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 2001.1 2 In the third quarter of 2012, the average price for $1 million in coverage limits decreased 8.8 percent from the second quarter of 2012, with the Index moving from 0.91 to 0.83. It is not uncommon to see these fluctuations from one quarter to the next due to the mix of business renewing at different times of the year. This is the ninth consecutive quarter that the Index is below the 2001 baseline value of 1.00.

As we have said in the past, a more meaningful measure derived from this Index is to compare the current quarter with the prior year quarter, which for Q3 2012 represents a decrease of 1.2 percent over Q3 2011. 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 significant indicator of renewal results in the quarter.

Another comparison is to look at only those programs that renewed in both Q3 2012 and Q3 2011. On that basis, pricing was flat (0.0 percent).

Quarterly Index of D&O Pricing
Q1-2002 through Q3-2012 | Base Year: 2001 = 1.00

A Turning Point
Prior to last quarter we experienced year-over-year decreases in 33 out of 35 quarters dating back to Q4 2003. The two exceptions (Q4 2008 & Q2 2009) were during the Credit Crisis, and were primarily
driven by results in the S&P Financial sector. While this quarter made it 35 out of 37, we sense that the undercurrent of change is getting stronger.

The 0.0 percent change for those clients in both Q3 2012 and Q3 2011 is the smallest since we began tracking these “same store sales” in Q3 2009.

As we have in the past, we looked closely at the primary layer. In Q1 2012, primary pricing (same clients/limits/deductibles) decreased 2.7 percent, while in Q2 2012, primary pricing increased 2.1 percent. Now, for Q3 2012, we note primary pricing for this group increased 4.5 percent. What is even more interesting is when we look at the trend line by month.

There was clearly an inflection point in April in terms of primary pricing. That being said, we continue to see a separation between primary and excess rates. Primary rates are now trending upward, but most clients’ total D&O premiums are still flat overall because excess rates are still declining, albeit at a slower rate of descent.

In addition to the average pricing change, we also looked at the number of companies that experienced a decrease on their primary layer versus a flat renewal or an increase. The trend here is pretty clear as well. In January, 44 percent of clients received a year-over-year decrease on their primary layer, while only 9 percent received an increase. By June, only 21 percent of clients received a decrease, while 47 percent received an increase. This trend continues as only 9 percent of clients received a decrease in Q3 2012.
During the quarter, 90 percent of all primary placements renewed with the same carrier. While a 90 percent “retention rate” is the industry norm, a number of primary carriers (including several market leaders) have dropped into the mid- to low-80 percent range, exhibiting pricing discipline and/or risk selection not seen in recent years. The carriers that are not pursuing rate increases on a primary basis are in the minority, coinciding with that April inflection point. Some carriers are maintaining more underwriting and pricing discipline than others, but the playing field is clearly starting to level out. The average change for those primary policies that remained with the same carrier was positive 5.4 percent. The average change for those primary policies that switched carriers was positive 15.5 percent. This would indicate that a strategy of changing primary carriers is not solely focused on obtaining a decrease; rather it has been to diminish the headwinds a particular risk is facing. This is yet another sign of a market discipline, rather than a specific carrier shift in pricing strategy.

Changes by Sector
We may have reached equilibrium of sorts. In Q3 2012; four of the S&P sectors decreased, two were flat, and two sectors increased.

The Information Technology sector increased 11.4 percent, while the S&P Energy sector increased 11.7 percent. The Financials sector decreased 1.6 percent. Interestingly, as the chart below shows, the other nine sectors as a group were flat.

Quarterly Index of D&O Pricing: S&P Financials sector vs. All Other S&P sectors
Q1-2002 through Q3-2012 | Base Year: 2001 = 1.00

Limits & Deductible Purchasing Trends
In Q3 2012, our clients purchased on average 1.7 percent more limits than the previous year’s renewal. Looking at only those companies that were in both the Q3 2012 and Q3 2011 sample, 12.1 percent of companies purchased higher limits than in the prior year. Only 4.0 percent of companies reduced their limits. This continues to illustrate the point that companies are still focused on limit adequacy and with an overall index of negative1.2 percent, may still believe the pricing for high excess layers is reasonable. We also monitor deductible changes within our book of business. During the quarter, 10.2 percent of D&O program deductibles increased (a mechanism to further mitigate rate increases?), with
those clients retaining more upfront risk, and 1.4 percent of deductibles decreased, with those clients transferring more upfront risk to carriers. Historically speaking, deductibles were fairly stable (88.4 percent remained unchanged) for the quarter. An interesting finding is that for those that renewed with the same primary limit and a higher deductible experienced a primary increase on average of 9 percent. The decision to take the higher deductible in this past quarter appears to have been a mechanism to mitigate what would have otherwise been a significant premium increase.

Frequency of a Different Sort
For several years now we have been demonstrating that it is not the severity of D&O settlements that keeps insurance company executives up at night, but the frequency of claims. Insurance companies can manage D&O claims severity through careful risk selection and restricting their limits exposed to any one insured. Unfortunately, high frequency is difficult to underwrite against and creates problems, particularly for insurers with large primary books of business.

According to Stanford Law School’s Securities Class Action Clearinghouse, there were 188 federal securities class action (“SCA”) filings in 2011, a 6.8 percent increase over the 176 filings reported in 2010. But this was just one more than the 10-year average of 187 from 2001 to 2010. Based on the trailing twelve month average (Q4’11 – Q3’12), we are predicting 175 SCA filings for the full year 2012. 3

So it would seem that the frequency of filings has settled in the 175-185 range, which on the surface would appear to be a manageable number for the industry. That being said, The Economist recently reported that “The number of publicly traded companies has fallen dramatically over the past decade—by 38% in America since 1997...[t]he number of initial public offerings (IPOs) in America has declined from an average of 311 a year in 1980-2000 to 99 a year in 2001-2011.4 As a result, while the number of securities class actions may be down, the percentage of publicly traded companies being sued has actually gone up significantly over the years.

In January, a Cornerstone Research publication reported that in 2011, 96 percent of acquisitions valued at $500 million or more resulted in litigation objecting to the merger, as opposed to only 53 percent of acquisitions announced in 2007. Historically this litigation has been filed in state court rather than federal court. (We tracked over 200 mergers & acquisition (“M&A”) suits filed in state court in each of the past two years). An interesting new trend, however, is that 43 (23 percent) of the 188 federal SCA suits mentioned above were merger objection cases.

These M&A suits tend to be resolved fairly quickly, and usually impact only the primary layer, while leaving the excess carriers largely unaffected. According to Cornerstone, “Only a small fraction of these lawsuits, however, resulted in payments to shareholders; the majority settled for additional disclosures or, less frequently, changes in merger terms, such as deal protection provisions.” These “non-monetary” settlements have little, if any, effect on primary carriers.

What are impacting the primary carriers are attorney’s fees. Cornerstone stated that, “The amount of plaintiff attorney fees was reported in 81 of 190 settlements in 2010 & 2011. The average fee reported was $1.2 million. This of course, was in addition to the target company’s own defense attorney fees, which are also affecting the primary policies.

We also watched with interest as Federal Deposit Insurance Corporation (“FDIC”) bank failures jumped from 25 banks in 2008, to 140 banks in 2009, topping out at 157 banks in 2010. Bank failures seemed to have peaked in 2010, as there were 94 bank failures in 2011. Through Q3 2012 there were only 43 bank failures. But the story doesn’t end there. We believe the other shoe is starting to drop.
The FDIC may pursue the directors and officers of these failed banks by specifically targeting said banks that have D&O coverage as a means of increasing the likelihood of a recovery. As of October 9, 2012, the FDIC “has authorized suits in conjunction with 80 failed institutions against 665 individuals for D&O liability [with damage claims in excess of $8.0 billion]. This includes 34 filed D&O lawsuits (two of which have settled) naming 280 former directors and officers.”

It is important to note that “not all bank failures result in D&O lawsuits. The FDIC brought claims against directors and officers in just 24 percent of the bank failures between 1985 and 1992.” Granted, not all of these banks are publicly traded, and not all of them will result in litigation. However, there were 457 bank failures between January 1, 2008 and September 30, 2012. If the FDIC brings suit in just 24 percent of these current bank failures, that’s over 100 lawsuits for the system to digest.

This is particularly troublesome for primary carriers, especially those that specialize in community banking.

So while the federal securities class action filings seem to be holding steady, the insurance buying pool is much smaller than a decade ago. Combine that with the fact that regulatory actions are up, M&A objection litigation is thriving, and the bank failures continue to be an unknown liability. All of these issues are taking a toll on the lower layers in the way of increased defense costs and indemnity. We suspect that it is this increased activity, combined with a prolonged soft pricing environment that has begun to affect the overall pricing of Public Company D&O programs.

**Insurers Report Third Quarter Results**

Only one of the five largest providers of D&O insurance\(^5\) posted a combined ratio\(^6\) over 100 during the third quarter, with four out of five of them posting combined ratios that were an improvement over Q3 2011. It should be pointed out that, excluding catastrophe losses, industry loss ratios remain at historically low levels. Note that a 100 percent combined ratio isn’t what it once was given the substantial effect that today’s meager investment environment has had on Return on Equity (ROE). Digging deeper into the Schedule P data for the Other Liability - Claims Made section of regulatory filings for the D&O carriers over the last few years, many are struggling to eke out an underwriting profit, driven largely by adverse claims activity on their primary D&O business.

<table>
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<tr>
<th>Insurer</th>
<th>Q3 Results</th>
<th>P&amp;C Combined Ratio</th>
<th>Net Income/(Loss) in millions</th>
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<tr>
<td>ACE Limited (NYSE: ACE)</td>
<td>Q3 2012 92.0%</td>
<td>Q3 2011 90.2%</td>
<td>$640 ($39)</td>
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<tr>
<td>American International Group (NYSE: AIG)</td>
<td>Q3 2012 107.1%</td>
<td>Q3 2011 107.2%</td>
<td>$1,641 ($2,996)</td>
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<tr>
<td>Chubb Corporation (NYSE: CB)</td>
<td>Q3 2012 86.3%</td>
<td>Q3 2011 102.6%</td>
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<tr>
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<td>Q3 2012 92.2%</td>
<td>Q3 2011 101.6%</td>
<td>$172 $42</td>
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<tr>
<td>Zurich Insurance Group Ltd. (PINK:ZURVY)</td>
<td>Q3 2012 97.6%</td>
<td>Q3 2011 98.8%</td>
<td>$477 $1,239</td>
</tr>
</tbody>
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*Source: Corporate earnings reports: ACE, AIG, Chubb, XL, and Zurich*

**Market Capacity**

In the past we’ve talked about the effect “supply and demand” has on D&O pricing. The “theoretical capacity” available to any one buyer of D&O insurance remained steady at a little more than $1.2 billion. As our commentary on primary versus excess pricing illustrates this “surplus” increases competition and serves to keep total program pricing in check. However, the universe of experienced insurance carriers willing to accept primary risk is much smaller and we believe they will continue to address the pricing on
their lower layers of exposure. While excess layers, especially from those carriers that also have significant primary books, are showing signs of following the changes in primary pricing, we do continue to see healthy competition on most risks. We are cautiously watching these layers of programs so we can inform buyers appropriately on when excess capacity starts firming on a more regular basis.

Summary
In summary, Aon FSG’s observations about the D&O marketplace for Q3 2012 are as follows:

- Overall, D&O price per million decreased 1.2 percent compared to the prior year quarter
- “Same store sales” price per million were flat (0.0 percent) compared to the prior year quarter
- Primary layer price per million increased 4.5 percent compared to the prior year quarter
- 90 percent of primary policy premiums were either flat or increased
- Financial sector “same store sales” pricing decreased 1.6 percent compared to the prior year quarter (the twelfth consecutive decrease year-over-year)
- Companies purchasing higher limits compared to the prior year quarter was 12.1 percent
- Federal SCA claims frequency decreased 15.6 percent from the prior year quarter

The Glass Half Full?
Historically, hard markets in the D&O industry have been balance sheet driven, resulting in double- and triple-digit increases, lack of capacity, and more restrictive coverage terms & conditions. This “whipsaw” effect of markets reacting swiftly and violently was neither healthy nor pleasant for their customers. This current, more benign “correction” in the D&O market is income statement driven and a “soft landing” of sorts after years of declining D&O pricing. To date we consider this a balanced response from the marketplace for the following reasons:

- Average single digit increases on primary only at this point as opposed to double or triple
- Excess capacity is still abundant and prices on most excess layers are still competitive
- Coverage terms and conditions are not being restricted
- This pricing environment is income statement driven as opposed to balance sheet driven
- There is relative consistency across the marketplace in terms of differentiating risk and those that present high levels of risk are experiencing a higher level of correction (both primary and excess)

Overall we continue to have a cautious outlook on the future of D&O rates for all companies. Excess carriers are testing their ability to follow the actions of the primary markets. Those companies with specific underwriting challenges should expect a more difficult pricing environment than that of all other companies.
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 7,750 D&O programs for publicly traded companies between January 1, 2001 and September 30, 2012. 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.

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.

Stanford Law School’s Securities Class Action Clearinghouse (as of November 27, 2012). These totals include IPO Allocation, Analyst, and Mutual Fund filings.

May 19, 2012 (Print Edition): Rival versions of capitalism - The endangered public company - The rise and fall of a great invention, and why it matters

The top five public company D&O insurers based on gross written premium placed by Aon in 2011.

Combined Ratio is defined as Loss Ratio\(^7\) + 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)

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)

About Aon
Aon plc (NYSE:AON) is the leading global provider of risk management, insurance and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 62,000 colleagues worldwide, Aon unites to empower results for clients in over 120 countries via innovative and effective risk and people solutions and through industry-leading global resources and technical expertise. Aon has been named repeatedly as the world’s best broker, best insurance intermediary, reinsurance intermediary, captives manager and best employee benefits consulting firm by multiple industry sources. Visit www.aon.com for more information on Aon and www.aon.com/manchesterunited to learn about Aon’s global partnership and shirt sponsorship with Manchester United.

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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. FSG’s global platform assists clients in addressing their executive liability exposures across their world-wide operations. Aon’s Financial Services Group manages more than $2.2 billion in annual premium, assists with claim settlements in excess of $3.5 billion, and uses its unmatched data to support the diverse business goals of its clients.