The Specialist ESSL

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A Message from the Chairman

by William P. Teich, CPCU

William P. Teich, CPCU, is claim director for Horizon Management, a division of Hartford Financial Services specializing in run-off claim management. He manages its assumed business and a surplus lines claim unit, leading teams in Hartford, Boston, and London. Teich entered the insurance industry in 1986, and has been with Hartford for his entire career. He has experience in direct, ceded, and assumed claims.

Welcome to all of our E/S/SL Section members. I am proud to introduce myself as the new chairman for our section, although I have been a section committee member for several years now. I must apologize upfront for the limited interaction that we have had over the past year. However, we are viewing this as a time to change and grow and are quite interested in any topics, ideas, or training that will be of value to our section, as well as to the CPCU Society as a whole. Please feel free to e-mail me at william.teich@thehartford.com.

Well, what have we been working on over the past year?

- A revised newsletter with a new editor, W. Wesley Carroll, CPCU. Please share any ideas for content and format with Wes. We will also be sharing our newsletter with other E/S/SL organizations such as PLUS and X/S Claims to increase the visibility of the CPCU Society and our section.
- We are working on a turnkey program to be used at the regional or chapter level to educate our membership on the nature and purpose of the surplus lines market. We are planning on a preliminary roll out this winter following our Annual Meeting and Seminars in October.
- We are conducting a seminar at the Annual Meeting and Seminars in Los Angeles on Sunday, October 24, from 9 to 11 a.m. entitled "Where Have All the Companies Gone?" This seminar will cover a broad industry perspective to include: macroeconomics, regulation, policyholders surplus problems, bad management, asbestos/pollution, and all the other class-action litigation, Wall Street, etc. The speakers will provide a current view of our environment and some projections as to where the industry is going and the expected impact.
- We are considering our seminar options for the 2005 Annual Meeting and Seminars and would appreciate any ideas or suggestions on timely topics.
- Finally, we are reaching out to our membership through e-mail, our newsletter, and web site. We are interested in what we can do to provide greater value for our section. We are also in need of additional assistance with our section committee. Please let me know if you are interested, or know someone who is interested, in joining the committee or in providing any type of assistance to our section.

I am hopeful that our section seminar will be well-attended at the Annual Meeting and Seminars, and that many of our section members will attend the conference. I look forward to seeing you in Los Angeles, trading e-mails, or otherwise corresponding on how to add greater value for our membership, and to make our section a Circle of Excellence winner.

Thanks for your continued support of the E/S/SL Section. ■

What's in this Issue?

Directors and Officers—
Taking a Hard Look at the Hard Market

Employment Practices and Merger Activity Are Leading Drivers of Claims

by Phil Zinkewicz

Editor's note: This article originally appeared in the April 2004 issue of *Rough Notes* and is reprinted here with permission.

- **Phil Zinkewicz** is an insurance journalist with *Rough Notes.* He has some 25 years of experience covering the international insurance and reinsurance arenas. Zinkewicz was the insurance editor of the *Journal of Commerce* for a number of years, handling all of its domestic and international supplements. In addition, he regularly writes for a number of London publications.

One of the more volatile of the professional liability lines of insurance in the property/casualty business is directors and officers (D&O) coverage. The terrorist attack of September 11, 2001, has often been used as a guidepost for the beginning of today's overall hardening of the property/casualty marketplace, and small wonder. But even before September 11, the P/C arena was experiencing a slight hardening, especially in the D&O area. Rate increases in the area of directors and officers liability have persisted during the last three years, but there are signs that the market may be stabilizing a bit, according to a recent survey.

Directors and Officers (D&O) liability insurance premiums increased approximately 33 percent on average from 2002 to 2003, according to the Tillinghast business of Towers Perrin's 2003 Directors & Officers Liability Survey. While employee lawsuits were significant for all types of respondents, entities with more than 500 shareholders saw most of their claims come from some of those shareholders. Despite record premium increases during the year, the 2003 D&O Premium Index indicates that the market started stabilizing toward the end of 2003 with premium increases beginning to level off, according to Tillinghast's survey, which included 2,139 participants.

The 2003 D&O Premium Index median and average premiums were the highest ever reported by survey participants (see accompanying graph), with 70 percent of U.S. respondents reporting an increase in premiums from a prior policy and only 19 percent reporting a decrease. Signs of stabilization occurred toward the end of the year, however, with 62 percent of U.S. participants with renewals reporting a premium increase in the third quarter, compared with 76 percent in the third quarter of 2002, according to Tillinghast.

"While many companies are still seeing increases in D&O premiums, the proportion of participants reporting increases declined in the last half of our survey period," says survey leader Elissa Sirovatka.

Other key findings from the survey include:

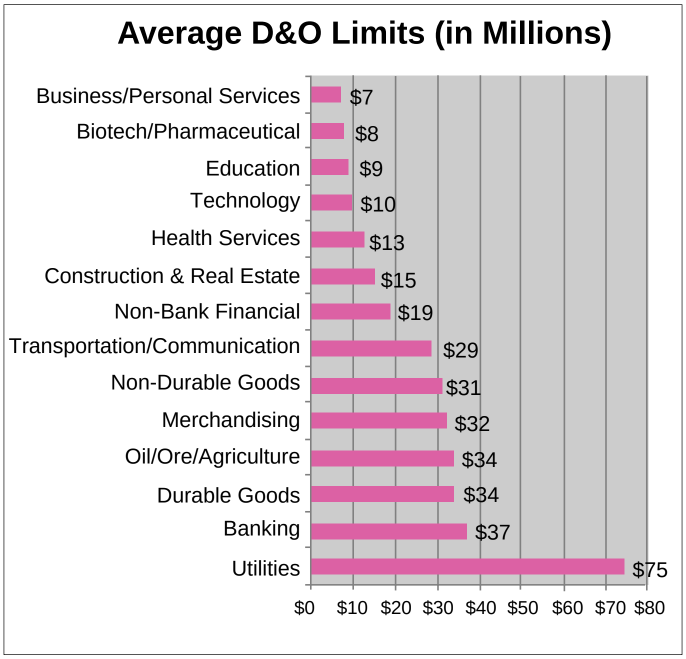
- Coverage is available despite decreased capacity levels. According to information provided by D&O insurance carriers, $1.35 billion in full limits capacity was available during 2003, which is the lowest capacity level since 1997. Yet few survey participants cited availability problems.
- The year 2003 was the 11th consecutive year that less than 5 percent of all U.S. participants not purchasing D&O coverage made their decision because coverage was completely unavailable to them. "Though 2003 capacity was low, we believe it has reached a bottom and will increase in 2004," says Sirovatka.
- Employment practices liability (EPL) saw the most significant increase in incidence of D&O claims. "Employment-related claims have become a driving force behind D&O liability losses, increasing the perceived need for coverage among public and private companies alike," says Sirovatka. During 2003, 91 percent of D&O claims against nonprofit organizations were brought by employees. At for-profit companies with fewer than 500 shareholders, 50 percent of D&O claims were brought by employees, compared with 24 percent at companies with more than 500 shareholders. Employment discrimination (40 percent) was the most frequently cited employment-related claim, followed by wrongful termination (24 percent).
- Though there was a dip in the frequency of D&O claims, severity—excluding shareholder claims—increased by 40 percent. Severity of shareholder claims, however, was down, averaging $14.2 million per claim award in 2003, compared to $23.4 million in 2002. "We were surprised to find a drop in the average claim award; however, these claim trends are highly volatile and vary by category," says Sirovatka. "The drop in shareholder claims could be good news for the D&O insurance market."
- M&A activity more than doubled odds of D&O claims. Twenty-seven percent of U.S. respondents were involved in a merger, acquisition, or divestiture during 2003, and these companies were more than twice as likely to have at least one D&O claim. On average, they also had three times as many D&O claims as their counterparts that did not undergo such reorganization.

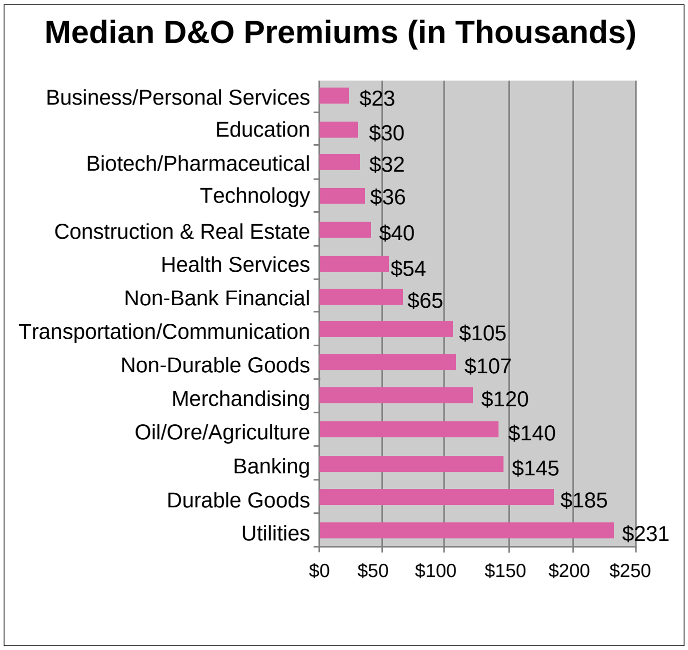
Tillinghast predicts the D&O market will take the following shape in 2004:

- Capacity will increase. After bottoming in 2003, capacity should bounce back this year with new entrants coming into the market.
- Market will remain hard. In spite of the increase in capacity, the market will not begin to soften. Though premium increases will stabilize

Directors & Officers Liability Exposure

Average Limits & Median Premiums by Business Type





Source: *Tillinghast-Towers Perrin D&O Survey 2003*

(US Business—For Profit)

overall, some industry sectors will still experience increases of 30 percent or more.

- Narrowing of coverage. There will be some continued narrowing of coverage by virtue of more restrictive coverage forms and carriers imposing more exclusions. However, most of this is expected to occur in the first half of 2004 with coverage stabilization likely during the second half of the year.
- Sarbanes-Oxley creates an interesting dynamic. Regulation from Sarbanes-Oxley will likely make buyers more concerned about having enough coverage limits. However, insurers will be concerned about claim frequency increasing and may become more selective in offering coverage limits.

In order to elicit comments on the Tillinghast survey, *Rough Notes* spoke with John McElroy, senior vice president and head of management liability products for Gulf Insurance Group, and Ivan Dolowich, senior vice president and claims officer.

McElroy agreed with the Tillinghast survey regarding the level of rate increases in D&O and with the survey's findings regarding merger and acquisition activity. "I believe there is a definite correlation between merger and acquisition activity and D&O claims," he said. "There were a number of acquisitions in the last couple of years that resulted in D&O lawsuits and large settlements.

"As for rate increases," he continued, "here again our experience tracks with the survey. Of course, certain insureds are seeing higher increases than others. For example, companies that have multi-year contracts and that have not had a renewal in a few years are seeing the greatest increases. As for the survey's findings regarding the dwindling of capacity in the business, this is true to a certain extent. The reinsurance business has been hit hard in recent years and reinsurers are restricting the business they are willing to write. Then again, this does not necessarily mean that the capacity is not there. At Gulf, we have the same capacity as 10 years ago, but we are being more prudent in the use of that capacity. We have cut back on our full capacity by about 40 percent."

Dolowich disagrees with the Tillinghast survey on a couple of points. "I don't see that there has been a drop in shareholder claims from 2002, as the survey suggests," he said. "We have not seen a decrease in the frequency or severity of shareholder claims. In fact, according to the latest NERA study, there were about 122 securities class-action settlements during 2002 and 163 cases that were settled in 2003. Because of the average duration of securities class-action claims, it's very difficult to draw conclusions from these statistics on a year-to-year basis with accuracy. Also, I don't agree that EPL claims have been a driving force in D&O claims. There is no question that EPL claims are on the rise in terms of frequency, but they are overshadowed by claims involving securities class actions." ■

White Paper Available:

Making Excess Casualty Cover a Wise Statement

In an era of unprecedented "tort excess," excess casualty insurance is one of the most important investments a company makes to ensure its future viability—and the purchase must be evaluated accordingly. David Perez, president of AIG Excess Casualty, elaborates.

The commercial umbrella policy a company invests in today can be pivotal in determining its fate when claims arise years from now. Yet some companies and brokers are more likely than ever to make a poor choice when purchasing coverage—and face potentially devastating consequences—for three main reasons.

1. Liability claims have become more frequent, severe, and unpredictable.
2. Ensuring a carrier's future solvency has never been more difficult.
3. Few carriers evidence the commitment and claims expertise excess casualty lines require.

Perez is among the authors of *Tort Excess 2004: The Necessity for Reform from a Policy, Legal, and Risk Management Perspective.* This white paper, which updates a previous paper published last year, examines the current economic impact of the U.S. tort system and the prudent application of insurance to manage risk in an unpredictable tort environment.

Do you want to know more? Send an e-mail to W. Wesley Carroll, CPCU, at wcarroll@wes-carroll.com and request a free copy of the entire white paper. ■

2004-2005 CPCU Society Chapter-Sponsored Workshops Off to a Fast Start!

If you're looking for the latest technical and leadership information, be sure to check out the CPCU Society web site at http://www.cpcusociety.org/?p=16012.

The September schedule is the most robust we have ever offered, so look for a workshop in your area. Here's the 2004-2005 schedule as of early August; by the time you read this newsletter, it's likely there will be even more opportunities to acquire the knowledge and skills you need to succeed! ■

Date	Location	Title	Cosponsor
9/8/04 (a.m.)	Philadelphia	2004 CGL	Philadelphia Chapter
9/8/04 (p.m.)	Philadelphia	Contractual Risk Transfer	Philadelphia Chapter
9/9/04 (a.m.)	Albany, NY	2004 CGL	Northeastern New York Chapter
9/9/04 (p.m.)	Albany, NY	Contractual Risk Transfer	Northeastern New York Chapter
9/16/04 (a.m.)	Harleysville, PA	Hidden Coverages	Greater Valley Forge Chapter
9/16/04 (p.m.)	Harleysville, PA	Insurance Valuation Problems	Greater Valley Forge Chapter
9/21/04	Houston, TX	2004 CGL	Houston Chapter
9/28/04 (a.m.)	Uniondale, NY	2004 CGL	Long Island Chapter
9/28/04 (p.m.)	Uniondale, NY	Insuring Defective Construction	Long Island Chapter
9/29/04 (a.m.)	Boston	2004 CGL	Boston Chapter
9/29/04 (p.m.)	Boston	Umbrella and Excess Liability	Boston Chapter
9/30/04 (a.m.)	St. Paul, MN	Hidden Coverages	Minnesota Chapter
9/30/04 (p.m.)	St. Paul, MN	Insuring the eCommerce Account	Minnesota Chapter
11/18/04	Worcester, MA	Executive Liability	Central Massachusetts Chapter
4/21/05 (a.m.)	Worcester, MA	2004 CGL	Central Massachusetts Chapter
4/21/05 (p.m.)	Worcester, MA	Umbrella and Excess Liability	Central Massachusetts Chapter

Municipal Bond Insurance Solvency

by Billie Ann Brotman

Municipal bonds are issued by states, territories, municipalities, political subdivisions, authorized agencies, and possessions of the United States. More than 50,000 state and local governmental units sell bonds to raise needed capital. In 2001, approximately $300 billion worth of municipal bonds were issued in the United States. They funded public works projects, and some private projects deemed in the public interest. More than 40 percent of all municipal bonds issued in 2001 were insured.

Municipal bonds, like other bonds, are subject to many types of risk. However, default risk can be lessened by purchasing insured bonds. The governmental agency that issues the bond often relies on project revenues to generate funds for the bond issue. Should the project fail to produce the expected revenues, then default may occur. Insurance provides investors with the security that no matter what happens to the finances of the agency that issues the bond, the bond's scheduled interest and principal payments will be met.

Ownership Shifts

Individual ownership of municipal bonds, either purchased directly or indirectly through mutual funds or trusts, has grown rapidly. In 1980, the public owned $137 billion worth of municipal bonds, and in 2003 the ownership level had grown to $1,404 billion. While many investors are aware of the protection municipal bonds insurance offers against default and downgrade, they may not realize it also shields them from other risks as well. Protection may be afforded for natural disasters, such as earthquakes, floods, and tornadoes, environmental hazards, and some business practices. If an insured defaults, the insurer would immediately step in and make schedule payments. Payments are not accelerated ahead of schedule as with mortgage defaults. The interest and principal payments are made as originally planned.

Examples of Insurance Shields Causing Defaults

The World Trade Center was built in 1970 by the Port Authority of New York and New Jersey, but was transferred to a private developer prior to the September 11 tragedy. The Trade Center was originally financed using an insured municipal bond arrangement. Since the ownership had changed, the major bond insurers reported no direct material claims were due.

During the California utilities crisis, the two largest utilities in the state were under serious financial stress. Pacific Gas and Electric Company filed for bankruptcy. The bond insurers paid the current bond claims. The insurers have recovered most of what was paid out.

Enron filed for bankruptcy in 2002. The insurance had no direct exposure, but had indirect exposure because Enron securities were held in many portfolios as credit default swaps for which insurance had been underwritten.

Ownership and Regulations

In the early 1970s, the majority of municipal bondholders were banks, insurance companies, and other large financial institutions. Nowadays, the municipal bond market is dominated by small investors. Municipal securities are exempted from federal registration and review requirements. There is no prospectus delivery requirement; they are sold without revealing financial information about the issuing agency, without providing information about expected project proceeds or bond call provisions. The municipal bond market is self-regulated.

Literature Search

There are numerous research studies examining insurer solvency. They analyze solvency and underwriting patterns for casualty-liability insurers and life insurance companies. Solvency issues regarding municipal bond insurers have largely been addressed by rating agencies and brokerage research divisions. They calculate and discuss zero-loss underwriting models.

Research papers that specifically focus on municipal bond insurance generally find that the existence of insurance reduces interest cost for lower-rated, long-term municipal debt issues. The insurer's credit rating is substituted for the lower-rated municipality when investors consider the risk premium.

Justice and Simon (2002) found that there are interest savings associated with the purchase of insurance. Denison (2003) examined insurance purchases given that net savings were not predicted. They suggest that municipal bond insurance is delegated the quality monitoring role by investors.

Insurers

Municipal bonds are insured by monoline insurers. The insurer is only in one business, for example debt securities, and not exposed simultaneously to other forms of risk that might arise from issuing property. Namely, the insurer would not have exposure to any unanticipated event in multiple ways.

There are eight municipal bond insurers currently operating. Reinsurance companies are not included in this study. All companies were rated by S&P. The ratings ranged from AAA to A. Six of the companies were rated AAA, one insurer was AA, and one insurer was A rated. Table 1 provides rating information.

Continued on page 6

Municipal Bond Insurance Solvency

Continued from page 5

Table 1: Municipal Bond Insurer Ratings

Moody's	S&P	Fitch	Insurer
Aaa	AAA	AAA	AMBAC Assurance Corporation
Aaa	AAA	AAA	Financial Guaranty Insurance (FGIC)
Aaa	AAA	AAA	Financial Security Assurance Inc. (FSA)
Aaa	AAA	AAA	MBIA Insurance Corporation
Aaa	AAA	AAA	XT Capital (XLCA)
Aa2	AAA	-	ACE Guaranty Corporation
-	AA	AA	Radian Asset Assurance Inc.
-	A	A	American Capital Access (ACA)

Table 2: Municipal Bond Insurer Ratings

Variable	Coefficient	STD Error	T-stat	2-Tail Sig.
C	-.0110852	.0194838	-.568947	.577
ROC	.5004631	.0003138	1594.9612	.000
COMBINED	-.0133015	1.845D-05	-720.78669	.000
YIELD	-1.640923	.0006527	-2514.2019	.000
NET	.123307	.0002134	577.85896	.000

Log Likelihood -.3430408

Table 3: Financial Information 2001

	ROC	Combined	Yield	Net
AMBAC	13.7	11.6	7.3	97.5
FGIC	10.7	21.3	6.9	89.6
FSA	11.4	42.9	7.4	136.2
MBIA	12.1	22.8	6.9	91.6
ACE	8.5	69.2	7.2	124.2

Complete information was unavailable for XLCA. The sample was comprised of seven companies over the three-year period 1999–2001. The dependent variable was the rating assigned by S&P. Insurers with an AAA rating were assigned a "1," and those below that level were assigned a "0." A probit model was used to assess the significance of the independent variables. They were return on capital (ROC), combined ratio, which is the addition of expense and loss ratios, net investments yield (Yield), and net par/qualified statutory capital (NET). The results are reported in Table 2.

The variables were all significant, and have the expected signs. They give some indication of the likelihood a given rating will be assigned. The financial ratios varied greatly within the AAA rating class. Table 3 presents the financial ratios for the end of 2001 for AAA-rated insurers.

The combined ratio and net par ratio showed the most variation within the AAA rating. The combined ratio ranged from 11.6 to 69.2, and the net par ratio ranged from 89.6 to 136.2.

Conclusion

The probit model indicates that the independent variables help to predict rating class. However, within the AAA rating there is a great deal of variation. The municipal bond insurance market has grown substantially over the years with more than 50 percent of new issues being insured. The credit worthiness of the company providing this insurance is certainly a factor that investors should consider when purchasing an insured municipal bond. ■

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Standard and Poor's online information.

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The E/S/SL Section Is Proud to Announce that It Will Sponsor an Informative Seminar at the 2004 Annual Meeting and Seminars in Los Angeles!

Reach for the Stars!

Where Have All the Companies Gone?

Sunday, October 24, 9 - 11 a.m.

What You Will Learn

What does the future hold for the insurance industry? Attend this seminar for a broad perspective on various insurance topics, such as macroeconomics, regulation, policyholders' surplus problems, bad management, asbestos, pollution, and all other class-action litigation. An examination of the insurance industry's current problems and shortcomings, such as these, is the best way to understand how you can succeed. In addition to this, a case study of select companies will be used to provide a current view of the industry and projections as to where the industry is headed.

Presenters

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Andrew Barile Consulting, Inc.

Eric C. Nordman, CPCU, CIE
National Association of Insurance Commissioners

Gregg Rentko, CPCU
ACE Insurance

Nelson Rivera, CPCU, CPA
A.M. Best Company

Damian V. Sepanik, J.D., CPCU
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Register Today!

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