

Leading the way on D&O

An industry first: A frequency and severity model for directors' & officers' liability risks



Charles B LaLone, a principal at Guy Carpenter & Company, Inc, discusses the current D&O marketplace and development of the industry's first frequency and severity model designed specifically for US publicly traded companies.

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The directors' and officers' (D&O) liability market has experienced massive changes over the past few years. High-profile bankruptcies, accounting scandals, and increased legal and judicial oversight have led to greater scrutiny and a heightened threat of litigation for a firm's directors and officers. In addition, the industry has had to contend with an increase in the number of "mega settlements" over \$100mn and the certain prospect of more in the "pipeline." Despite these challenges, the annual likelihood of a company being sued has not changed significantly since 1995, and there is even a growing perception among insurers and reinsurers that there has been a return to profitability throughout the industry on an accident year basis.

The D&O marketplace in 2004

As a result of the high degree of volatility and the large limits required in D&O, most insurers in this line of business are dependent on reinsurance. Finding adequate and affordable coverage is a balancing act between developing the structure that transfers the most volatility for the lowest price and placing it with the most well managed and financially strong reinsurers.

The January 2004 D&O treaty renewal season was relatively smooth, which is consistent with a relatively stable D&O reinsurance market, dating back to 1 July 2003. For the most part, the hard market "correction" in treaty terms was more than likely completed at that time. There is an abundance

of capacity for some deals, particularly if the ceding company increased its net line significantly over the past year. "New" D&O facilities also obtained the capacity they required, albeit at more restrictive terms.

For the first time since the mid 1990s, it seemed that reinsurance terms were "earned." That is, carriers with proven track records and management/underwriting teams now have better economic treaty terms and conditions than those who don't for whatever reason. Another notable trend involves the amount of detailed data that ceding companies are now required to produce to secure the best quality capacity.

Insurers, on the other hand, are looking for the most stable, financially secure capacity. The importance of credit quality has increased in the past 12 months as a result of the very large ceded premium dollars and the overall heightened scrutiny surrounding this topic. Going forward, ceding companies are likely to look favourably at those reinsurers that can help them gain greater confidence about their future reinsurance recoverables; whether that be through superior ratings or collateralisation of estimated future treaty liabilities.

Generally, D&O reinsurance covers all losses arising from a cedent's D&O portfolio on a follow-the-fortunes basis. Approximately 80 percent of the reinsurance purchased is proportional, with the remainder currently structured as excess of loss treaties. The maximum limit being offered by virtually all

carriers is \$25mn, but in practice carriers have been limiting a large proportion of their book to \$15mn limits and less.

About 75 percent of reinsurance treaties written contain some type of aggregate limit, whether through a loss ratio cap or limited reinstatements. Ceding commissions have come down roughly 5 to 7.5 points from where they were in 2000 and before.

A third important trend in treaty structures is the dramatic increase in retentions taken by cedants. Whereas four years ago it was not unusual for there to be retentions as small as \$2.5mn to \$5mn on a \$25mn or \$50mn treaty, D&O carriers are now retaining a minimum of \$5mn and as much as \$10mn or more of their total capacity net after reinsurance. Ceding companies are attempting to maximise retained premium in a hard D&O market as well as satisfy reinsurers' concerns that they have significant capital of their own at risk.

Analysing US publicly traded D&O risks

An overwhelming proportion of D&O insurers' loss activity emanates from the costs to settle and defend securities class action suits. In the past, new securities class action suits have been difficult to predict and model for several reasons, including the limited number of vendors that have experience creating frequency and severity models and the shortage of comprehensive securities class action suits databases. Moreover, traditional assumptions about claim severity and the profitability of D&O business have been called

into question in the wake of high profile bankruptcies and the new laws contained in the Sarbanes-Oxley Act.

Clearly, there is considerable demand for a new approach that will help insurers to analyse US publicly traded companies' D&O risks. In response to this need, Guy Carpenter & Carpenter, Inc. teamed up with NERA Economic Consulting, a Marsh & McLennan Companies subsidiary, to create the industry's first D&O frequency and severity model specifically designed for US publicly traded companies.

Assessing the loss potential of a D&O portfolio

The LEAD™ model (Loss & Exposure Analysis for D&O) was officially launched in February 2004. It is a risk selection and portfolio tool that brings together a wide range of publicly available data, including stock issuer characteristics, stock trading information, financial statement metrics, and stock ownership breakdown. The model, which helps calculate the likelihood that a company will face a future securities class action suit and the possible severity of that suit, enables insurers to assess probabilistic results based on verifiable data and determine potential settlement distribution of their US D&O risk portfolio.

More specifically, the model can help insurers to better analyse and manage shifts in frequency and severity within their portfolios, serve to supplement existing risk avoidance methods, and benchmark loss potential. Early responses to the model indicate that it is filling the need for empirical analyses in the D&O line of business.

Future of the D&O market

The current D&O reinsurance market continues to reflect flattening prices of the underlying business. The current conditions also indicate that some of the "mega claims" are settling for more than anticipated and that reserves for underlying claims inventory may be inadequate. Nonetheless, insurers and reinsurers appear to be optimistic about the strong fundamentals in the business and the profitability of their in-force portfolios.

In addition, Guy Carpenter believes that as the D&O reinsurance market continues to improve, the sector's profitability may grow as well. Research suggests there is a direct correlation between economic and capacity decisions made by reinsurers and the health of the underlying market. Better equipped reinsurers will presumably make better decisions so that profits for both reinsurers and ceding companies can be maximised.