

Understanding Global

In 2002, HCC become a significant D&O carrier as insurance rates responded to the perfect storm of securities litigation, soft terms and shrinking capacity. But almost three years on and the sector has changed significantly. Here the Texan-headquartered company explains why it is committed to the product and how globalisation is changing demand...

The concept of D&O dates back to the early 1930s when Lloyds introduced coverage in the US for the "personal financial protection" of corporate directors and officers. But demand for the product remained low until the mid 1980s, mainly because directors and officers did not perceive great risk in their positions if they performed their jobs well. The tide changed when US securities laws provided private shareholders with the right to sue these individuals for securities fraud. Increased claims activity highlighted the need for coverage and competition was created as new carriers entered the D&O market.

There was a brief turn in the market in 1985 when the general insurance industry experienced a capacity crisis. It became difficult to buy D&O coverage then, despite the growth in demand for the product. A quick reaction to this

capacity crisis was the formation of companies like CODA, XL Insurance and ERMA (AETNA).

Indeed D&O insurance capacity increased in the late 1980s which, led, inevitably to the weakening of price and terms felt in the 1990s - creating the first prong of what some would later call "the Perfect Storm" that would engulf the D&O industry at the turn of the Millennium.

By this time, most public companies in the US were able to purchase D&O programmes with huge limits of liability relatively cheaply. D&O carriers were not overly concerned about extending so much under-priced capacity. They had seen so few "catastrophic" losses that they did not perceive significant risk to their policies. That thinking would prove to be very shortsighted, and very expensive.

Ironically, this complacency was partially caused by legislation created to temper plaintiff abuse of the legal process. The Private Securities Litigation Reform Act (PSLRA) of 1995 was designed to prevent so-called "strike suits" where plaintiff lawyers would file shareholder actions immediately after a decrease in a company's stock price and then use the litigation process to find whatever evidence they needed to win their case.

After PSLRA was passed, most insurers felt it would reduce their exposures. Unfortunately, that thinking was wrong. While the PSLRA did make it tougher for plaintiffs to bring securities lawsuits, it did not decrease the number of suits filed. Instead, it made the suits that did survive attempts to have them dismissed much more expensive to settle. The end result? Claim frequency has remained relatively constant as compared with pre-PSLRA levels, while claim severity has actually increased.

The second prong of the "Perfect Storm" brewing throughout the 1990s was the introduction of coverage for the company in D&O policies. This came about during the late 1980s when D&O carriers lost a number of coverage lawsuits regarding the difficult issue of allocating the ultimate loss between the company and the directors and officers in shareholder class actions. As a result, and because the carriers were always looking for ways to enhance their product during the extended soft market, coverage for the company (for securities claims only) was introduced. The unfortunate by-product of this enhancement is that the company was no longer motivated to negotiate the lowest possible settlement of any given shareholder class action.

By the end of the 1990s, the world became a big capital market party. The US stock market hit record highs and there was a vast accumulation of wealth based primarily on stock appreciation tied to potential earnings rather than actual earnings.

D&O

But the bubble had to burst and, when it did, share prices dropped dramatically and a morass of securities litigation followed. Billions of market capitalization disappeared, seemingly overnight. The enormous losses suffered by investors constituted the third and final prong of the "Perfect Storm".

Shareholder suits rolled in through 2000, 2001 and 2002. Companies that were being sued were happy to use their large D&O programs to settle claims. The result was settlements and attendant D&O insurance losses of unprecedented proportions. Not only were those companies and their directors and officers taken to task; the financial institutions that brought the IPOs to the market were also being blamed for these losses. They were - and still are - the subject of massive litigation.

Reinsurance capacity dries post 9/11

The 11 September attacks in 2001 caused even more problems for the sector, as reinsurance capacity was diverted to other more profitable lines of insurance. The D&O insurance market hardened immediately. Capacity shrunk and prices soared as D&O insurers, at least those that had survived the storm, tried to quickly recover and correct the flaws that had left them susceptible to the tremendous losses they had just suffered.

Separately, public and shareholder outrage at an array of corporate abuses finally drove the passage of the Sarbanes-Oxley Act of 2002 (SOX). SOX changed the US federal securities law that governed directors and officers' responsibilities, setting and strengthening requirements for internal controls, transparency and liability - setting the stage for a new era of corporate governance. Senior executives must certify financial statements issued by their companies, with the threat of significant criminal liability, including imprisonment, for violations.

Furthermore, accounting firms - the supposed "watchdogs" of financial statements - will now perform more thorough audit functions before providing unqualified

opinions regarding financials. All of this should have a positive impact on corporate governance in the US, which should result in diminished risk in the D&O insurance industry.

Corporate governance is also an issue outside of the US as European scandals such as Parmalat, Vivendi and Shell drew issues of shareholder accountability and acceptable market practices. Indeed, most experts believe that we will see more uniform guidelines being developed over the next three to five years formalising the responsibilities of directors and officers in EU companies.

As everyone knows, no law can eliminate crime, and certainly that is the case with SOX. Even though boards of directors and other corporate executives will be watched more closely now than ever before, fraud will continue to occur. The demand for D&O insurance will only increase as directors and officers all over the world realize how significant their responsibilities are and that their personal assets are at stake. The future of D&O insurance in Asia and many emerging markets will be especially challenging, as D&O carriers manoeuvre through social, cultural and political issues.

D&O is no longer purely an American phenomenon, but a global one

The rising need for D&O coverage has indeed reverberated across continents. International companies that are listed on the US Stock Exchanges, in particular, are forced to comply with tougher US regulations or face shareholder litigation and regulatory sanctions. Although corporate governance is still relatively new in many countries, companies worldwide have been facing stricter internal control guidelines in recent years.

D&O coverage gained its foothold in the UK in the late 1970s, spreading to most parts of Europe by the turn of the decade. Policies were, at this time, drafted using US forms and wordings. These were basically translated and approved by the insurer's US entities. There was little negotiation on terms and conditions or customising

of policies for local markets.

Some D&O carriers have now established local entities in certain jurisdictions within Europe and elsewhere in the world, however, with limited progress. We still need more specialised D&O insurance that caters for specific markets. We need a long-term and stable global provider of D&O coverage that possesses detailed local knowledge of the jurisdiction in which they work.

It was this state of flux which drew HCC Insurance Holdings into the industry. HCC had watched the sector for some time and, in 2001, it was approached by an ambitious team of professionals who operated their own agency, MAG Global Financial Products (MAG Global).

MAG Global had been founded in 1999 by Matthew Fairfield. In 2002, HCC agreed to purchase the company, thus creating HCC Global Financial Products. The organisation is now one of the principal global D&O and financial lines underwriters, providing coverage to companies around the world.

We've entered a softening market phase this year, one of uncertainty and increased risk for D&O insurers, buyers and sellers. There are still significant amounts of old claims to be paid causing market leaders to feel the pain and concern for the future. Fresh capital may be out there, but providers like these are not seasoned in the D&O business and therefore make inexperienced decisions. What we need is "intelligent capital".

As noted, US high profile companies are no longer the only culprits of scandals. US-listed companies based in China have been found guilty of fraud resulting in billions of dollars in claims. Directors and officers worldwide now realise the need for D&O insurance. The future of this type of coverage in Asia and many emerging markets will be challenging as D&O carriers maneuver through social, cultural and political issues.

The acute risks of D&O insurance remain tied to capital markets as

it insures the civil, criminal and regulatory liabilities of the board of directors. The world's need for capital at a competitive cost will drive the product even further. The insurers that will take the reigns in this global industry are those that are financially stable and can provide a certainty of coverage; those possessing core underwriting abilities and detailed local knowledge; and those that are committed to promoting the understanding and management of risk.

HCC is an international insurance holding company and a leading specialty insurance group since 1974, based in Houston, Texas with offices across the USA and in Bermuda, England and Spain. HCC is traded on the NYSE (symbol: HCC), has assets exceeding \$6bn and is rated AA (Very Strong) by Standard & Poor's and A+ (Superior) by A.M. Best Company.