



May 20, 2008

## **D&O – Current Market Update**

Anju Arora, XL Professional

Julia Chu, Guy Carpenter & Company

Tom Smith, PartnerRe US



## Outline

- Market Overview
- Industry Trends
- Current Litigation Environment
- D&O Reserves Adequacy
- Market Cycles

# Market Overview



## Market Overview

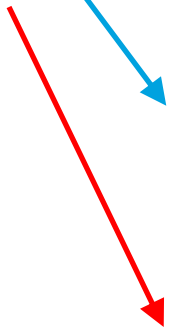
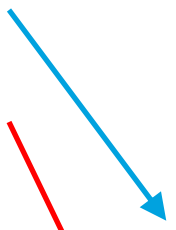
- Securities Class Actions filings
  - 70+ subprime related
  - 4Q07 and 1Q08 experienced largest numbers in a quarter since 1Q05
  - Increase in international filings
  - Where is frequency headed?
- Volatile equity market
  - 60% increase of stock market volatility from 2006 to 2007
    - Increased equity market volatility often precedes large numbers of Securities Class Actions lawsuits
  - Increased number of acquisitions
  - Tightening of credit for leveraged buyouts
- Pricing still softening
  - Rates are down single digits in 1Q08
  - Market dislocation in FI, less capacity going forward

# Securities Class Action Filings and Stock Market Volatility



Calendar Year	Annual SCA Filings	% Market Cap Change (1/1 - 12/31)	Max % Market Change	Annual Market Volatility
1996	112	19.2%	-3.3%	11.3%
1997	174	29.5%	-1.7%	16.7%
1998	240	22.3%	-6.3%	19.8%
1999	209	19.4%	-1.8%	17.3%
2000	215	-8.5%	-12.8%	23.6%
2001	497	-12.6%	-27.0%	21.7%
2002	267	-22.8%	-32.2%	25.8%
2003	224	28.7%	-8.8%	16.5%
2004	233	10.1%	-5.0%	11.6%
2005	182	4.3%	-6.2%	10.8%
2006	118	13.7%	-1.8%	10.6%
2007	173	3.3%	-2.7%	16.2%
2008	74	-4.8%	-13.5%	23.6%

Calendar Quarter	Quarterly SCA Filings	% Market Cap Change	Quarterly Market Volatility
1/1/96	20	6.1%	12.5%
4/1/96	28	3.3%	9.6%
7/1/96	32	1.8%	13.1%
10/1/96	32	6.9%	9.9%
1/1/97	32	0.7%	13.2%
4/1/97	47	16.6%	15.0%
7/1/97	39	8.9%	14.4%
10/1/97	56	1.2%	22.5%
1/1/98	68	13.3%	23.0%
4/1/98	46	2.0%	13.3%
7/1/98	59	-15.4%	28.9%
10/1/98	67	25.1%	18.4%
1/1/99	71	3.6%	19.5%
4/1/99	54	7.5%	17.3%
7/1/99	29	-7.5%	16.1%
10/1/99	55	16.0%	16.2%
1/1/00	61	4.1%	24.0%
4/1/00	50	-3.6%	26.8%
7/1/00	56	0.4%	14.9%
10/1/00	48	-9.2%	26.9%
1/1/01	58	-12.4%	24.5%
4/1/01	106	6.5%	21.9%
7/1/01	135	-16.2%	22.5%
10/1/01	198	11.8%	17.0%
1/1/02	52	0.6%	17.3%
4/1/02	74	-15.4%	19.9%
7/1/02	74	-12.5%	35.1%
10/1/02	67	3.7%	26.7%
1/1/03	61	-2.4%	22.5%
4/1/03	63	15.2%	16.3%
7/1/03	39	4.5%	14.6%
10/1/03	61	9.5%	10.8%
1/1/04	57	2.5%	12.5%
4/1/04	59	-0.8%	11.8%
7/1/04	73	0.3%	11.7%
10/1/04	44	8.0%	10.3%
1/1/05	57	-3.2%	10.5%
4/1/05	52	2.8%	11.5%
7/1/05	37	3.2%	9.3%
10/1/05	36	1.6%	11.7%
1/1/06	27	4.9%	9.1%
4/1/06	37	-2.4%	13.6%
7/1/06	29	4.2%	10.9%
10/1/06	25	6.6%	7.9%
1/1/07	33	0.8%	12.5%
4/1/07	36	5.3%	10.9%
7/1/07	43	2.5%	19.6%
10/1/07	61	-5.1%	19.8%
1/1/08	55	-6.8%	25.7%

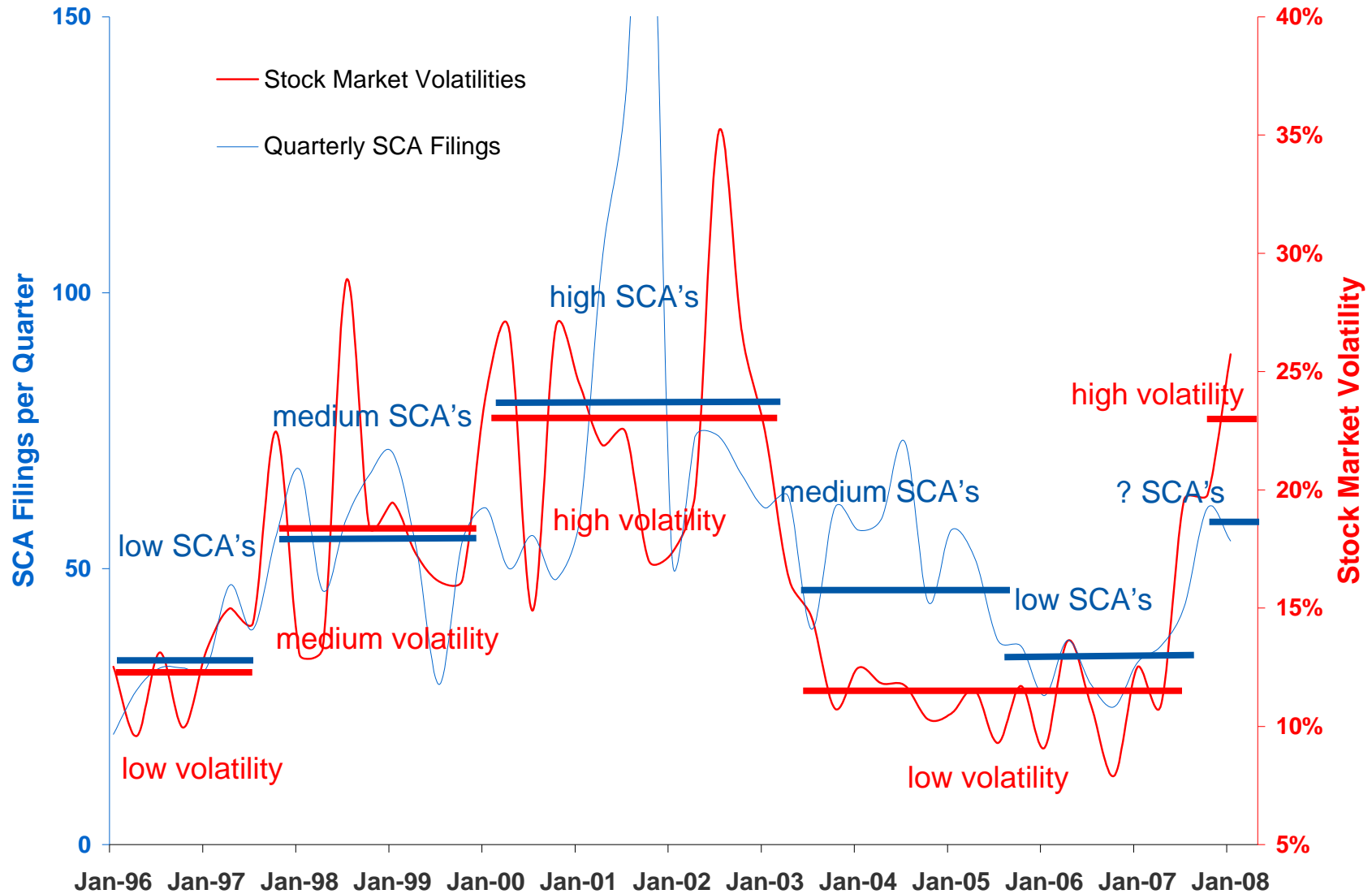


IPO  
 Analyst  
 Mutual fund  
 Backdating  
 Subprime



# Volatility and SCA Filings High Correlation

All sectors





## Subprime

- What is considered a Subprime related SCA claim?
  - Direct vs. indirect claims
- Magnitude of market cap drops
  - Large banks only carry A-side or small amount of ABC D&O policy, up to \$300m
  - Limits insured ranges up to \$200m for large non-FI companies

**Bear Stearn's building \$1.2b > \$240m sale price**



- How this event compares to S&L crisis and other Clash events
  - Severity: various sources put event b-tax \$5b - \$10b (60 – 120% loss ratio pts.) in addition to normal loss activity
  - Crisis differs compared to S&L (small community banks, government treats D&O policy differently.)
  - More recent events appear to pale in comparison (backdating, mutual funds, insurance companies, ...)

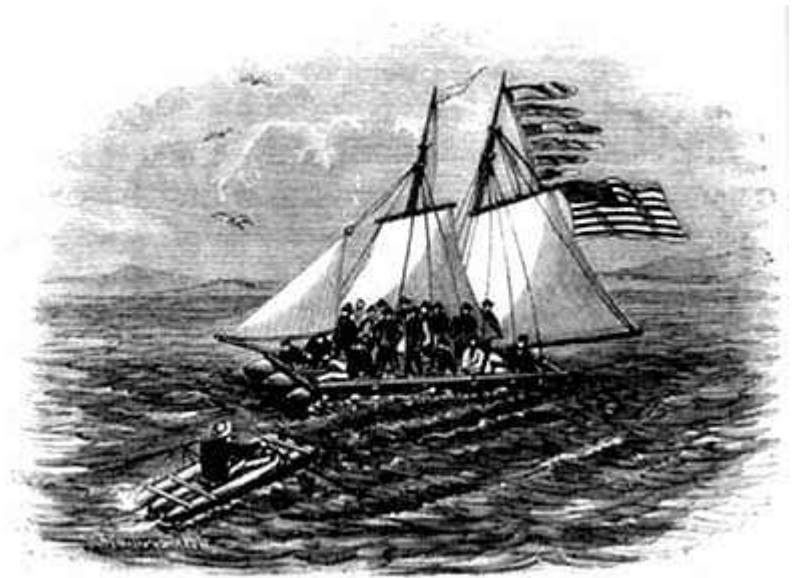
# Industry Trends





## Pricing

- Small risk/middle market vs. larger risks
- Commercial D&O vs. financial institutions
- US risks vs. international
- A-side vs. ABC
- Layer factors
- Life Rafts
  - Small Commercial
  - Private
  - A-side
  - Prices gutted
  - Life raft is getting full and sinking





## Frequency Trends

- What caused Frequency decline from 2Q05 to 2Q07
  - Sarbanes Oxley, better compliance
  - Orange Jumpsuits
  - Lerach / Weiss / Subpoenas
  - Economy: lower stock market volatility
  - Law firms busy with mega-settlements
  - Court decisions
  - Generally increasing dismissal rates
  
- Recent frequency increases
  - Subprime
  - Economy downturn: increased market volatility



# Severity Trends

- Average settlement

### PwC Study

Table 13. Settlements (in thousand \$): all cases, 1996–2007\*

Year settled	1996–2000	2001	2002	2003	2004	2005	2006	2007
Number of settled cases	248	108	108	115	115	120	112	113
Total settlement value	6,813,200	1,934,500	2,101,600	2,744,100	5,771,200	18,621,200	6,444,300	6,365,000
Total settlement value excluding outliers	3,627,200	—	—	—	3,196,200	7,926,700	—	3,165,000
Average settlement value†	14,700	17,900	19,500	23,900	28,000	67,200	57,500	28,300
Median settlement value†	5,000	5,500	6,300	5,600	6,800	9,000	6,400	7,900
Average settlement value for cases settled for \$1M or more, up to \$50M	9,100	10,900	9,300	9,700	9,700	10,400	9,100	10,200

\* Year of settlement is determined based on the primary settlement pronouncement. Any subsequent settlement amounts are attributed to the primary announcement year. Settlement information reflects only those cases filed and settled after passage of the PSLRA (12/22/1995). Table excludes \$0 settlements.

† Excludes all settlements over \$2.5 billion (outliers).

- Settlement as a % of market cap damage
- Defense costs

Damage Range	Median Settlements as a % of Damages	
	Through 2006	2007
Less than \$50m	10.2%	12.1%
\$50m - \$125m	5.0%	4.7%
\$126m - \$500m	3.2%	3.5%
\$501m - \$1b	1.7%	1.8%
\$1b - \$5b	1.0%	1.5%
Greater than \$5b	0.9%	1.1%
<b>Total Sample</b>	<b>3.6%</b>	<b>2.9%</b>



# Current Litigation Environment



## Current Litigation Environment

- Recent court cases and impact on D&O trends
  - Higher hurdles for plaintiffs bar → less frequency and better quality?
    - Tellabs: inference of action must be cogent and compelling
    - Dura: must prove misrepresentation as proximate cause
  - Lower probability of clash events
    - Stone Ridge: false statement misrepresentation must be elsewhere in addition to company's financial document
- Plaintiff resurgence
  - Will firms behind Milberg/Weiss now step up and lead complaints?
    - Coughlin Stoia
- International litigation vary by country
  - Locally admitted policies

# **D&O Reserve Adequacy**



## Industry D&O Reserve Adequacy

- Industry Schedule P Other Liability Claims Made can be used as a proxy for D&O
  - Part 2 Development

Accident Year	Industry Aggregate Other Liability Claims-Made						
	Earned Premiums	Current Ultimate Loss	% EP	Initial Ultimate Loss	% EP	Reserve Changes	% EP
1998	5,843,884	5,063,546	87%	3,864,265	66%	1,199,281	20.5%
1999	5,537,799	5,954,554	108%	3,778,958	68%	2,175,596	39.3%
2000	6,688,968	7,247,611	108%	4,749,150	71%	2,498,461	37.4%
2001	7,120,424	7,460,464	105%	5,248,688	74%	2,211,776	31.1%
2002	9,592,964	9,093,521	95%	6,607,179	69%	2,486,342	25.9%
2003	12,137,507	7,712,631	64%	7,961,907	66%	(249,276)	-2.1%
2004	14,536,453	7,738,025	53%	9,498,328	65%	(1,760,303)	-12.1%
2005	15,507,084	8,658,563	56%	9,811,684	63%	(1,153,121)	-7.4%
2006	15,340,200	9,746,857	64%	9,875,296	64%	(128,439)	-0.8%
2007	14,853,556	9,932,415	67%				

Reserve charges

AY's 1998-2002

vs.

Reserve releases

AY's 2003 - 2006

- Recent quarters' reserve releases from AY's 2003 to 2006 in professional liability business accounted for up to 23 CR pts.
- Is Subprime within reserve pick?

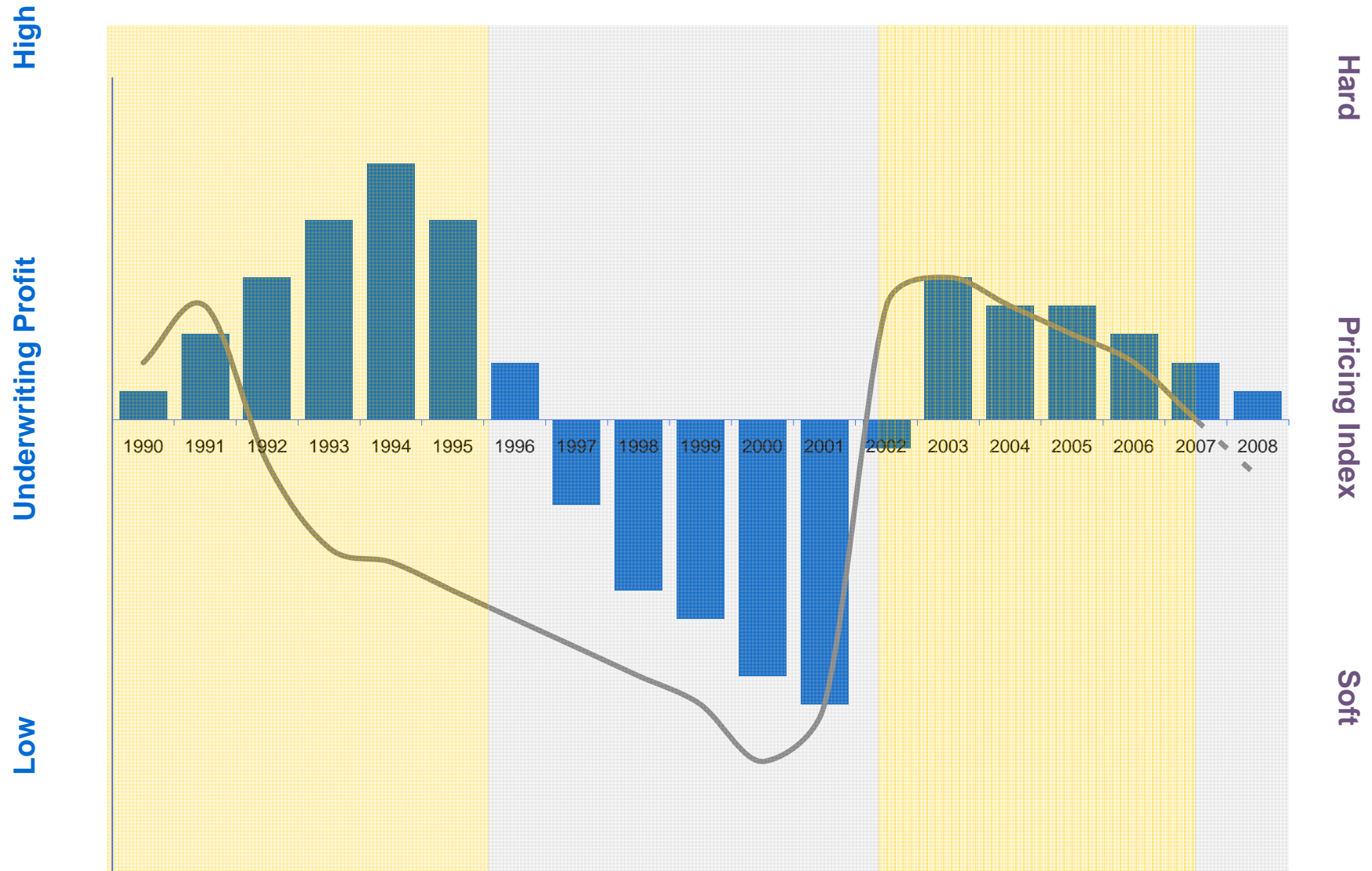
# Market Cycles





# Market Cycle

## Underwriting Profitability and Pricing Index





## Market Cycles

- Where we are
  - Pricing: back to 2000#? rate adequacy
  - Frequency: SCA filings heating up
  - Litigation landscape: ?
  - Reserve level: redundancy from 2003 to 2007
- Where we are heading
  - Market still softening
  - Brake pedal for those in pain, capacity leaving FI
  - Who leads a hard market?