GUY CARPENTER

Reinsurance Boot Camp
Professional Liability

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MARSH & McLENNAN COMPANIES

What are the major Professional Liability coverages?
Each covers against a different type of exposure

- Directors & Officers (D & O)
  - Liability from Management of Company
- Errors & Omissions (E & O, aka PI, etc.)
  - Liability Professional service provided to customers
- Employment Practices (EPL)
  - Employment issues (hiring, harassment, etc)
- Fiduciary
  - Administration of benefits - health, life, 401k, etc
- Fidelity/Crime
  - Often marketed with liability, but first party cover
- Cyber Liability
  - Spinoff of E&O for computer related issues
  - Evolving liability for privacy, viruses, etc

How are the Professional Liability written and sold?
It depends on the insured

- For small private firms – for simplicity and economy lead many of these coverages to be blended into simpler package form
- For large Financial Firms – traditionally Fidelity & E&O and sometimes D&O sold together, with blended limits
- For large Commercial firms – D&O usually separate from E&O, Fiduciary & EPL are sometimes sold with or tied to D&O
- For reinsurance treaties:
  D&O and E&O can be covered together or separate
  EPL and Fiduciary often included, as they are rarely reinsured separately
  Fidelity can be packaged with professional or surety

Large Towers

Building large towers

- With potential claims in excess of $100 Million, Large public companies seek substantial limits – sometimes as much as $500 Million
- Few insurers willing to commit $25 Million or more in capacity - so multi-insurer towers are constructed
- Generally insurers with strongest reputation/rating and willing to offer largest blocks of capacity are primary
- The market price for each successive layer rarely follows any actuarial assessment of loss exposure
- Stacking / Ventilated Limits - When the same insurer covers more than one layer on an insured
- Multiple insurers may share a single layer
  (for example 20% of a 100M layer = 20M p/o 100M)
  This is common for some types of E&O and Fidelity, but rare for Commercial D&O

General Properties of Professional Liability

- Mostly Claims Made or Claims Made and Reported basis
- Non-standard forms
- Many corporate policies written on aggregate basis – rather than per claim
  Smaller policies may have both per claim and aggregate limits
- ALAE often inside of limit, though some lines not
- Medium-to-long tail
- Most lines subject to high severity claims
- Often difficult to reserve

Errors and Omissions (E&O)
Covers liability for professional services provided to customers

- Covers wrongful acts from providing professional services
  - Including negligence and misrepresentation
  - Extends to liability beyond specific injury protection provided by GL coverage
- Medical Malpractice is probably the best known
  But most specialized professions offering services are exposed – even actuaries!
- The key issues involved in underwriting the line is:
  - What does the firm do – what are the professional services?
  - What is the standard of care?
  - How is liability adjusted through contracts?
- Typically rated on Revenue (or for some lines # of professionals)
- No standard policy forms

Errors and Omissions (E&O)
Covers liability for professional services provided to customers

- Some insured specialties are typically segregated into programs and written by specialist underwriters or MGA's
  - Medical (incl. Hospitals, Physicians, Nurses…)
  - Lawyers
  - Architects & Engineers
  - Accountants
  - Financial Institutions (incl. Banks, Insurance, Asset Managers, …)
  - Tech Firms

  Whatever is left (and this can vary by company) is "Miscellaneous" MPL

  Reinsurance treaties often cover multiple programs, but will not necessarily combine all E&O programs the company writes

Directors & Officers (D&O)

- Policies insure:
  - Directors and Officers
    - historically, only D's & O's, but broadened in soft market of 90's to include some entity coverage
  - For wrongful acts
    - defined as any act, error or omission in their capacity as D&O
    - Usually includes Employment Practices Liability, but excludes "professional services" (E&O)

- Typically rated on Assets or Market Value (for public companies)
- No standard policy forms

Who buys D&O?

Companies that need their D&O's to serve…

- Bought by the Company
  - D&O Coverage is voluntary (not required by law)
    But almost all large Public firms and many private firms buy some
  - Primarily for the benefit of the Directors and Officers
    (It's expensive, but then so are other executive benefits!)
  - Multiple Towers are possible, but generally all the D&O's share coverage and limits

Why buy D&O?
Litigation, Litigation, Litigation!

- Private or Not-for-Profit Companies
  - Mostly Employment Litigation
  - Bondholders (if for profit)
  - More rarely Customers, Competitors or Regulators

- Public Companies
  - Exposed to similar suits as Private
  - Shareholder Litigation
  - Even options speculators can sue for stock fraud
  - Usually some EPL coverage, but often also have separate EPL policy

But shareholder litigation often involves much larger payouts (and defense costs) than other causes, so it leads to most of the payout $ of public D&O

Shareholder Litigation
What type of Allegations?

Common Allegations include:

- Making unsupportable positive forecasts of future results
- Failing to disclose the likely/imminent failure of a key product
- Improper Accounting (Failure to accurate state historical results)
- Self-enrichment by Directors such as Options Backdating
- Merger & Acquisition issues – such as blocking a favorable buyout

While allegations differ in their likelihood to prevail, the circumstances and quality of evidence can lead some claims to be summarily dismissed and others to mandate payment.

Legal Standard

What plaintiffs need to prove

1. Defendants made material misrepresentations or omissions
2. Defendants acted intentionally or recklessly, not simply in error
3. Misrepresentations pertained to the purchase or sale of securities
4. Plaintiffs relied on the representations (directly or indirectly via share price)
5. Plaintiffs suffered economic loss
6. The fraud caused this economic loss

- Interpretations have changed with laws and court rulings
  - PSLRA requires plaintiffs to show reliance on <u>specific</u> misrepresentations
  - *Dura* decision requires showing tying plaintiffs economic loss to the fraud, not merely that the fraud influenced the price

Know your ABC's
The many sides of D&O

- A-side
  – Covers D&O when the employer cannot
  – Bankruptcy / Derivative / "DIC" situations (such as recissions)
  – Historically A-side only policies have had fewer payouts
- B-side
  – In most circumstances, companies must defend and indemnify their current and former D&O's, B-side reimburses for this expense (So in essence this protects the company, not the D&O)
- Entity Coverage/C-side
  – Coverage when entity is itself named in by its shareholder
  – Intended to avoid allocation issues when settling a joint suit
- While A-side is often covered by itself (if company retains B-side risk), or as a supplement on top of a tower of full coverage D&O (A/B/C), it is rare for a policy to include B-Side without A-Side

Employment Practices Liability (EPL)

- Policies insure:
  - Typically Company and its Employees
  - For allegations of wrongful employment practices
    - Discrimination (Gender, Race, Age, Disability)
    - Wrongful Termination
    - Sexual Harassment
    - Retaliation
- Most claims involve individuals, but large firms have class-action exposure

Pricing

Professional Liability Contracts

- Majority of reinsurance treaties tend to be simple structures
  - QS and XOL per risk
  - some Variable QS (by limit or attachment) – but few Surplus Shares
  - Some treaties involve aggregate loss sensitive features
    - Aggregate Limits or reinstatements
    - Aggregate Deductibles (“AAD”)
    - Loss Corridor, Swing Rate, or Sliding Scale Commission
- Event/Clash covers are rare, except for Medical
  - Can be difficult to define, and more difficult to price
- Aggregate Stop Loss are presently rare, but growing interest
- Most treaties are currently single year

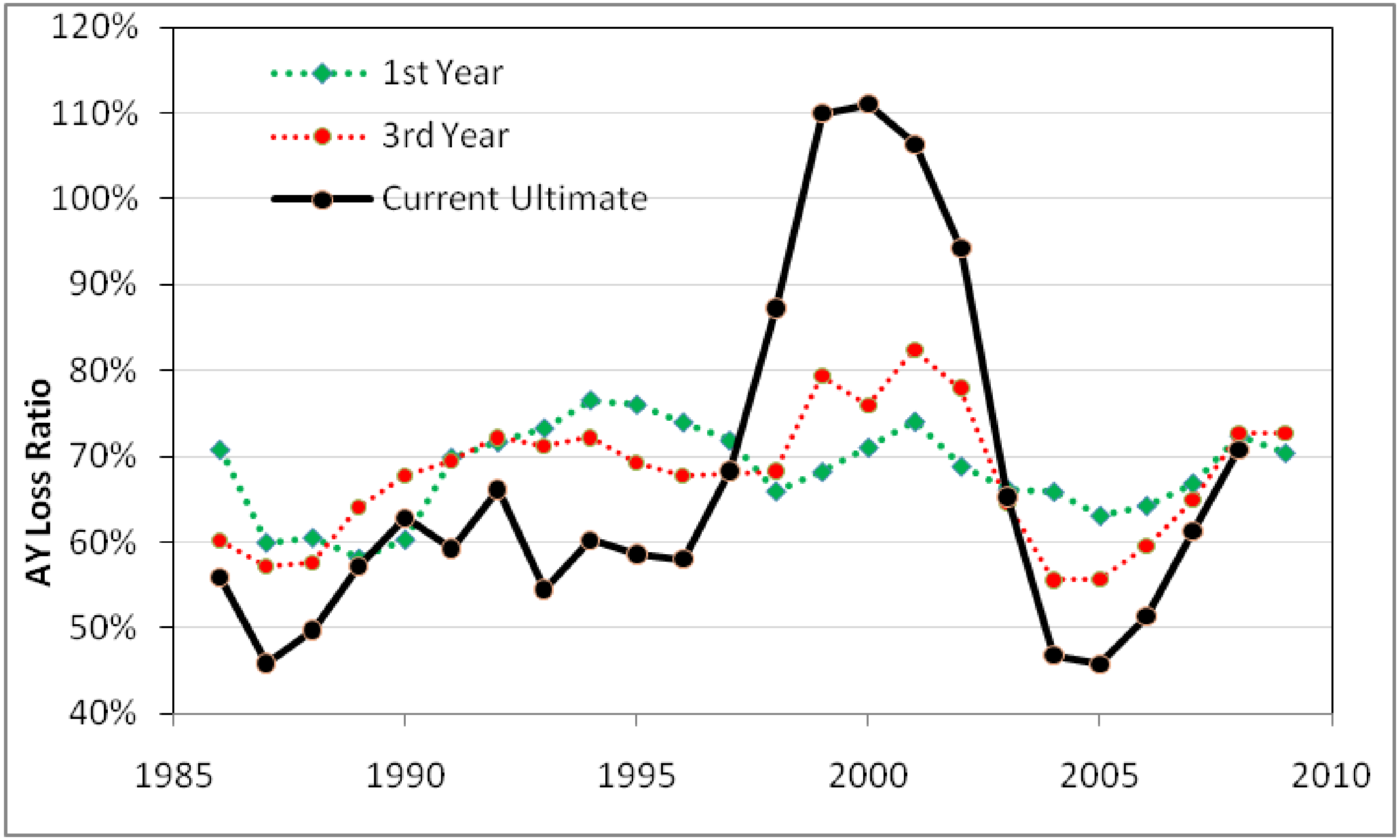
Pricing Issues

- Losses can be severe
- Some lines/layers have few claims – but even when we have many, for most projects the by year results can be driven by few claims
- Large claims can be correlated – either from true clash, general events affecting an entire class of policies, or systemic events across the industry
- Projecting ultimate difficult – especially for the latest years
- Case law, forms, and underwriting can all be moving targets
- An insurer with $100 Million premium of Public D&O might have 100 policies each with $25M limits.
  Paying less than 3 (limit) claims=profit,
  more than 3 claims=loss,
  And it may takes years to know the difference…

Recent Financial and D&O Events

Events / Litigation Wave	Sectors Affected	Allegation
Predatory Credit/Lender	Banks/Consumer Finance	Misleading and/or usurious interest (Settled $2B)
IPO Laddering (2001)	Inv. Banks (+IPO firms)	**Unfair IPO allocation and price manipulation ($600M)**
Banking/Enron (2002)	Banks (Money Center)	Helped fund Enron with disguised loans ($4B)
Analyst Claims (2002)	Investment Banks	Fraudulent research to solicit investment banking ($1.5B)
Banking/Worldcomm (2002)	Investment Banks	Conflict of Interest & Due Diligence in public bond ($5B)
Mutual Late Trading (2003)	Mutual Funds /Brokerage	Deceptive/preferential treatment for select investors ($2B)
Variable Annuities (2004)	Security Broker/Dealer	Unsuitability, Failure to disclose tax & other issues
Insurance Bid Rigging (2005)	Insurance Brokers	False quotes, violating duty to clients ($1B)
Options Backdating (2006-)	***General D&O***	Intentional Misreporting of Exec. Compensation (About $2B)
Credit Card Interchange(2007)	Consumer Finance	Collusion in setting merchant fees (Settled $7B)
Subprime (2007-2008)	Inv. Banks/Brokers/Banks…	Deceptive practices - UW / packaging loans (~1.5B)
Credit Crisis	Mostly Banks	Hiding impairment of assets (subprime loans) ($6.5B+)
Auction Rate Securities	Inv. Banks/Brokerage Firms	Banks promoted then withdrew support for debt market
Madoff+ (2008-2009)	Asset Managers	Ponzi Schemes - with Funds diverting
M&A Bump-ups ('09+)	*General D&O*	D&O injunctive suits against most major M&A Activity
Chinese Reverse Mergers ('10)	*General D&O*	Discrepencies between US reporting and in China
FDIC Involvment?	Regional/Comm.Banks	FDIC pursuing action vs. executives of some failed banks
LIBOR	Banks (Money Center)	LIBOR Manipulation - Barclay's settled for $200M… Others?
Euro Currency Issues	Banks (Money Center)	MF Global had $1.6B shortfall… Are others exposed?

Rate Cycle generally drives Professional Lines Results

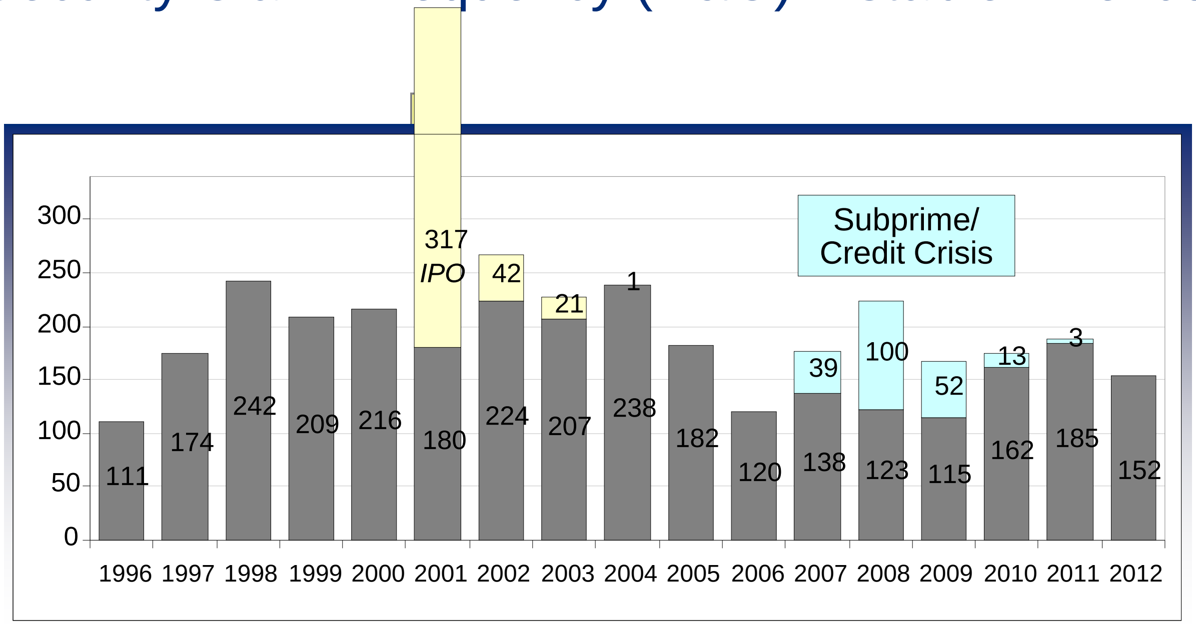


Timing & smoothness suggest Financial Events are not dominant.
2002 had much higher claim count & payout than 1999-2000, but at higher rate levels.
Rates softened from 2003 until 2011 – but loss activity also reduced during 2003-2006.

Recent Financial Institutions results vary only slightly from the above
– with significant increases for 2002(Enron D&O), 2003(MF E&O) & 2008(Subprime)
Fewer Financial claims in 2006 (options backdating) and 2010.

Source: Schedule P – Other Liability – Claims Made for Industry
(Predominantly Professional Liability)

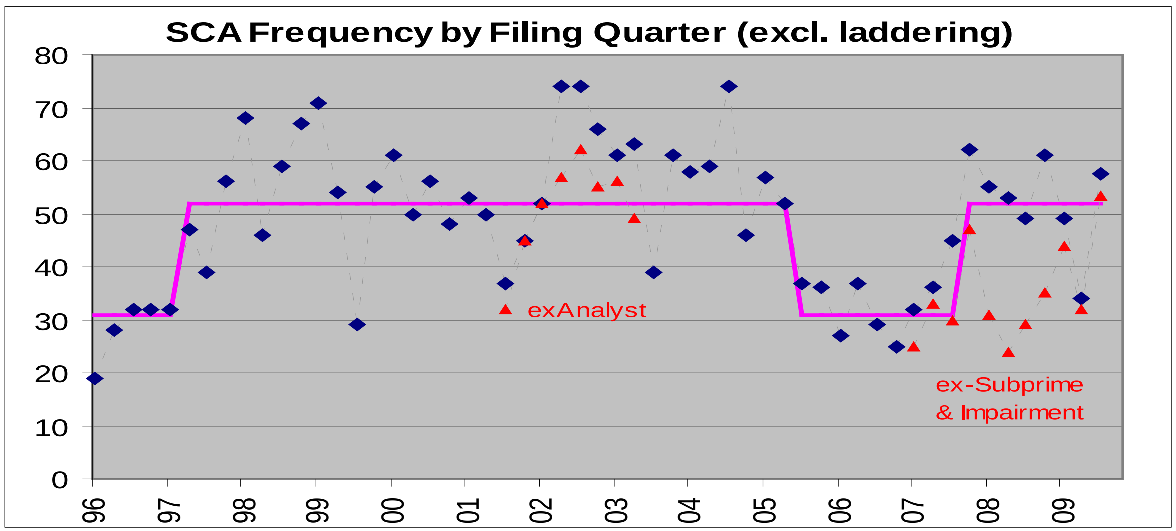
Security Claim Frequency (D&O) – stable … except when it isn't



About 160 security class actions per year.

This amounts to 2-3% of the 6000+ companies traded in the US

Typical claim counts have declined since 2000, but so are # of public companies



In early 2005 claim count dropped abruptly from about 50 per quarter to 30

Subprime contributed many additional cases, but the recent trend is close to 40.

The cause of the 2005 drop is still debated: US Supreme Court decision *Dura*?

Problems with the plaintiff attorneys?

Sarbanes-Oxley?

Stable stock market?

Source: Stanford Law School

D&O Sector Shocks

Sector	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Basic Materials	5	6	8	3	7	5	7	2	2	8	7	6	13
Capital Goods	5	4	6	5	5	11	1	4	7	8	3	8	6
Conglomerates	3	2	1	4	2	1	1			2	3		
Consumer Cyclical	18	10	12	5	10	8	13	5	7	3	4	6	10
Consumer Non-Cyclical	11	8	5	4	8	5	6	4	4	9	4	4	9
Energy	5	2	1	6	2	6	3	2	4	6	3	10	16
Financial	23	28	23	40	49	48	32	14	41	113	77	41	23
Healthcare	24	19	27	34	39	40	32	19	26	23	23	36	24
Services	52	49	116	74	40	47	30	27	46	19	25	32	31
Technology	60	78	290	68	56	56	55	39	35	28	14	22	49
Transportation	2	3	4	2	1	6	1	2	1	2		1	3
Utilities	1	6	4	22	6	4	1		2	3	2	5	4
Grand Total	209	215	497	267	225	237	182	118	175	224	165	171	188

Within Finance:

Insurance	**7**	**10**	**6**	**7**	**9**	**15**	**9**	**8**	**11**	**11**	**10**	**2**	**5**
Money Center Banks	**5**	**1**		**4**	**4**	**6**	**4**			**16**	**9**	**3**	**4**
Regional/Comm. Banks	**5**	**1**	**3**	**5**	**4**	**5**	**5**		**10**	**16**	**14**	**14**	**5**
Investment Services	**1**	**9**	**6**	**14**	**23**	**16**	**12**	**3**	**9**	**41**	**24**	**8**	**5**
Other Financial Services	**5**	**6**	**7**	**8**	**8**	**3**	**2**	**2**	**10**	**23**	**13**	**9**	**3**

Overall Claims by year vary due to legal & financial environment,

Claim distribution *by sector* is sometimes driven by these specifics (Subprime disproportionately affecting finance & real estate, Spikes in IPO/M&A Litigation affect Technology firms)

We also have Sector specific shocks – such as Utilities or Pharmaceuticals

Major components in reinsurance pricing

- Historical Industry Loss Ratios
- Reinsurance Exposure Rating
- Reinsurance Experience Rating
- Rate Change
- Trend
- Expense & Risk Load

Historical Industry Loss Ratios

There are many sources of industry losses and loss information

- Annual Statement (incl. Schedule P) provides some information
  - "Other Liability Claims-Made" = Most Professional Liability
  - Med Mal is its own section
  - Fidelity is grouped with surety
  - D&O only supplement starting in 2011
- ISO, Brokers and Third Party vendors have statistics on various segments – but the information is not always be representative of the whole
- Public D&O shareholder claims available at Stanford website
- Some EPL claims available from EEOC and vendors
- The challenge is that few sources let you drill-down – to estimate the profitability of layers/classes of a portfolio *(What loss ratio to use for insurance? … for reinsurance broker actuaries?)*

Reinsurance Exposure Rating?

- Exposure rating combines portfolio exposure with industry loss information
- Often there is no single standard benchmark ILF's or primary rates
- Primary Insurers will often have their own ILF’s that assist them in pricing, calculating rate changes, etc, but these may not be reflective of the layer risk to industry and/or their portfolio
  - *For XOL on excess policies, most PL ILF’s quickly converge to pro rata*

- For Public D&O, some primary companies use exposure models for individual risks
  - D&O experience on individual risks is too scarce
  - Industry loss data is more easy to get and combine
    Gunpowder and baby powder firms face different E&O & WC risk but their accounting, governance and investor relations are similar

Reinsurance Experience Rating?

- Claims made means (most) claims will be known quickly, but identifying the significant ones is more difficult.
- So many companies may hold claims at an initial or signal value until they have sufficient information to reserve or close
  - This “sufficiency” leads to inconsistent development across companies, and even within a company across lines/years
    (distorting incurred LDF’s, especially for excess layers)
  - Reserves on emerging systemic events can be “sticky”
- Most PL books undergo substantial mix changes over time
  - E&O segments and D&O industries get added/dropped/reweighted
  - Limits and excess layers can substantially shift
  - Underwriters (and even whole teams) move between companies

Reviewing Experience

In reviewing claims, especially for XOL, make sure you understand:

- ECO/XPL – how does treaty respond?
- ALAE treatment (for lines where not included in limit)
- How claims and policy data reflects stacking
- How will related claims on a policy be aggregated?

Supplemental Estimates?

In certain instances, some primary companies may provide unofficial projections of individual claim ultimate values that differ from the carried incurred, this could involve:

- Coverage litigation
- Emerging events
- Timing lag between the data report and current information

If you use this information to revise your ultimate pick, use caution

- The sum of such ultimates still will not fully reflect IBNR
- If LDF’s are derived excluding these, developing case+supplement will overstate the true ultimate

Rate Change

- For experience rating, we need rate change information to on-level the premium
- Different companies measure rate change differently
  - Premium changes on exact like-to-like renewals
  - Adjusted premium change on most/all renewals
  - Year-over-Year change in actual rate vs (internal) benchmark
- Only the benchmark method can reflect adequacy of new/lost business
- Rate may or may not reflect change in underwriting exposure (such as an increase in revenue or a growing D&O market cap)

- For most of PL, rates surged over 2001-2003 market hardening, but with good experience fell back until recently

Trend

- Loss Trend is difficult for PL lines
- Frequency can shift over time
- Loss Ratio trends are often based on observations of severity trend
  - Short term shifts difficult to measure due to impact of few large claims
  - Some focus on median rather than mean, or cap the largest
- Where many claims hit policy limits, limited severity trend is often significantly lower than the unlimited severity trend
- In some cases, there may be an offsetting exposure trend. This would depend on how frequency trend and rate change are measured

Disclaimer

- The opinions contained in this presentation are the author’s and do not necessarily represent Guy Carpenter or the Casualty Actuarial Society.

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