Willis Re

# CAS Reinsurance Seminar

Effect of European Sovereign Debt Crisis on the International D&O Marketplace – A Reinsurance Intermediary's Perspective

June 4th, 2012

## Presentation Purpose

- Provide some insight into the state of the current Management Liability segment
- Consider the threats to Management Liability insurers from the current disruption in global financial markets and the impact or potential impact on liability insurers
- Current technical and modeling challenges facing reinsurance underwriting organizations
- Potential developments and conclusions

2

## Provide some insight into the state of the current Management Liability segment

## Some insight into the state of the current Management Liability segment- US Markets

- Notwithstanding current financial market volatility since 2007 US Management Liability insurance market remains "stable" a/k/a soft
  - Public company buyers experienced a decade of rate reductions except Financial Institutions
  - Private companies now experiencing technical rate adjustments driven by Employment Practices (EPL) losses
- Plentiful supply of capacity, favorable litigation environment and manageable inventory of severe securities class actions
- Despite the daily headlines, reported liability results remain viewed as acceptable



## Some insight into the state of the current Management Liability segment- International Markets

- International (ex-US domiciled insureds) Management Liability market is even more competitive
  - Excess capacity on the supply side
  - Limited demand, remains an elective purchase for many
  - Severe prosecutorial hurdles historically
  - Presumed glacial pace towards collective redress
  - Absence of contingency fee system
- Exposure and pricing differentials driven by perceived proximity to US litigation risk e.g. ADR's
- Notwithstanding the above, certain risks are experiencing severe disruption, primarily those located in PIIGS countries



## Some insight into the state of the current Management Liability segment- Conclusion

- So from an insurance perspective the immediate question is "Euro zone crisis, what Euro zone crisis?"
  - Negligible impact for commercial D&O so far…
  - Effect limited to a few dozen Financial Institutions that are perceived to be vulnerable to the Euro zone (both solvency and liquidity concerns)
    - Most notable victim so far is MF Global *located at One Battery Plaza, New York, NY [not Athens]*
- From a claims perspective, limited inventory of notices
- The question remains, are we out of the woods or just heading into them?

Consider the threats to Management Liability insurers from the current disruption in global financial markets

## Threats to Management Liability insurers from the current disruption in global financial markets

- Causation for most insured loss in these classes is financial loss accompanied by a wrongful act / negligence
- In theory, current economic disruption should be fertile ground for potentially significant claims
  - Economic instability, asset volatility, adverse financial transactions are all sources of litigation against professional advisors and Directors and Officers
- US sub prime once considered the "Katrina" moment for liability insurers but in fact, the impact to date is isolated and somewhat muted -- why?
  - Perhaps the problem was <u>too big</u> and <u>too extensive</u>
  - Wrongful act claims really need "fools" or "crooks"
  - There are some difficult claims but not everybody can be negligent
  - Courts required more than housing collapse and recession



## Threats to Management Liability insurers from the current disruption in global financial markets

- Current economic landscape is fragile, global slowdown and existential threat to parts of the Euro Zone
- The potential for litigation exists on paper but where and how?
- Obvious exposure to Financial Institutions
  - In the US e.g. client actions (E&O) in asset managers alleging negligence and shareholders (D&O) – MF Global the poster child
  - Ex US more E&O exposure than D&O at least so far
  - Allegations will center around failure to disclose e.g. "had I known that …"
  - Defense expenses can be significant, somewhat muted by "loser pays" rules outside the US
- For Non-FI insureds, harder to fathom any systemic liability threats

Current technical and modeling challenges facing reinsurance underwriting organizations

Willis Re

## Current technical and modeling challenges

Willis Re

- For some reinsurance companies the Euro zone presents a concern on the investment side
  - No comment other than to say that underwriting appetite is partially suppressed by wider Enterprise concerns
- While insurance loss activity has been limited, economic impact of Greek sovereign default and/or Euro zone disruption is severe
- The fact that losses haven't materialized doesn't mean that they can't or won't -- dynamic shift
- Profitability in Management Liability impacted by exogenous events (non price / form / trend factors)

11

## Current technical and modeling challenges

Willis Re

- The loss dynamics of these lines are more akin to property cat than casualty lines
  - Extended periods of profitability with a lack of frequency and severity followed by sudden bubbles of extreme frequency of severity driven by exogenous macroeconomic events
- As a result, everyone in this room can probably relate to the challenges inherent in modeling these lines, especially internationally where there is no comprehensive source of publicly available data
  - Even if there was a data source, there are not enough claims ex-US to build a credible model

12

## Current technical and modeling challenges

- Traditional actuarial models do not often include sufficient recognition of changes to the external environment
  - Exogenous events can produce wild swings in the loss trend (i.e. +100% one year and -100% the following year)
  - Difficult to say what is correct, but +7% annually over a 10 year period is definitely not correct
- Often, a combination of methodologies is the only way to approach a reasonable answer
  - Stochastic Modeling
  - Realistic Disaster Scenarios
  - Stress Testing
  - Regime Change Simulations, etc.



## Potential developments and conclusions

## Potential developments and conclusions

- While Euro zone crisis is the flavor of the month for many (re)insurers, there are many other forces driving the current D&O market dynamics
  - Abundance of Capacity (especially A Side for Non-FI Risks)
  - Absence of Frequency of Severity (Especially ex-US)
  - Chinese Reverse Mergers
  - Private/NFP EPLI Claims
  - M&A Bump-up Claims
  - Cumulative Effect of Rate Reductions
- No Euro zone claims to date (aside from MF Global), just speculation/concern
- Dynamics of many segments of the D&O market entirely unaffected by the Euro zone crisis
- When we look back 5 years from now, this may end up being a massive systemic (re)insurance event or it may end up being a non-issue like options backdating, only time will tell