

# Quarterly D&O Pricing Index

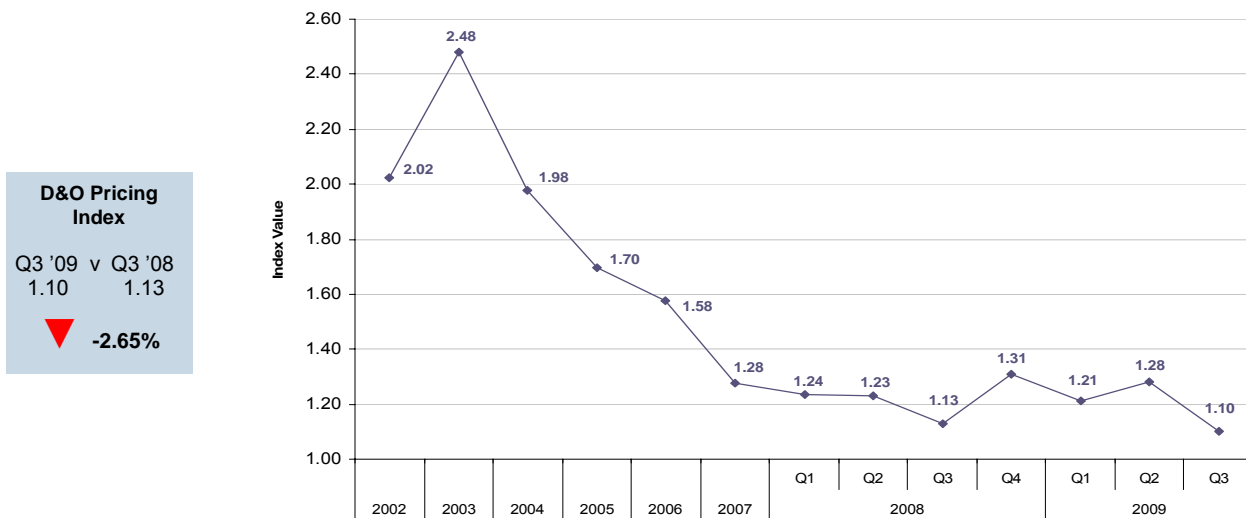
## THIRD QUARTER 2009

Each quarter, Aon's Financial Services Group (FSG) publishes a pricing index of Directors' and Officers' liability (D&O) insurance that tracks premium changes relative to the base year of 2001.<sup>1,2</sup> In the third quarter of 2009, the average price for \$1 million in coverage limits decreased 14.06 percent from the second quarter of 2009, with the Index moving from 1.28 to 1.10.

A more significant result is that pricing decreased 2.65 percent in Q3 2009 as compared with Q3 2008. Since D&O policies are typically written for a 12-month period, this year-over-year comparison is a close approximation of renewal pricing and a more meaningful indicator of renewal results in the quarter. We generally associate claims frequency with price fluctuations. After an uptick in frequency beginning around the middle of 2007, we have seen renewal price increases in two of the last four quarters (with Q1 and Q3 2009 showing only modest decreases in pricing) after 20 consecutive quarters of price decreases.

Perhaps an even more realistic comparison is to look at only those programs that renewed in both Q3 2009 and Q3 2008. On that basis, pricing decreased 2.63 percent. This may not be a significant difference due to the overall sample size, but it does smooth out some of the volatility at the Sector and Industry Group level due to differences in the composition of the samples from one year to the next.

Quarterly Index of D&O Pricing  
Q1-2002 through Q3-2009 | Base Year: 2001 = 1.00



### Market Easing for S&P Financials sector

The unprecedented events in the S&P Financials sector during the eighteen months leading up to Q3 2009 resulted in a difficult underwriting environment for financials sector buyers. Pressure seems to be easing a bit as year-over-year pricing in Q3 2009 for the financials sector was up 3.16 percent

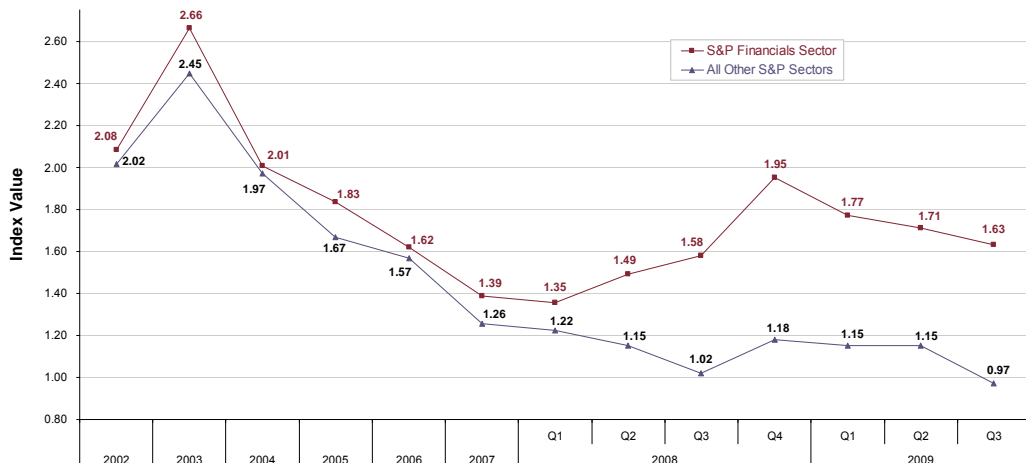
compared to the most recent high in Q4 2008 when pricing increased 50.45 percent. Cumulatively, the other nine S&P sectors were down 4.90 percent for the quarter. Despite increases in each of the past four quarters, the financials sector is still 38.7 percent lower than the high point in 2003.

### Quarterly Index of D&O Pricing: S&P Financials sector vs. All Other S&P sectors

Q1-2002 through Q3-2009 | Base Year: 2001 = 1.00

**S&P Financials sector**  
 Q3 '09 v Q3 '08  
 1.63 1.58  
 ▲ **+3.16%**

**All other sectors (as a group)**  
 Q3 '09 v Q3 '08  
 0.97 1.02  
 ▼ **-4.90%**



### Limits & Deductible Purchasing Trends

In Q3 2009 our clients on average purchased 1.6 percent more limits than the previous year's renewal. As stated in past quarters, clients' decisions to purchase limits may be related to one or more of the following factors: 1) increasing D&O claims frequency, 2) increasing D&O claims severity, 3) changing pricing environment, 4) concern about the financial health of D&O insurance carriers, and 5) personal preference of individual directors and officers. This modest increase in limits is likely most correlated with point four above.

We also monitor deductible changes within our book of business. During the quarter, 3.6 percent of deductibles increased, with those clients retaining more risk, and 8.5 percent of deductibles decreased, thus transferring more risk to carriers. Overall, deductibles were fairly stable (87.9 percent remained unchanged) for the quarter.

### Developments During the Quarter

While the stock markets have recovered from the lows in the first quarter, claims that the recession is over may be premature as the unemployment rate continues to rise. The recession and the turmoil in the global financial markets continued with the following developments this quarter:

- The Department of Labor reported 921,000 jobs lost for the American economy:
  - 463,000 jobs lost in June, and the unemployment rate jumped to 9.4 percent.
  - 304,000 jobs lost in July, and the unemployment rate spiked to 9.5 percent.
  - 154,000 jobs lost in August, and the unemployment rate edged up to 9.7 percent.
  - The "underemployment rate" (which includes people whose hours have been cut, and those working part-time for lack of full-time positions, along with the jobless) reached 16.8 percent in August, the highest level since the government began tracking it in 1994.
- The Dow Jones Industrial Average hit 9,544.20 on August 28, 2009, a 45.8 percent increase from the low of 6,547.05 on March 9, 2009.

A recession refers to a general slowdown in economic activity over a sustained period of time, or a business cycle contraction. A recession is often defined simply as a period when Gross Domestic Product falls (i.e., negative real economic growth) for at least two consecutive quarters. Some economists, however, prefer a more robust definition—any period in which the unemployment rate rises by 1.5 percentage points within a 12-month period.

By that definition, the last such recession occurred in November 2001 when the unemployment rate increased to 5.5 percent, up 1.6 points from 3.9 percent in November 2000. Within 12 months, the D&O Pricing Index had doubled from the base year of 2001. Again, using that definition, we entered into the current recession in August 2008 when the unemployment rate rose to 6.4 percent, up 1.5 points from 4.7 percent in August 2007. Subsequently, we have now seen the unemployment rate more than double moving from 4.4 percent in March 2007 to 9.7 percent in August 2009. (It should be noted that based on a number of factors the National Bureau of Economic Research declared the recession officially began as of December 2007.)

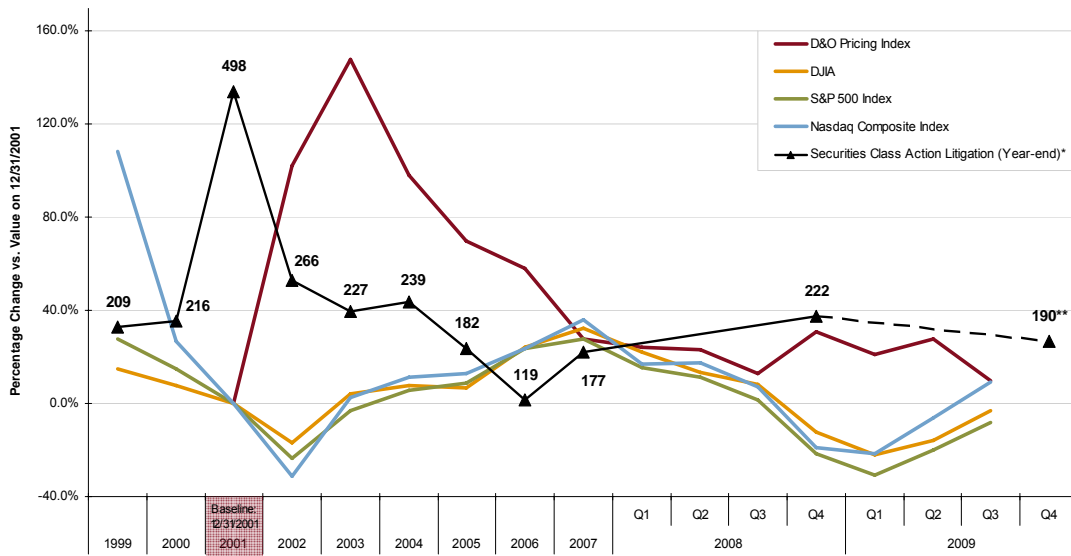
### Comparing Pricing, Frequency and Indices

As the stock market has recovered, the pace of claims frequency has slowed. If the markets continue to rise and frequency continues to abate, buyers may see favorable pricing in the future. In previous quarters we highlighted Newton’s Third Law, which states, “For each action, there is an equal and opposite reaction.” Historically, D&O claims and pricing move in the opposite direction of the equity markets. When a company’s stock is doing well, shareholders are typically content. Starting in 2002 and lasting midway through 2007, investors enjoyed the benefits of a prolonged bull market, one of the longest in history. Stock prices were up and companies experienced both decreasing claims activity and favorable D&O pricing.

We’ve seen the markets fall precipitously from the highs in Q4 2007 to the lows in Q1 2009. As stock prices fall, shareholders become increasingly disgruntled and eventually look for someone, or something, to blame. That, in turn, produces an increase in securities claims frequency. With increases in claims frequency often comes deteriorating underwriting results. It is interesting to note that it generally takes the industry approximately one year to amend its pricing in reaction to such deteriorating results. The following chart illustrates this phenomenon.

D&O Pricing vs. Claims Frequency vs. Market Indices

Q1-2002 through Q3-2009 | Base Year: 2001 = 1.00



\* Source: Stanford Law School’s Securities Class Action Clearinghouse as of November 16, 2009. These totals include IPO Allocation, Analyst, and Mutual Fund filings.

\*\* Projected year-end securities class action filings for 2009 based on Q4 2008 – Q3 2009 actuals.

## D&O Securities Class Action Claims Activity

According to Stanford Law School's Securities Class Action Clearinghouse, there were 130 federal securities class actions filed during the first nine months of 2009.<sup>3</sup> Using the trailing twelve months as a guide, we are on a pace to see 190 filings for the year. While this figure is off the pace of 222 filings made in 2008, it is on par with the eight-year (2001–2008) average of 191 filings and is considerably greater than the 119 and 177 filings reported in 2006 and 2007 respectively.<sup>4</sup> Of the filings reported in 2009, 49 are related to credit crisis issues.

Through the first nine months of 2009, 47.7 percent of federal securities class actions were filed against companies in the financials sector as compared with 50.5 percent in all of 2008. However, looking at the most recent quarter, only 31.3 percent of filings were against financials sector companies in Q3 2009, as compared with 47.1 percent in Q3 2008, perhaps signaling an end to the litigation explosion for financial services firms.

As of Q3 2009, the settlement value of the average D&O securities class action was \$27.43 million (excluding settlements of \$1 billion or greater), a decrease of approximately 18.7 percent from the preceding three-year average settlement value of \$33.74 million. This temporary dip in settlement values is not predicted to continue. We are closely monitoring the situation to determine if this is similar to what we saw in 2007 or a sustained pattern.

## Insurers Reported Second Quarter Results

While four of the five largest providers of D&O insurance<sup>5</sup> posted combined ratios<sup>6</sup> under 100, three of those posted significant (double-digit) improvements on the prior year's quarter. One of the mitigating factors to D&O rate increases is the industry's overall underwriting performance. In that regard, industry loss ratios remain at historically low levels. While their underwriting results in this environment were still impressive, their net results continue to be negatively impacted by net realized losses on their investment portfolios. American International Group (AIG), the largest writer of D&O through Chartis Inc., posted its second consecutive quarterly profit since the third quarter of 2007.

Insurer	P&C Combined Ratio		Net Income/(Loss) in millions		
	Q3 2009	Q3 2008	Q3 2009	Q3 2008	% Change
ACE Limited (NYSE: ACE)	88.1%	97.9%	\$494	\$54	814.8%
American International Group (NYSE: AIG)	105.2%	104.5%	455	(24,468)	NM
Chubb Corporation (NYSE: CB)	85.4%	98.1%	\$596	\$264	125.8%
Hartford Financial Services Group (NYSE: HIG)	93.8%	91.8%	(\$220)	(\$2,631)	91.6%
XL Capital Limited (NYSE: XL)	93.2%	106.3%	(\$11)	(\$1,649)	99.3%

Source: Corporate earnings reports: ACE, AIG, Chubb, Hartford, and XL

## Increased Market Capacity

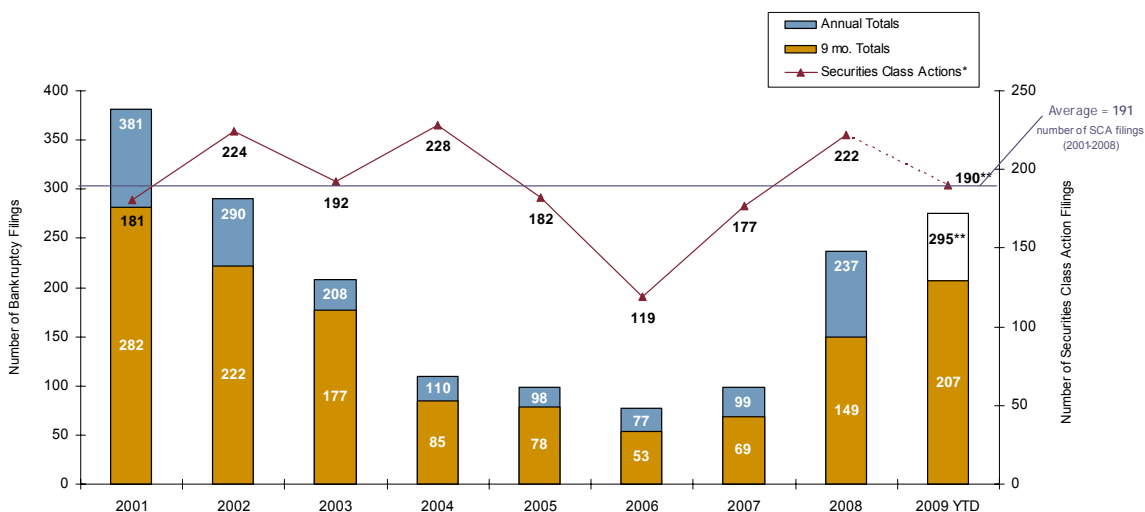
While the historically low combined ratios of the property & casualty insurers participating in the D&O insurance marketplace serve to mitigate the specific need to increase premium rates, competition among these providers of capital, perhaps most importantly, is keeping the market soft. In 2008, the insurance capacity available to any one buyer of D&O insurance increased by almost 11 percent. In 2009, this "theoretical capacity" is up another 4 percent. One reason for this dramatic increase in capital is the dislocation of talent resulting from the financial instability of many of the major insurers. A large number of underwriting professionals have moved from old-line underwriting companies to start-up facilities. The resulting increase in capacity and competition has served, and will likely continue to serve, as an additional deterrent to major D&O price increases.

## Bankruptcies Revisited

Historically corporate bankruptcies have led to an increase in securities litigation. Typically companies filing bankruptcy have experienced significant increases in D&O premium. According to Bankruptcydata.com,<sup>7</sup> there were 207 public and major company bankruptcy filings in the first nine months of 2009, an increase of 39 percent over the 149 filings through Q3 2008, and a staggering 200 percent increase over the 69 filings through Q3 2007.

### Public and Major Company Bankruptcy Filings

2001 through 2009 (9 months YTD)



Source: Bankruptcydata.com Public and Major Company Database as of November 16, 2009. Stanford Securities Class Action Clearinghouse as of November 16, 2009.

\* These totals exclude IPO Allocation, Analyst, and Mutual Fund filings  
 \*\* 2009 full-year projections

During the first half of 2009, and Q2 2009 in particular, the Pricing Index was impacted by the increased incidence of corporate bankruptcies: those companies either on the verge of bankruptcy, in bankruptcy, or having just emerged from bankruptcy. While the bankruptcy filing rate seems to have eased in the third quarter, if the bankruptcy rate continues at the current pace, it will continue to have an impact on the Index for the remainder of the year.

## Summary

The marketplace for D&O remains “soft.” While the financials sector has seen hardening in the past 12 months, overall, it is an excellent time to be purchasing D&O insurance.

<sup>1</sup> The Quarterly D&O Pricing Index is compiled using the proprietary policy data of Aon's Financial Service Group (FSG). The D&O Pricing Index is currently comprised of policy information on over 5,500 D&O programs for publicly traded companies between January 1, 2001 and September 30, 2009. The Index represents the weighted average cost of \$1,000,000 of D&O insurance (Total Premium / Total Limits). The average "rate per million" of limit includes D&O placements (A/B/C Coverage), Side A only (non-indemnifiable loss) placements, and Side A DIC (difference-in-conditions) placements. Programs with blended coverage (e.g. a shared limit for D&O and Fiduciary Liability combined) are excluded from the Index.

While the Index data includes a small number of foreign companies that trade on a U.S. exchange, the majority of the companies are U.S. issuers traded on U.S. exchanges. As such, the data is representative of the U.S. D&O market and not the global D&O market.

FSG first produced the Quarterly D&O Pricing Index in Q2 2006. The base year (2001) is the average price per million for \$1,000,000 of D&O coverage costs for the 2001 calendar year.

<sup>2</sup> In the first quarter of 2008, FSG began adding S&P's Compustat company data to our proprietary policy data. Some companies previously included in our pricing index are not included in this S&P data, primarily foreign issuers not traded on U.S. exchanges and some smaller U.S. companies (e.g. OTC:BB). These companies have been removed from the D&O Pricing Index which resulted in some minor changes to prior results. We do not view these changes as material to the overall results of the Index.

<sup>3</sup> Stanford Law School's Securities Class Action Clearinghouse (as of November 16, 2009). These totals include IPO Allocation, Analyst, and Mutual Fund filings.

<sup>4</sup> Stanford Law School's Securities Class Action Clearinghouse (as of November 16, 2009). These totals exclude IPO Allocation, Analyst, and Mutual Fund filings.

<sup>5</sup> The top five insurers as measured by written premium.

<sup>6</sup> Combined Ratio is defined as Loss Ratio<sup>8</sup> + Expense Ratio + Dividend Ratio. It measures the percentage of premium used to cover losses, expenses and policyholder dividends. If the combined ratio is below 100 percent, the company is operating at an underwriting profit. If the ratio is above 100 percent, the company is dependent on Investment Income to earn a profit. (Source: Highline Data LLC 2008)

<sup>7</sup> Bankruptcydata.com's Public and Major Company Database includes more than 2,800 public and major company bankruptcy filings dating back to 1986. This database includes: public company filings dating back to 1986 as well as selected private company filings with public debt or debt that [they] have deemed significant and newsworthy dating back to 1986.

<sup>8</sup> Loss Ratio is defined as (Losses + Loss Expenses Incurred) divided by Net Premiums Earned. Loss Ratio is a component of the Combined Ratio measuring the percentage of premium dollars used to settle claims. This measure can be affected significantly by changes in estimates of losses from prior years. (Source: Highline Data LLC 2008)

## Aon Contacts:

**Michael D. Rice, II**  
National Practice Leader,  
Financial Services Group  
p: +1.303.639.4163  
e: mike\_rice@aon.com

**Peter M. Trunfio**  
National Knowledge  
Management Practice Leader,  
Financial Services Group  
p: +1.212.441.1647  
e: peter\_trunfio@aon.com



## About Aon

Aon Corporation (NYSE: AOC) is the leading global provider of risk management services, insurance and reinsurance brokerage, and human capital consulting. Through its more than 37,000 colleagues worldwide, Aon readily delivers distinctive client value via innovative and effective risk management and workforce productivity solutions. Aon's industry-leading global resources and technical expertise are delivered locally through more than 500 offices in more than 120 countries. Named the world's best broker by *Euromoney* magazine's 2008 and 2009 Insurance Survey, Aon also ranked highest on *Business Insurance*'s listing of the world's largest insurance brokers based on commercial retail, wholesale, reinsurance and personal lines brokerage revenues in 2008. A.M. Best deemed Aon the number one insurance broker based on brokerage revenues in 2007 and 2008, and Aon was voted best insurance intermediary, best reinsurance intermediary and best employee benefits consulting firm in 2007, 2008 and 2009 by the readers of *Business Insurance*. For more information on Aon, log onto <http://www.aon.com>

## About Aon's Financial Services Group

Aon's Financial Services Group is the premier team of executive liability brokerage professionals, with extensive experience in representing buyers of complex insurance products including directors' and officers' liability, employment practices liability, fiduciary liability, fidelity, and professional liability insurance. Aon's Financial Services Group has over \$2.4 billion in annual premium under management, has assisted with claim settlements in excess of \$3.5 billion, and uses its unmatched data to support the diverse business goals of its clients.