

# Quarterly D&O Pricing Index

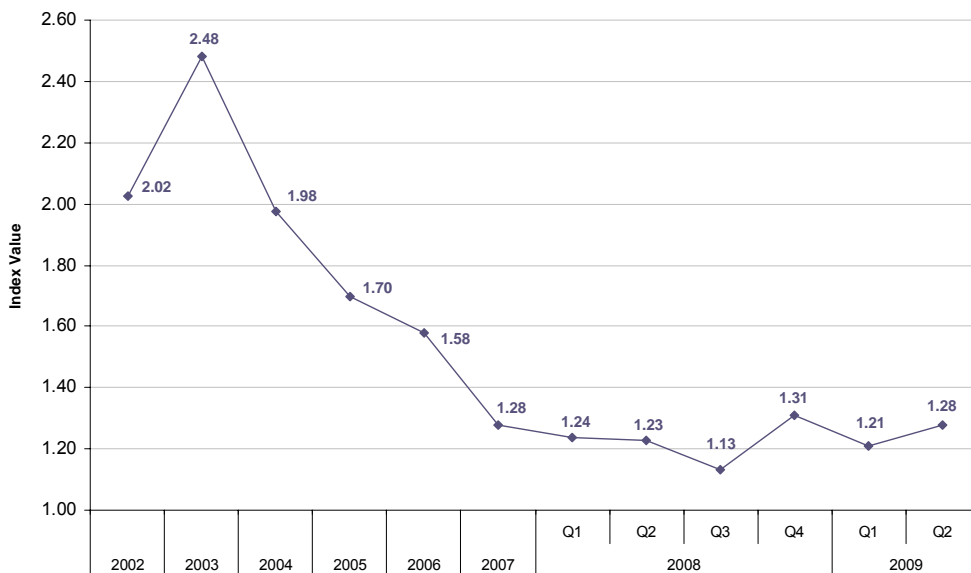
## SECOND QUARTER 2009

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 second quarter of 2009, the average price for \$1 million in coverage limits increased 5.79 percent from the first quarter of 2009, with the Index moving from 1.21 to 1.28. In recent years, pricing decreased from Q1 to Q2 due to the mix of business renewing in those quarters. This year, however, a wave of bankruptcy filings affected renewal pricing for the quarter (more on this topic to follow).

A more significant result is that pricing increased 4.07 percent in Q2 2009 as compared with Q2 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 now seen renewal price increases in two of the last three quarters (with Q1 2009 showing only a modest decrease in pricing) after 20 consecutive quarters of price decreases.

**Quarterly Index of D&O Pricing**  
*Q1-2002 through Q2-2009 | Base Year: 2001 = 1.00*

**D&O Pricing Index**  
 Q2 '09 vs Q2 '08:  
 ▲ +4.07%



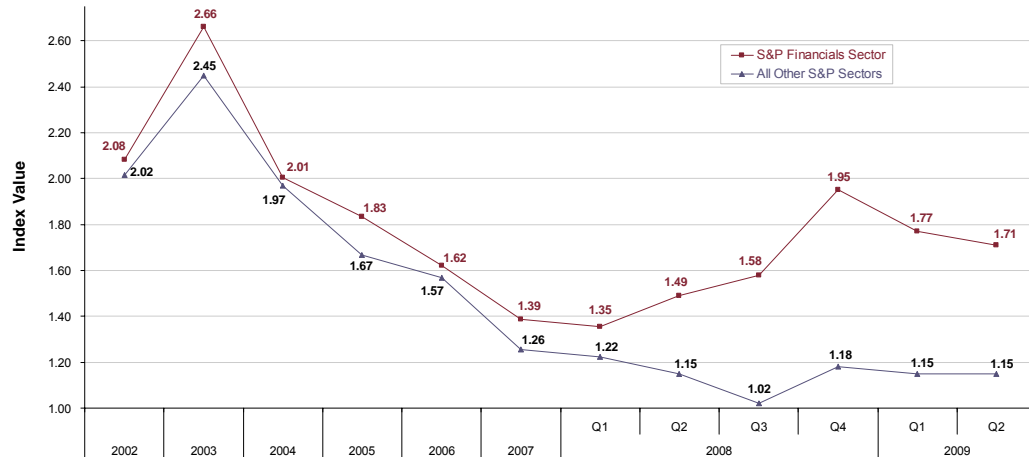
### Market still firming for S&P Financials sector

The unprecedented events in the S&P Financials sector during the eighteen months leading up to Q2 2009 are still resulting in a difficult underwriting environment for financials sector buyers. Pricing in Q2

2009 compared to Q2 2008 for the financial sector was up 14.77 percent. Cumulatively, the other nine S&P sectors were flat at 0.00 percent for the quarter. While this is not the first time the S&P Financials sector posted an increase, it is the first time in over three years that all non-financials sectors as a group were anything other than down.

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

Q1-2002 through Q2-2009 | Base Year: 2001 = 1.00



#### S&P Financials sector

Q2 '09 vs Q2 '08:

▲ +14.77%

#### All other sectors (as a group)

Q2 '09 vs Q2 '08:

— 0.00%

### Limits & Deductible Purchasing Trends

In Q2 2009 our clients on average purchased 2.1 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.

We also monitor deductible changes within our book of business. During the quarter, 5.9 percent of deductibles increased, with those clients retaining more risk, and 3.0 percent of deductibles decreased, thus transferring more risk to carriers. Overall, deductibles were stable (91 percent remained unchanged) for the quarter.

### Developments During the Quarter

The recession and the turmoil in the global financial markets (that began in earnest during the third quarter of 2008) continued with the following developments this quarter:

- On April 30, 2009, Chrysler LLC filed for bankruptcy protection, becoming the first major American automaker to seek bankruptcy protection since Studebaker in 1933.
- The Department of Labor reported more than 1.26 million jobs lost for the American economy:
  - 519,000 jobs lost in April, and the unemployment rate jumped to 8.9%.
  - 303,000 jobs lost in May, and the unemployment rate spiked to 9.4%.
  - 443,000 jobs lost in June, and the unemployment rate edged up to 9.5%.
- On June 1, 2009, General Motors Corporation filed for bankruptcy protection, with the federal government taking a 60 percent ownership stake in the company during its restructuring.

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 9.5 percent in June 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.)

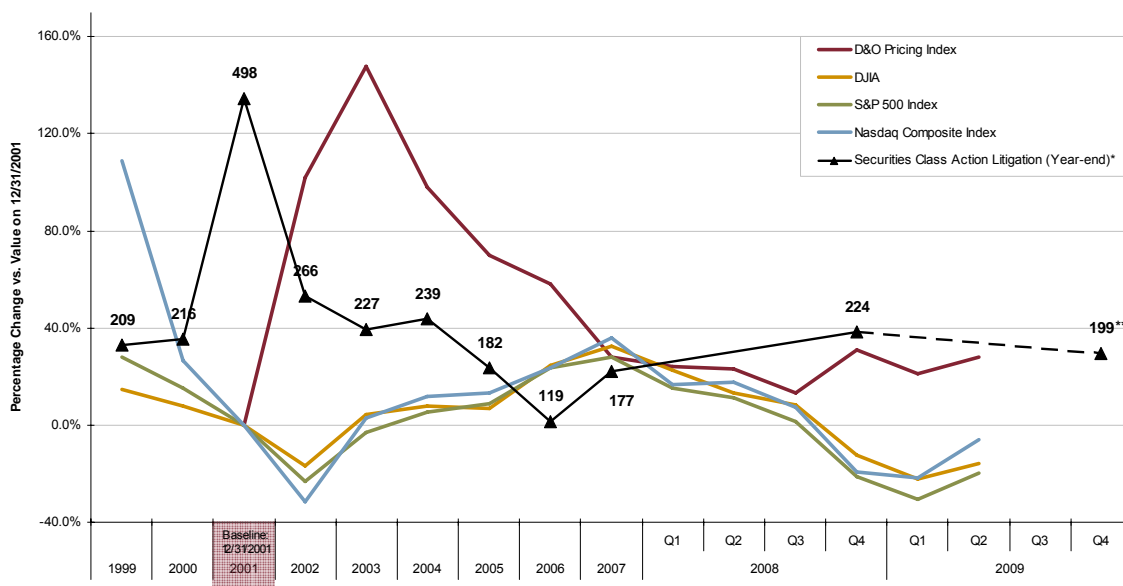
### Newton’s Third Law Revisited

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 chart below illustrates this phenomena.

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

Q1-2002 through Q2-2009 | Base Year: 2001 = 1.00



\* Source: Stanford Law School’s Securities Class Action Clearinghouse as of July 15, 2009. These totals include IPO Allocation, Analyst, and Mutual Fund filings.

\*\* Projected year-end securities class action filings for 2009 based on Q3 2008 – Q2 2009 total.

## D&O Securities Class Action Claims Activity

According to Stanford Law School's Securities Class Action Clearinghouse, there were 86 federal securities class actions filed during the first six months of 2009.<sup>3</sup> Using the trailing twelve months, we are on a pace to see 199 filings for the year. While this figure is off the pace of 224 filings made in 2008, it represents a slight increase over 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 Q2 2009, 34 are related to credit crisis issues.

As of the second quarter of 2009, the settlement value of the average D&O securities class action was just over \$27.37 million (excluding settlements of \$1 billion or greater), a decrease of 18.0 percent from the preceding three-year average settlement value of \$33.38 million. We are closely monitoring the situation to determine if this is a temporary dip similar to what we saw in 2007 or a sustained pattern.

## Insurers Reported Second Quarter Results

All five of the largest providers of D&O insurance<sup>5</sup> posted combined ratios<sup>6</sup> under 100, although two of the five posted less favorable results while a third was flat. 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 were negatively impacted by realized losses on their investment portfolios. It should be noted, American International Group (AIG), the largest writer of D&O, posted its first quarterly profit since the third quarter of 2007.

Insurer	P&C Combined Ratio			Net Income/(Loss) in millions		
	Q2 2009	Q2 2008	% Change	Q2 2009	Q2 2008	% Change
ACE Limited (NYSE: ACE)	87.7%	87.8%	(0.1%)	\$535	\$746	(28.3%)
American International Group (NYSE: AIG)	98.2%	92.8%	6.5%	1,822	(5,357)	NM
Chubb Corporation (NYSE: CB)	85.9%	88.5%	(2.9%)	\$551	\$469	17.5%
Hartford Financial Services Group (NYSE: HIG)	90.4%	90.7%	(0.3%)	(\$15)	\$543	NM
XL Capital Limited (NYSE: XL)	93.0%	91.6%	1.5%	\$80	\$238	(66.4%)

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

## Increased Market Capacity

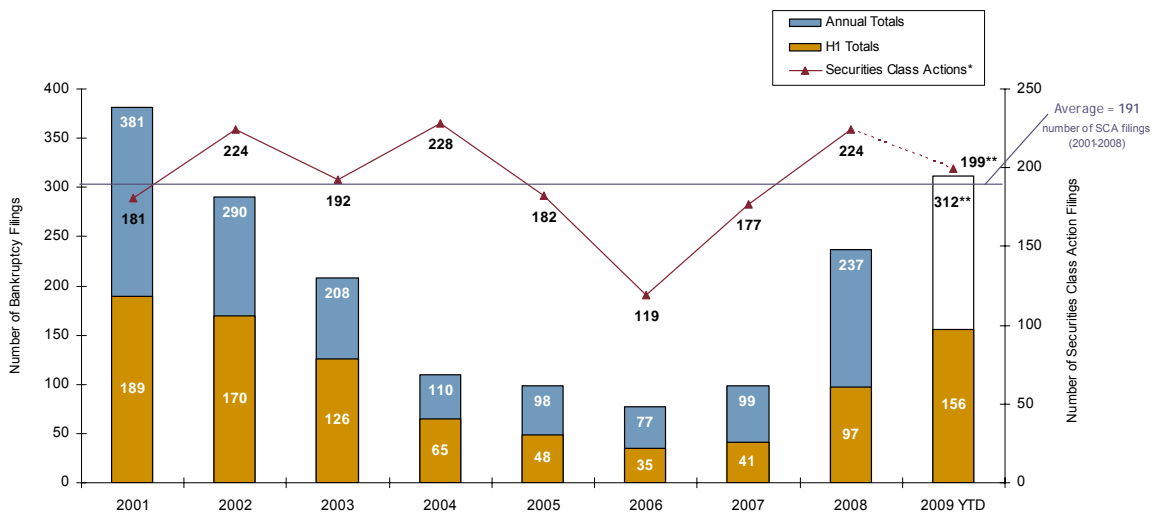
While the historically low combined ratios of the property & casualty insurers participating in the D&O insurance marketplace serve to mitigate the specific need to increase premium rates, competition among these providers of capital, perhaps most importantly, is keeping the market soft. The theoretical insurance capacity available to any one buyer of D&O insurance has increased by almost 11 percent in the past 18 months. 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.

## The Next Big Thing?

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 156 public and major company bankruptcy filings in the first six months of 2009, an increase of 61 percent over the 97 filings in H1 2008, and a whopping 280 percent increase over the 41 filings in H1 2007.

### Public and Major Company Bankruptcy Filings

2001 through 2009 (6 months YTD)



Source: Bankruptcydata.com Public and Major Company Database as of August 3, 2009. Stanford Securities Class Action Clearinghouse as of July 15, 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. If the bankruptcy rate continues at the current pace, it will continue to have an impact on the Index in the latter part of this year.

## Summary

As the recession continues to negatively impact the financial condition and stock prices of insureds, while potentially impacting underwriting results of insurers, the delicate balance between the forces holding prices down and the need for rate increases could soon shift in the underwriters' favor. Fortunately for insureds, pricing in the D&O marketplace still remains at levels that could classify as "soft."

<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 5,000 D&O programs for publicly traded companies between January 1, 2001 and June 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 July 15, 2009). These totals include IPO Allocation, Analyst, and Mutual Fund filings.

<sup>4</sup> Stanford Law School's Securities Class Action Clearinghouse (as of July 15, 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 over 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)

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## 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 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 and 2008 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.