A High Profile Segment: Directors and officers (D&O) liability insurance is a rather small specialty segment of the property/casualty insurance market, representing approximately 1% of total industry direct premiums and written by relatively few individual insurers. However, this line has greater notoriety than its modest stature would imply, as many large D&O claims arise from episodes of corporate insolvencies, stock price declines, financial reporting irregularities, or regulatory investigations that receive wider coverage in the business and mainstream media.

Direct Loss Ratios Stable in 2012: Greater interest in D&O insurance spurred insurance regulators to add a specific D&O supplement to statutory financial statements in 2011. This filing requires individual insurers to provide annual premium and incurred loss data on a direct basis for D&O business. Aggregating D&O supplement data to analyze industry aggregate underwriting results shows direct written premium grew by approximately 6% in 2012 and the industry direct loss ratios improved by 3 points to 48%.

D&O Market Share Concentrated: Statutory supplemental data provides information on D&O market share. The largest 2012 D&O writers that have 48% combined market share were American International Group, Inc. (AIG); XL Group Ltd (XL); The Chubb Corporation (Chubb); HCC Insurance Holdings, Inc. (HCC); and Travelers Companies, Inc. (TRV).

D&O Premium Rates Rising: D&O and, more broadly, professional liability business is currently generating accident year underwriting losses for the industry, despite the noted recent stability in loss ratios. D&O premium rates were previously lagging the market recovery in the broader commercial lines segment, but pricing trends are now catching up. Aon’s D&O Pricing Index shows that rates in fourth-quarter 2012 were 9.9% above the prior year fourth quarter. From a credit rating perspective, a market pricing shift before extensive underwriting losses materialize promotes future earnings stability, and thus, a more stable ratings profile for participants in these business lines.

Constant Claims Uncertainty: D&O is a more volatile product line than other property/casualty product segments as policy limits and individual claim costs are relatively large and the threat of new lawsuits or claims exposures are always looming. Key sources of claims relate to securities litigation and regulatory actions and settlements. More recently, claims related to mergers and acquisitions are a source of material losses for D&O insurers.

Insight from OLCM: Analysis of the other liability claims made (OLCM) segment results in statutory filings provides additional insight on underwriting performance in D&O and professional liability insurance broadly. OLCM results for the industry aggregate and top 10 D&O insurers show that accident year loss ratios in this segment have been relatively stable over the last five years, but have risen to levels well above highly profitable years in the mid-2000s. Industry combined ratios in OLCM on a calendar year basis are slightly above 100%.

Loss Reserve Development Trends: Favorable loss reserve development continues to boost underwriting performance, reducing the industry OLCM loss ratio by approximately 4% in each of the last two years. Questions remain on the strength of recent accident years, and the potential for future adverse development. However, the chances of recent underwriting periods, including accident years from the recent credit crisis, experiencing severe adverse development are becoming more remote.
**Explanation of Typical D&O Programs**
The typical D&O insurance program for a publicly traded company contains three types of coverage in one policy. These coverages are often referred to as Side A, Side B and Side C coverage. In recent years, there has been increased demand for additional stand-alone, Side A coverage for directors and officers.
- Side A provides coverage for both defense expenses and settlements/judgments that arise from claims against individual directors and officers, when those costs cannot be indemnified by the company. Shareholder derivative claims and firm bankruptcy are traditionally covered by Side A.
- Side B is often referred to as “company reimbursement” coverage. It reimburses the company for the costs of paying claims against individual directors and officers when the company is permitted, or required, to indemnify them. Side B is typically the primary coverage under which payments are made under a D&O insurance policy.
- Side C/Entity Coverage provides coverage for claims when the company itself is a defendant in the claim and typically only provides coverage for securities-related claims.

**High-Profile Specialty Segment**
D&O is a key segment within professional liability lines of the property/casualty industry. D&O covers an organization’s management and board members from lawsuits against allegations of negligence or other wrongful acts.

Direct written premiums in 2012 for D&O represented approximately 1% of total industry premiums. However, the segment receives considerably more widespread attention relative to its size, as D&O claims arise from situations that receive greater media exposure such as insolvencies or corporate scandals. More recently, new D&O claims have been prevalent in any sizeable public merger or acquisition transaction.

Corporate litigation and legal settlements have expanded dramatically over the last 40 years. The D&O market has grown proportionately with this activity as companies need to mitigate the liability risk of key managers and directors to induce the most qualified professionals to take leadership roles in an organization.

D&O products are offered to professionals in publicly and privately held corporations, as well as nonprofit organizations. A description of the key coverage available in a D&O policy is provided in the box at left.

**D&O Market Share**
Greater interest in the D&O segment following the 2008 credit crisis and economic recession, led state insurance regulators to require greater disclosure of insurers’ D&O specific underwriting activity. Starting in 2011, underwriters are required to file a supplement with their statutory financial statements that provides information on D&O underwriting experience on a direct basis. Compiling this data provides information on the overall size of the market and changes in market share over time.

As a line that requires unique underwriting and claims expertise, a willingness to write relatively large policy limits and bear corresponding potential claims severity, D&O market activity is concentrated within a smaller number of larger insurers. Market share for 2012 based on D&O supplement data is listed below.

The top 10 D&O writers combined wrote approximately 70% of D&O 2012 direct premiums, and the top 20 companies wrote more than 90% of all U.S. business. Of the leading companies, AIG has traditionally been the largest writer and has maintained that position despite substantially shrinking its overall written premium base since 2008. XL Group was the second-largest direct writer of U.S. D&O in 2012.

Chubb, previously the second-largest writer of D&O, moved to the third largest in 2012. HCC is a relatively newer entrant to the segment that has expanded quickly. Other leading writers of
D&O, including TRV, ACE American Insurance Company (ACE) and Continental Casualty Company (CNA), are long time participants in the segment.

Reported Direct Loss Ratio Declines

D&O supplement data also provides information on incurred loss experience for the segment. The table below shows both direct premiums written and direct loss ratios for the last two years for the top 10 D&O writers, providing perspective on relative underwriting performance. However, direct loss experience does not provide a full account of profitability for a segment as not all losses and expenses incurred or benefits from reinsurance are considered.

In most cases, direct loss ratios appear relatively stable in 2012 versus the prior year. The industry aggregate direct loss ratio improved to 48% in 2012 from 51% in 2011. This information will prove helpful to track direct loss experience specific to the D&O line going forward.

Direct Written Premiums and Loss Ratios

<table>
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<tr>
<th>Group</th>
<th>2012 D&amp;O Direct Written Premiums ($ Mil.)</th>
<th>2011 D&amp;O Direct Written Premiums ($ Mil.)</th>
<th>2012 D&amp;O Direct Loss Ratio (%)</th>
<th>2011 D&amp;O Direct Loss Ratio (%)</th>
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</table>

D&O – Directors and officers.
Source: SNL Financial.

D&O Premium Rates Increasing

After years of declining premium rates, in mid-2011 the commercial lines market commenced a turn in pricing across a broad number of segments. This pricing momentum continued in first-quarter 2013 and should last through the rest of the year. This cyclical shift in the pricing environment is unique to past hardening markets, as it is driven less by sharp reductions in market capital or underwriting capacity, but rather a response to underwriting losses and a need to offset lower investment yields with better underwriting performance.

In the current hardening market phase, D&O and professional liability lines were slower to gain price momentum relative to other segments, but have now shifted positively. Aon Corporation’s fourth-quarter 2012 D&O Pricing Index indicates that D&O renewal rates increased by 9.9% versus fourth-quarter 2011. Aon also indicated that of the last 38 quarters, the index showed year-over-year improvement in only four quarters.

This index result corresponds with company disclosures on D&O pricing in recent earnings calls as well as reports from insurance brokers and other experts. Willis North America, Inc.’s Marketplace Realities 2013 report predicted price increases from flat to up 10% for primary D&O in 2013, with up to 15% increases for private companies.
Demand for coverage continues to remain relatively stable, and there are no signs that policyholders are decreasing D&O policy limits in light of rising rates. Enhanced focus of businesses on corporate governance and enterprise risk management is leading to greater interest in mitigating risks that lead to D&O claims through implementing greater internal controls and optimizing purchases of professional liability coverage.

Claims Uncertainty a Constant

A key prevailing characteristic of the D&O insurance landscape is the consistent emergence of unanticipated risk exposures and litigation catalysts that lead to periodic spikes in volatility. D&O underwriters must therefore price risks to achieve a healthy underwriting margin in most periods, in order to offset the occasional unwelcome surprises that will inevitably arise.

Current Litigation Trends

Investor Suits Are Primary Driver of D&O Claims

According to Towers Watson’s most recent Directors and Officers Liability Survey, direct and derivative shareholder/investor suits continue to be the most prevalent sources of D&O claims filed. Towers Watson notes that direct shareholder suits have decreased while the pace of derivative shareholder suits have been consistent during the period examined. While risk of D&O claims is perceived to be highest for public companies, Towers Watson notes that nonprofit organizations have experienced the highest recent increase in claims activity.

Merger and Acquisition Claims

Lawsuits from shareholders and other constituencies are a regular outcome from any merger or acquisition. Allegations of misrepresentations or inappropriate disclosures or a failure to meet fiduciary duties by board members or corporate officers are typical. These claims tend to settle relatively quickly and are not the source of large individual payments. Still, merger-related suits have become an increasing source of losses for D&O insurers, which may lead to more active contesting of these claims in the future.
Emerging Litigation Trends

FDIC Activity and LIBOR Manipulation Allegations Could Spur Settlements

Emerging litigation trends point towards a near-term uptick in the pace of litigation settlements. Federal Deposit Insurance Corp. (FDIC)-related litigation and lawsuits related to LIBOR manipulation are chief among those areas that appear poised to spur potentially large settlements, possibly within a short time horizon.

The FDIC filed 26 lawsuits in 2012, up from 16 in the prior year and only two in 2010. Moreover, a December 2012 report by Cornerstone Research notes that the impending end of the statute of limitations for institutions that failed in 2009 and 2010 could provide the impetus for more FDIC actions to be filed in the coming months.

While it is unclear whether lawsuits related to the LIBOR manipulation scandal will be covered under D&O policies, there is ample reason to believe that this activity could lead to additional securities class action lawsuits. Fines already imposed related to LIBOR manipulation include a $1.5 billion fine against Swiss bank UBS A.G. Whether or not D&O insurers are ultimately required to reimburse their policyholders for penalties such as these will likely be hotly contested going forward.

SEC-Enforced Actions Poised to Increase

Recently intensified regulatory scrutiny has further contributed to an environment that could increase the frequency and magnitude of class action settlements. The Dodd-Frank Wall Street Reform and Consumer Protection Act made sweeping changes to the American financial regulatory environment that affect almost every part of the nation's financial services industry.

Among other points, Dodd-Frank provided the Securities and Exchange Commission (SEC) with greater powers of enforcement, including the ability to financially reward “whistleblowers” who provide information that leads to a successful SEC enforcement. Incentives such as this, coupled with increasingly onerous and complex regulatory requirements, create more opportunities for rules to be broken, while also increasing the likelihood that these lapses are noticed and ultimately reported to the SEC.

According to a recent report authored by Cornerstone Research (Securities Class Action Settlements, 2012 Review and Analysis), the median settlement amount for cases involving corresponding SEC actions has been more than twice the median for cases without accompanying regulatory actions.

Cornerstone further notes that the percentage of settled cases involving a corresponding SEC action rose more than 20% in 2012 and that 2011 and 2012 were both record years for SEC enforcement actions. This could lead to a greater percentage of class action settlements with corresponding SEC actions as these enforcement actions are resolved.

Opt Out Litigation Prevents Closure/Adds Expense

Further complicating affairs for D&O insurers is the increasing use of “opt out” litigation, where plaintiffs opt out of settlement agreements in the hopes of receiving greater recoveries by pursuing separate remedies. For D&O insurers, this approach increases the cost and reduces the efficiency of litigation while failing to result in final closure of litigation that would otherwise be achieved via global settlement.
Insights from Other Liability – Claims Made Segment

As indicated above, direct loss ratios provide a somewhat limited indication of overall underwriting performance. To gain a better perspective of underwriting performance for a business segment, it is helpful to look at results on an accident year basis using data from Schedule P of statutory filings. D&O business is mostly encompassed within the OLCM segment of Schedule P in statutory filings.

This segment encompasses most professional liability insurance products, including employment practices liability (EPLI), errors and omission (E&O) coverage and fiduciary liability. As such, this segment information is not a pure representation of D&O-only business as D&O direct premiums represents about 30% of industry OLCM premium.

Accident Year 2008–2012 Loss Ratios Relatively Stable

Following results that developed into very strong underwriting performance in 2004–2005, the industry experienced a prolonged period of declining premiums and rising loss ratios as seen in the chart below. The currently reported industry loss ratio in 2012 remains more than 20 points higher than hard market peak results achieved in 2004 and 2005.

However, the deterioration in accident year results has stabilized in the last five years. While overall commercial lines market premium rates have hardened since mid-2011, industry aggregate net earned premiums in OLCM remain below 2008 levels. Despite this revenue trend, accident year loss ratios are relatively stable and have trended down by several points since 2009 to 72% in 2012. With a segment expense ratio of approximately 30%, the industry continues to post accident year underwriting losses in OLCM.

The level and stability of OLCM industry loss ratios has been a bit surprising given the segment’s historical volatility and concern that underwriting experience in the 2008 and 2009 accident years would be vastly unprofitable due to losses from the economic crisis, particularly in financial services industry-related claims. Fitch believes that these results are in part related to more stable overall tort and litigation related costs, and low general inflation in recent years.

For the 10 largest U.S. D&O underwriters, we compare accident year loss ratios in OLCM for 2012 and the last five years (see Appendix). Several of these leading writers cede a considerable portion of business to offshore affiliates, which can influence net loss ratios. As such, it is helpful to compare company results on a direct and assumed basis, as well as net of reinsurance.

**Property/Casualty Industry Aggregate Other Liability – Claims Made**

![Graph showing net earned premium and net loss & LAE ratio from 2003 to 2012.](image)

LAE – Loss adjustment expense.
Source: SNL Financial.
Consistent Accident Year Underwriting Losses

Insurance Expense Exhibit (IEE) data in statutory filings provides information on segment underwriting performance. OLCM specific segment results have been included since 2009. The chart below shows the industry on a calendar year basis, with the combined ratio shifting to slightly above 100% in the last two years. The biggest factors contributing to this increase are rising expense ratios and reduced benefits from favorable loss reserve development. After adjusting calendar year results for loss reserve development, the industry OLCM accident year combined ratio was more than 100% in each of the past four years and 104% in 2012.

Other Liability – Claims Made — Combined Ratio

![Combined Ratio Chart]

Note: Property/casualty industry aggregate. Source: SNL Financial.

Other Liability – Claims Made — Reserve Development /Net Earned Premium

![Reserve Development Chart]

Note: Property/casualty industry aggregate. Source: SNL Financial.

D&O Versus OLCM Premiums

![D&O Versus OLCM Table]


For the 10 largest D&O underwriters, most have posted calendar year underwriting gains in the OLCM segment on average over the past four years. However, on a current accident year basis, adjusting for prior period reserve development, nearly all companies are reporting average combined ratios above 100% for the same period (see Appendix). Companies with the strongest OLCM net accident year results include HCC, Travelers, and Tokio Marine Holdings, Inc. (Philadelphia Insurance Cos.), and on a direct and assumed basis include Travelers, HCC, and Axis Specialty Insurance Company (Axis).
Reserve Development Trends Shifting

The reduction in calendar year favorable reserve development is suggestive of a change in the reserve position of recent underwriting periods, compared with underwriting years in the mid-2000s that exhibited strong reserve redundancies over time.

Incurred losses for more recent accident years (2008–2012) may show unfavorable development as claims mature. However, development patterns in these recent periods show considerable differences to past periods that proved to be greatly under reserved. The chart below compares industry aggregate originally estimated OLCM accident year loss ratios to the current or 10th year estimated loss ratio from 1987–2011.

Other Liability – Claims Made — Accident Year Loss and DCC Ratio History

The data reveals that OLCM has experienced cycles of highly favorable and unfavorable development over time, with the worst period from 1998–2002 due to extremely soft market conditions and high-profile large losses from entities such as Enron and Worldcom. In these years, accident year incurred losses increased by more than 50% from original estimates in 1999 and 2000 to loss ratios of approximately 110%.

Comparing loss reserve development experience with prior periods of favorable/unfavorable development is informative. The chart on page 9 compares changes in the accident year loss ratio over time for recent accident years 2008–2010 with the 2000–2001 years that developed strongly unfavorably, and the 2004–2005 years that developed highly favorably over time. The chart reveals that the historical periods of higher favorable/unfavorable development experienced greater loss ratio development in earlier stages of development compared with recent years. Over longer periods of development, loss ratios in these more volatile years continued to move in the same direction and did not stabilize until the seventh or eighth year of development.

Of the most recent years, 2009 has shown the most unfavorable development experience thus far. While Fitch believes that loss reserves in these less mature years have potential to develop deficiently, a return to the extreme unfavorable development of the 1998–2002 accident years is highly unlikely. Overall OLCM reserving remains more conservative in current periods versus 1998–2002 as evidenced by much higher levels of incurred but not reported (IBNR) reserves and slower reported loss payment patterns.
Other Liability – Claims Made Incurred Loss Development

Note: Property/casualty industry aggregate.
Source: SNL Financial.
Appendix

D&O Top 10 Direct Loss Ratio Comparison

Source: SNL Financial, Fitch.

Top 10 D&O Writers: Direct and Assumed Accident Year Loss Ratio — Other Liability Claims – Made

Top 10 D&O Writers: Net and Assumed Accident Year Loss Ratio —
Other Liability – Claims Made

Source: SNL Financial, Fitch.

Other Liability – Claims Made Accident Year Combined Ratio

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Source: SNL Financial.

Naming Nomenclature and SNL Codes Used in Report

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Source: SNL Financial.
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