX”), and international companies in over 70 countries are having to address the new International Accounting Standards as of January 1, 2005. But financial institutions are continually under additional scrutiny and must account for shifting rules and regulations on both the national and international level:

- Large banks must stay abreast of the evolving proposals for Basel II
- Hedge funds are responding to new formal requirements for registration with the Securities & Exchange Commission
- Mutual funds have new rules on board composition
- Insurance companies are under the threatened specter of potential federal oversight

With change as the only constant, the real challenges globally are effective implementation of transparency and disclosure, along with solid corporate governance. The financial institutions that are able to succeed in this new arena are undoubtedly the ones that will also succeed at risk management and in that crucial area outperform their peers.

*The following articles are summaries from sections of the 2005 edition of Willis’ Marketplace Realities and Risk Management Solutions.*
Directors & Officers General Marketplace
Forecast for 2005

Significant claim inventories held by the traditional insurance markets counter the generally softening insurance market. While the underwriting results for 2004 continue to be analyzed, it is understood that financial restatements have risen. A limited accounting review recently conducted by the Public Company Accounting Oversight Board indicated significant audit and accounting mistakes at public companies. These trends generate concerns about premium levels and reserves at direct writers and reinsurance carriers.

These recent developments may well be a result of two parallel factors:

- Increasingly conservative positions being taken by the accounting profession in response to recent financial scandals
- Compliance efforts under Section 404 of Sarbanes-Oxley (SOX)

Financial Institution Bond Market Forecast for 2005

The Financial Institution (FI) Bond market has remained somewhat insulated from the hard market experienced by its Commercial Crime counterpart, due in large part to the substantially higher deductible applied to FI bonds.

The much anticipated reduction in capacity resulting from the St. Paul and Travelers merger took full effect in mid-to-late 2004. The Gulf and Travelers reinsurance treaties were then non-renewed with all accounts being subsequently written on St. Paul paper. For the majority of financial institutions, the changeover to St. Paul was relatively seamless. For larger institutions, however, the consolidation of these three companies (St. Paul, Travelers and Gulf) created notable shortfall in capacity. For institutions requiring limits of $100 million or more, the loss of capacity required some to explore new or non-traditional markets.

From a coverage perspective, the agent losses sustained by the financial institution fidelity bond underwriters in 2004 will make insurers more cautious than ever when extending coverage for outside agents. Insureds who entrust their money, securities or other property to a third party will no doubt feel naked if this coverage is no longer available. As the availability of agent’s coverage becomes more restrictive, insureds may be faced with the prospect of higher premiums and deductibles. For those insureds unwilling or unable to purchase agents coverage, an exhaustive due diligence of the agents they use is highly recommended.

Having finally achieved profitability as an industry, fidelity underwriters would like to hold the line on pricing. After years of spotty or marginal profit margins, many feel they should reap the rewards associated with current pricing and more rigorous underwriting guidelines. Aggressive 2005 budgets by management, however, will invariably intervene, making it more difficult for underwriters to stay the course. In the end, insureds may find themselves forced to choose between their incumbent underwriter and moving coverage to a more aggressive player.
From the Fiduciary Liability General Market Forecast for 2005

The number one risk differentiator for Fiduciary Liability is whether a company has its own employer securities in any part of any employee benefit plan. If the answer to this broad question is “yes,” then most insurance carriers will decline the risk while others will look for sharply higher premiums and attachment points (retentions). As the majority of large public companies have to answer this question in the affirmative, this line of coverage continues to experience market adjustments.

The number of Fiduciary Liability claims is approaching that of D&O claims (although the severity is typically lower). The most recent statistical evidence indicates that 183 new claims were filed under the Employee Retirement Income Security Act (ERISA) in fiscal year 2003, while the Department of Labor reports that it “recovered and protected” $3.1 billion in retirement, health and other benefits in fiscal 2004. These amounts do not include the Enron and WorldCom settlements which fell in the 2005 fiscal year. Civil settlements also continued, with a number of cases fully eroding total insurance limits; some actually included payments from individual fiduciaries as well. One major carrier termed the situation “Armageddon” and acknowledged reserves for these claims in the $100 million+ range.

With the current investigation by the SEC into pension and other benefit plan assumptions as well as the possible migration of mutual fund claims into Fiduciary Liability claims, there is enough uncertainty to discourage new capital from entering the Fiduciary Liability market. As a result, companies continue to consider combining some or all of their Fiduciary Liability insurance with their D&O and/or E&O coverages. Where this may be the most cost effective and efficient method for transferring this risk, without the necessary firewalls between these programs, unexpected coverage gaps could occur.

Should you desire more detailed information, Willis has again published its annual Marketplace Realities and Risk Management Solutions, an industry-by-industry, product-by-product analysis of issues and trends that provides both guidance and enlightenment across a wide spectrum of disciplines and risk management concerns. Please contact John Bayeux or your local Willis Client Advocate for a hard copy, or if you prefer, this publication is also available on our web site at http://www.willis.com/news/Publications/Willis_Marketplace_Realities_2005_v2.pdf