Quarterly D&O Pricing Index

Third Quarter 2011

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 2011, the average price for $1 million in coverage limits decreased 11.6 percent from the second quarter of 2011, with the Index moving from 0.95 to 0.84. It is not uncommon to see fluctuations from quarter to quarter due to the mix of business renewing at different times of the year. This is the lowest Index value to date, and the fifth 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 2011 represents a decrease of 11.6 percent over Q3 2010. 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 2011 and Q3 2010. On that basis, pricing decreased 12.5 percent. Drilling down even further, pricing for primary policies in these programs is down 6.4 percent, confirming our suspicions that primary pricing is flattening and that the bulk of the decreases we are seeing recently are being driven by competition in the excess layers.

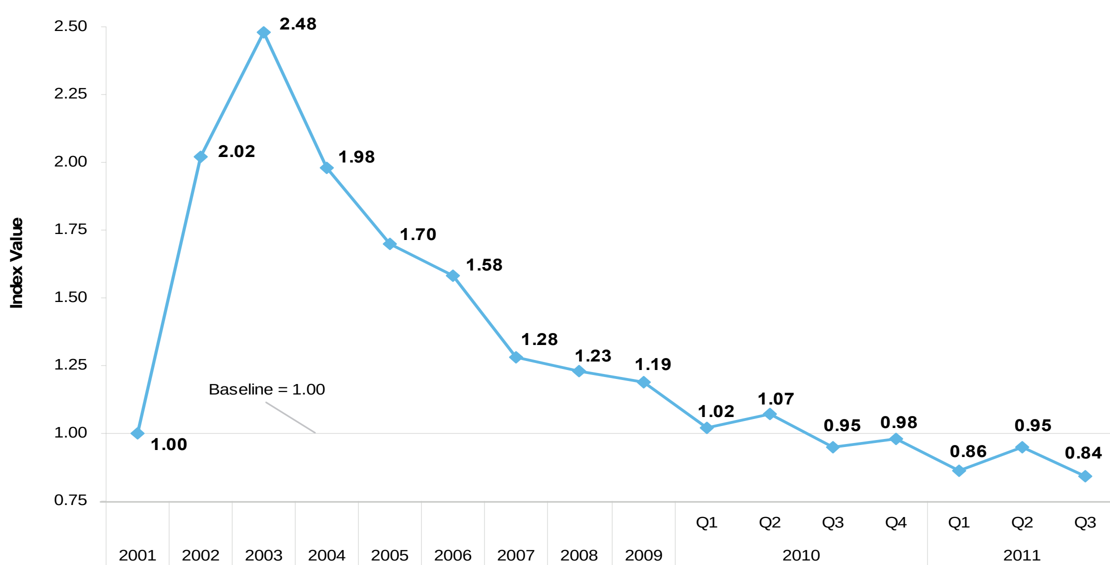
D&O Pricing Index

▼ **-11.6%**

Q3 2011	0.84
Q3 2010	0.95

Quarterly Index of D&O Pricing

Q1-2002 through Q3-2011 | Base Year: 2001 = 1.00



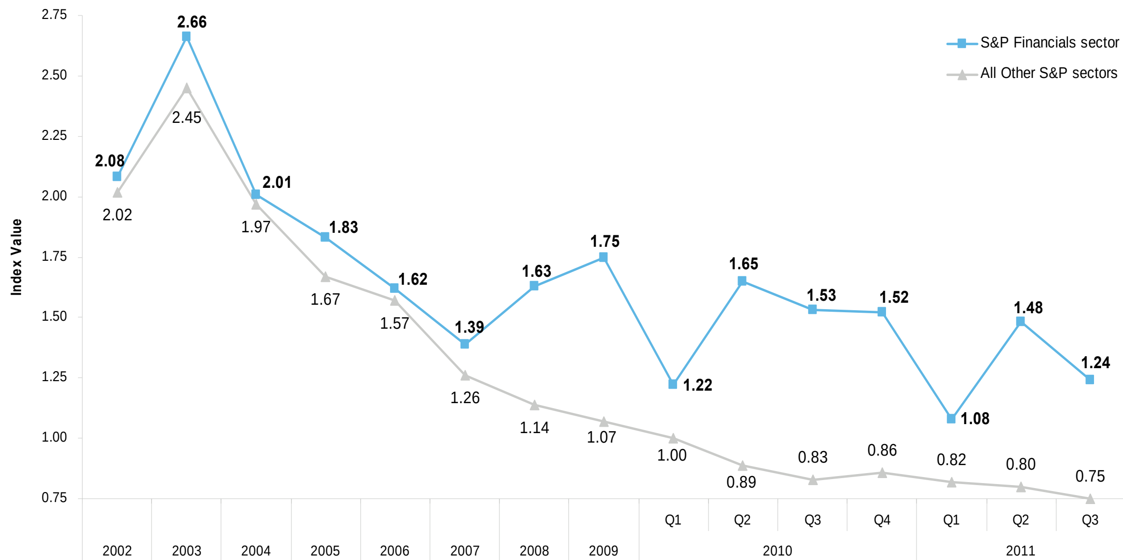
Decreases Across the Board

For the sixth consecutive quarter, all ten S&P sectors posted year-over-year price decreases.

The decreases by sector ranged from about 4 percent for the S&P Telecommunication Services sector to 19 percent for the S&P Financials sector. After seeing the average rate per million increase in five consecutive quarters from Q3 2008 to Q3 2009, the Financials sector has now seen the average rate per million decrease in eight consecutive quarters from Q4 2009 to Q3 2011.

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

Q1-2002 through Q3-2011 | Base Year: 2001 = 1.00



S&P Financials Sector

▼ **-19.0%**

Q3 2011	1.24
Q3 2010	1.53

All Other Sectors (as a group)

▼ **-9.6%**

Q3 2011	0.75
Q3 2010	0.83

Limits & Deductible Purchasing Trends

In Q3 2011, our clients purchased on average 4.8 percent more limits than the previous year's renewal. Looking at only those companies that were in both the Q3 2010 and Q3 2011 sample, on a year-over-year basis, 23.5 percent of companies purchased higher limits than in the prior year. Only 0.7 percent of companies reduced their limits. This continues to illustrate the point that companies may be using some of their premium savings to increase policy limits.

We also monitor deductible changes within our book of business. During the quarter, 9.9 percent of D&O program deductibles increased, with those clients retaining more risk, and 3.3 percent of deductibles decreased, with those clients transferring more risk to carriers. Overall, deductibles were fairly stable (86.8 percent remained unchanged) for the quarter.

As with last quarter, this percentage of unchanged deductibles is among the lowest since we began including deductible purchasing trend analysis in Q1 2009 and this is only the third time since Q3 2009 that this figure was below 90 percent. Rising deductibles could be an indication of a shift from a soft market to a hard market environment as 9.9 percent of our clients' deductibles increased during the quarter.

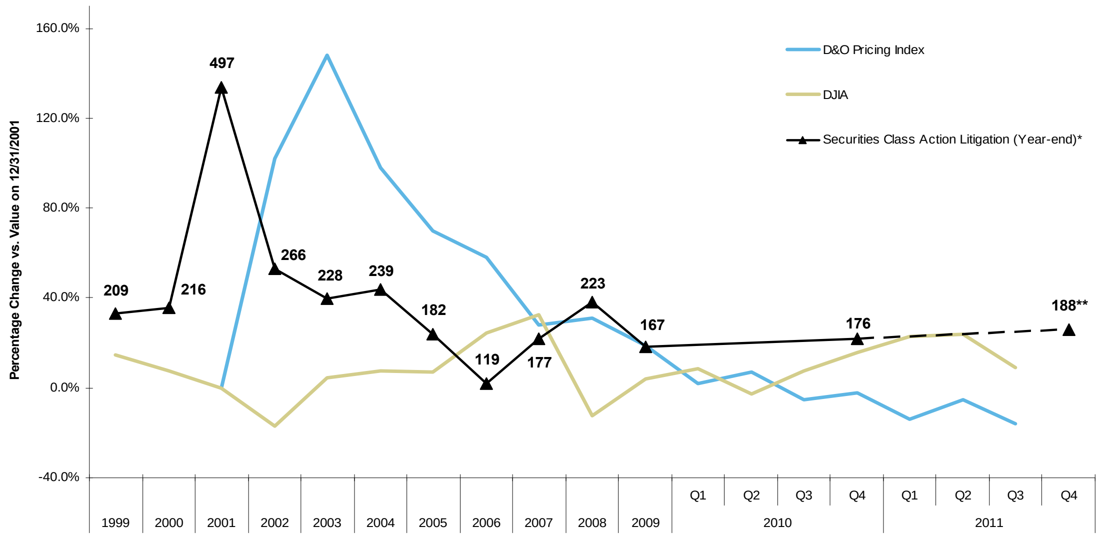
Future Outlook Shifts to Cautious

As we stated repeatedly in the past, we believe there is an inverse correlation between D&O rates and the stock market. So it gives us pause when we note that after briefly flirting with the 13,000 mark in April, the Dow Jones Industrial Average closed at 10,900 on September 30, 2011.

The following chart overlays the Dow Jones Industrial Average with securities class action (SCA) claims frequency and with Aon's D&O Pricing Index. As we have been suggesting for several years, there is a strong correlation between frequency and pricing.

Quarterly Index of D&O Pricing vs. SCA Claims Frequency vs. DJIA

1999 through Q3-2011 | Base Year: 2001 = 1.00



* *Source: Aon FSG; Stanford Law School's Securities Class Action Clearinghouse as of October 11, 2011. These totals include IPO Allocation, Analyst, and Mutual Fund filings.*

** *Projected year-end securities class action filings for 2011.*

Furthermore, the unemployment rate at the end of the third quarter was 9.1 percent, just 0.5 percent lower than September 2010, which was down 0.2 percent from September 2009.

The current shift reminds us of an *Insurance Journal* [3] article from last October summarizing the results of a KPMG LLP survey collected from 300 U.S. insurance executives. "These executives report[ed] that despite [then] improving market conditions, they remained concerned about their company's performance and the industry's ability to generate underwriting profit amid continuing economic concerns and the Dodd-Frank reform package."

"Some 22 percent predict[ed] another downturn/double dip recession before the economy begins to significantly recover. … When asked to identify the most significant challenges they face in the next three to five years, 44 percent of respondents cited the risk associated with adequately pricing of insurance products (referred to as pricing risk) to be the most significant."

Scott Marcello, KPMG's national leader for Financial Services and Insurance stated, "There are clear concerns surrounding pricing in this soft [property & casualty] market. And, there appear to be indicators that this market will persist over the near term."

All of which leads us to believe that the drag of the economy on the stock market may eventually manifest itself in D&O premiums turning around.

D&O Securities Class Action Claims Activity

The average D&O securities class action settlement (excluding settlements of $1 billion or greater) for Q3 2011 increased 12.7 percent to $35.23 million compared to $31.26 million for the prior year quarter, and increased 12.7 percent from the preceding three-year average, which was also $31.26 million. The median settlement in Q3 2011 was $7.16 million compared to $10.10 million in the prior year quarter.

According to Stanford Law School's Securities Class Action Clearinghouse, there were 45 federal SCA filings in Q3 2011, a decrease of 19.6 percent from the 56 filings reported in Q3 2010.[4] As we have demonstrated in the past, that pricing moves with frequency changes, we will closely monitor this quarterly decline.

The 188 SCA filings we are projecting for the full year 2011 (based on the trailing 12 months) would be equal to the ten-year annual average for SCAs from 2001 through 2010 (187), and 6.8 percent higher than the 2010 total (176). This projected increase in SCA filings is yet another warning sign that carriers could start to push rates in the coming year.

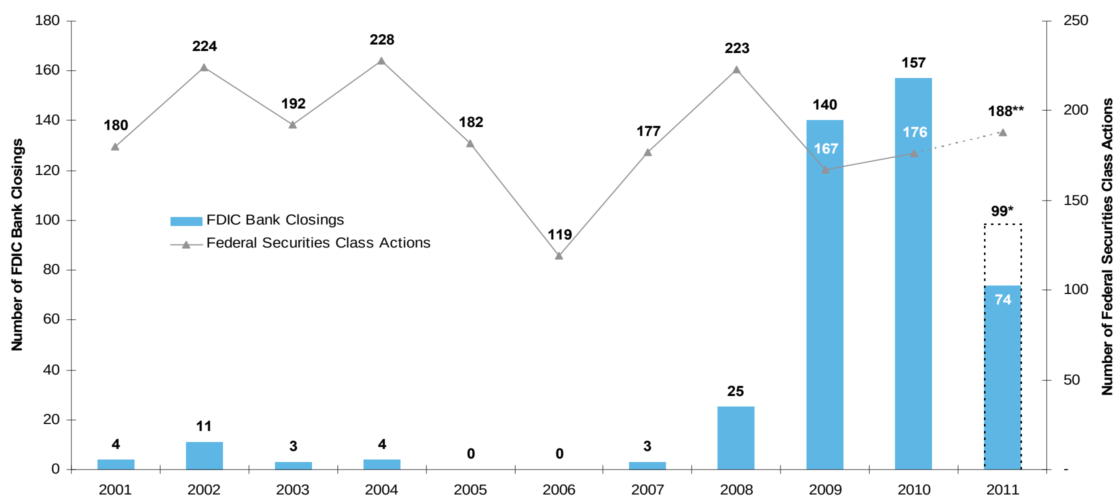
For the financials sector, the pace of SCA filings continues to drop. In Q3 2009, 13 (30.2 percent) SCA filings included companies in the financials sector; while in Q3 2010, that figure dropped to 10 (17.9 percent). In Q3 2011, only 3 out of 45 (6.7 percent) filings were against companies in the financials sector, further evidence of an end to the litigation explosion for financial services firms.

Bank Failures—A Potential D&O Event We Are Watching

As public and major company bankruptcy filings were winding down in 2010, we were monitoring another troubling development. From 2001 through 2007 the Federal Deposit Insurance Corporation (FDIC) closed 25 banks. In 2008, they closed an additional 25 banks. In 2009, that number jumped to 140 banks, an almost six-fold increase in the number of failed banks. In 2010, the FDIC closed 157 banks, the largest annual number of bank failures since 1992, when 181 institutions failed. Bank failures continued at a much slower pace for the first nine months of 2011, with 74 bank failures, compared to 127 failures in the same period of 2010.

FDIC Bank Closings

2001 – 2011 YTD



Source: FDIC Failed Bank List September 30, 2011
Source: Stanford Securities Class Action Clearinghouse as of October 11, 2011. These totals exclude IPO Allocation, Analyst, and Mutual Fund filings.
** Projected year-end totals based on Trailing Twelve Months. **Projected year-end total based on Q1 – Q3 2011 results.*

According to the FDIC's Q3 2011 Quarterly Banking Profile, the number of institutions on the FDIC's "Problem List" fell for the second consecutive quarter. The number of "problem" institutions declined from 865 to 844. This is the second time since the third quarter of 2006 that the number of "problem" banks has fallen. Total assets of "problem" institutions declined from $372 billion to $339 billion. Twenty-six insured institutions failed during the third quarter, four more than in the previous quarter, but 15 fewer than in the third quarter of 2010. This is the fifth consecutive quarter that the number of failures declined.

In February 2011, FDIC Chair Sheila C. Bair stated, “We believe that the number of failures peaked in 2010, and we expect both the number and total assets of this year's failures to be lower than last year's.” Admittedly, not all of these failed banks are publicly traded companies, and the deposits of some of these banks were simply acquired by other institutions in “shot-gun” weddings arranged by the FDIC. So why, if the number of bank failures likely peaked in 2010, do we think this is significant for D&O Liability insurance?

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. Recently, the FDIC has taken the unusual step of approaching D&O insurers directly in the hopes of reaching a hasty settlement without wasting valuable policy limits on protracted defense litigation.

According to the FDIC’s own website, “As receiver for a failed financial institution, the FDIC may sue professionals who played a role in the failure of the institution in order to maximize recoveries. These individuals may include officers and directors, attorneys, accountants, appraisers, brokers, or others. Professional liability claims also include direct claims against insurance carriers such as fidelity bond carriers and title insurance companies.”

The FDIC has several years to file suit from the time a bank is closed (three years for tort claims and six years for breach-of-contract claims). If state law permits a longer time, the state statute of limitations is followed. As of October 14, 2011, the FDIC “has authorized suits in conjunction with 34 failed institutions against 308 individuals for D&O liability with damage claims of at least $7.3 billion. This includes 15 filed D&O lawsuits naming 114 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.” However, there were 396 bank failures between January 1, 2008 and September 30, 2011. If the FDIC brings suit in just 24 percent of these current bank failures, that’s still almost 100 lawsuits for the system to digest.

So while the number of failed banks likely peaked in 2010, the repercussions may ripple through the D&O insurance system for several years to come. As we have said in the past, it is not the potential severity of individual claims that keeps insurance carriers awake at night. Many of these banks carry low limits. It is the sheer volume (frequency) of potential claims and the aggregate limits exposed on the 5,000+ community banks that would pose a problem for D&O carriers. We will watch this development closely to see how this may impact future D&O pricing.

Insurers Report Third Quarter Results

Only one of the five largest providers of D&O insurance[5] posted a combined ratio[6] under 100 during the third quarter, with all five of them posting combined ratios that were worse than Q3 2010. All five were impacted by catastrophe losses in the third quarter, primarily from Hurricane Irene. It should be pointed out that, excluding catastrophe losses, industry loss ratios remain at historically low levels. Having said that, only two of the insurers posted positive net income for the quarter.

Q1 Results	P&C Combined Ratio		Net Income/(Loss) in millions		
Insurer	Q3 2011	Q3 2010	Q3 2011	Q3 2010	% Change
ACE Limited (NYSE: ACE)	90.3%	88.4%	($31)	$675	(104.6%)
American International Group (NYSE: AIG)	106.4%	99.3%	($4,109)	($2,517)*	(63.2%)
Chubb Corporation (NYSE: CB)	102.6%	86.2%	$298	$572	(47.9%)
Hartford Financial Services Group (NYSE: HIG)	104.8%	84.9%	$0	$666	(100.0%)
XL Group plc (NYSE: XL)	101.6%	94.9%	$42	$78	(45.3%)

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

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 in limits during Q3 2011, yet even our largest D&O programs purchase about half that amount. This "surplus" increases competition and serves to keep pricing down. It will likely continue to do so until this "trade imbalance" evens itself out. We don't see this happening in the foreseeable future.

Summary

In summary, Aon FSG's observations about the D&O marketplace for **Q3 2011** are as follows:

- Overall, D&O price per million decreased 11.6 percent compared to the prior year quarter
- Primary layer price per million decreased 6.4 percent compared to the prior year quarter
- Financials sector pricing decreased 19.0 percent compared to the prior year quarter (the eighth consecutive decrease year-over-year)
- Companies purchasing higher limits compared to the prior year quarter was 23.5 percent
- Federal SCA claims severity increased 12.7 percent from the preceding three-year average (excluding settlements of $1B or greater)
- Federal SCA claims frequency decreased 19.6 percent from the prior year quarter
- Federal SCA claims frequency is driven by bull and bear markets
- Renewed uncertainty in the economic environment.

Increased securities class action frequency, however small it may be, coupled with further reductions in pricing and a very uncertain and potentially recessionary economic environment give us a very cautious outlook on the future of D&O rates.

[1] 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 7,000 D&O programs for publicly traded companies between January 1, 2001 and September 30, 2011. 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.

[2] 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.

[3] *Insurance Journal* article: "Survey: Execs Still Concerned Over Profitability, Double-Dip Recession" (October 7, 2010)

[4] Stanford Law School's Securities Class Action Clearinghouse (as of October 11, 2011). These totals include IPO Allocation, Analyst, and Mutual Fund filings.

[5] The top five insurers as measured by written premium (as of December 31, 2010).

[6] 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)

[7] 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 Corporation (NYSE: AON) is the leading global provider of risk management services, insurance and reinsurance brokerage, and human capital consulting. Through its more than 59,000 colleagues worldwide, Aon 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, 2009 and 2010 Insurance Survey, Aon also ranked highest on Business Insurance's listing of the world's insurance brokers based on commercial retail, wholesale, reinsurance and personal lines brokerage revenues in 2008 and 2009. A.M. Best deemed Aon the number one insurance broker based on brokerage revenues in 2007, 2008 and 2009, 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. Visit http://www.aon.com for more information on Aon and http://www.aon.com/unitedin2010 to learn about Aon's global partnership and shirt sponsorship with Manchester United.

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. 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.

Aon Contacts

Michael D. Rice, II
Global 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