

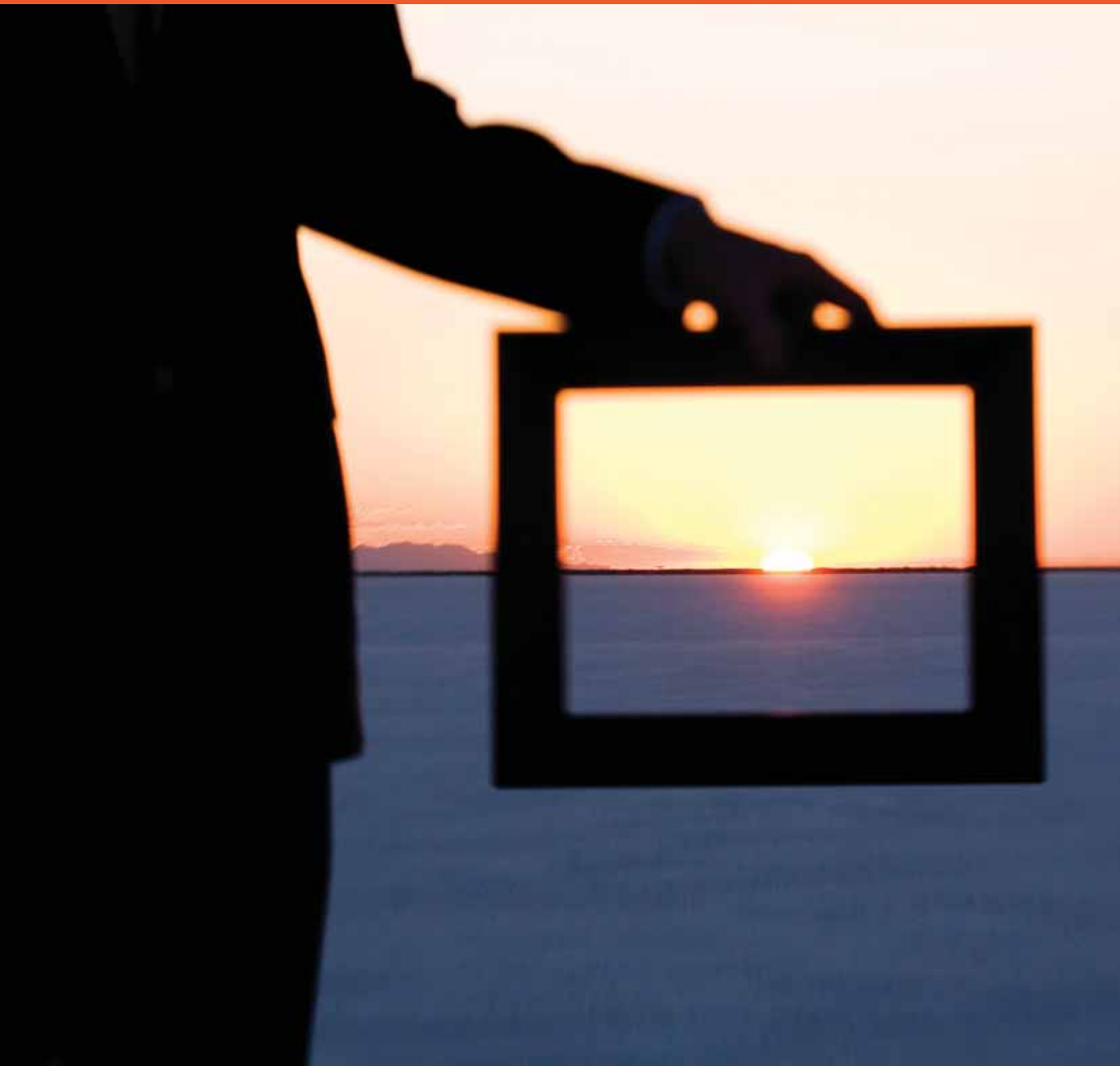
The Emergence of a Two Tier Insurance Market

A qualitative study identifying how fund and investment managers can differentiate themselves and secure the best insurance renewal terms

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FINANCIAL RISKS



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JLT is an international group of Risk Specialists and Employee Benefits Consultants and one of the largest companies of its type in the world. We offer a distinctive choice to our clients and partners through our combination of independence, scale and specialism.

As an independent business, we are able to operate with autonomy and flexibility. We have the scale to provide solutions to the complex demands of the world's leading companies and to deliver global servicing whilst recognising that the needs of each of our clients are unique. By developing highly specialised services, we provide our clients with a depth of expertise and experience.

The value we create is driven through the personal determination of our 5,500 highly motivated and skilled people.

A qualitative study was carried out by Jardine Lloyd Thompson Limited's (JLT) Financial & Professional team during the latter part of January 2009. It involved the main insurers in the London market that underwrite Directors' & Officers' and Professional Liability insurance for fund and investment managers. The purpose was to discover how insurers had been affected by Madoff and the global sub-prime crisis and, in turn, how this would influence the cost and availability of insurance for UK fund and investment managers, in particular hedge funds.

What we discovered was the emergence of a two tier market that differentiated fund and investment managers according to the risk profile they presented. A more professional approach to the renewal exercise and the support of a specialist fund and investment management insurance broker can be the difference in obtaining the best possible insurance renewal terms.



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1. Background

On the 12th December 2008 one of the world's biggest frauds came to light after Bernard Madoff allegedly admitted that his advisory fund was a "Ponzi" scheme, paying "profits" to existing investors out of funds provided by new investors. Estimates of the fraud range from US\$25-50bn and there is mounting evidence that Bernard Madoff's business and personal assets will not cover what investors believe they are owed.

Investors are, unsurprisingly, looking for scapegoats and the many different plaintiffs' lawyers are taking aim at targets with perceived deep pockets. Hedge funds, fund of funds, independent investment advisory firms, investment advisory firms within large banks and other financial institutions that placed investors' money with the Madoff Funds, as well as the plethora of auditors, accountants and lawyers connected to these organisations are clearly high on the plaintiff lawyers' agenda.

Most of these organisations carry insurance either against direct losses they incur from fraud, their legal liability in the event of professional negligence or to protect their directors if they are found to be personally liable. Insurers, already smarting from global losses arising from the sub-prime crisis of upwards of US\$12bn, now reportedly face further claims of up to US\$3.8bn from the Madoff fraud mainly relating to Professional Indemnity insurance.

The combined sum of almost US\$16bn is comparable to the insured losses arising from Hurricanes Ike and Gustav. More worrying for insurers is that new claims relating to the Madoff fraud continue to emerge and there is growing suspicion that similar frauds could be revealed, as we have recently witnessed with the Stanford revelation.

As a result there has been much comment about acceleration in the hardening of the financial lines insurance market, with premium rate increases and a capacity crunch, as some insurers allegedly look to reduce their exposure to the fund and investment management sector.

At JLT, we did not believe that this painted an accurate picture. Many fund and investment managers have no exposure to sub-prime or Madoff type losses so why should they be penalised in the same way as those that have? Our experience towards the end of 2008 suggested that these organisations were receiving unjust treatment.

We, therefore, implemented a research study to find out the reality. Our over-riding purpose is to inform fund and investment managers about the insurance environment so that they can develop the most appropriate insurance renewal strategies.

Paul Towler
Partner, Head of Financial & Professional
Jardine Lloyd Thompson Limited



2. The Study

We estimate that ten direct insurers in the London market (Lloyd's of London and Company) underwrite more than 90% of Directors' & Officers and Professional Liability insurance for fund and investment managers.

Senior underwriters from seven of these insurers took part in our study, which involved a semi-structured interview to enable us to collect a rich source of data.

Our research explored **three scenarios** that have been formulated from our own experience and which, in many ways, contradict the insurance and national press coverage since December 2008 when the Madoff story broke:

- 1 Insurance premiums are not increasing for all fund and investment managers;
- 2 There continues to be insurer competition for new business - but it depends on the risk profile of each fund and investment manager;
- 3 Fund and investment managers are not seeking higher levels of insurance despite the realisation that current levels purchased are generally inadequate



3. Past Dictates the Future for Insurers

Madoff claims are not widespread

Insurance availability, cost and conditions are dictated by many different factors, but high among these is the claims experience, both of the insured and in relation to the industry sector or class of insurance.

It was possibly ambitious to expect to collect much data relating to claims experience. Apart from the lack of time that has elapsed since the Madoff fraud came to light many insurers will not willingly give out such information for a variety of reasons, not least of which is the potential share price sensitivities.

A number of major reinsurers have publicly declared their loss estimates, for example Swiss Re, but these companies are outside of this study which focuses on the main direct insurers in the London market that underwrite fund and investment management insurance. Three insurers in our study reported a fairly low level of Madoff related claims with most being precautionary notifications and none involving significant quantum (at this stage).

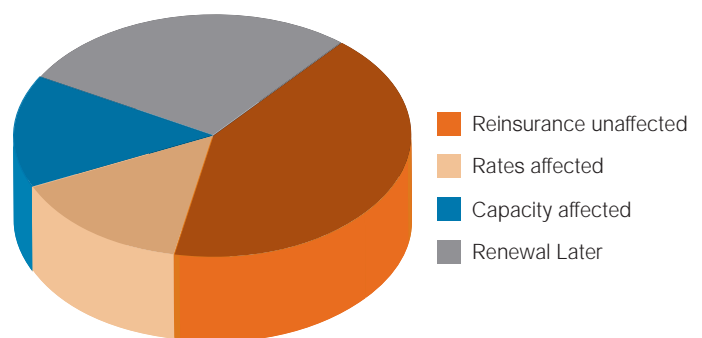
Aside from Madoff it was noted that there had been a marked increase in notifications relating to trading errors, exacerbated by the volatile financial markets, mandate breaches and regulatory investigation costs. Much of this is the result of more active regulatory authorities, and many felt that claim numbers were far from their peak.

One explanation for the lack of Madoff related claims is that many of the organisations exposed to substantial loss are part of the very large financial institutions that have global insurance programmes arranged outside the London market.

Diverse reinsurance picture

Another major factor driving insurance availability, cost and conditions is the reinsurance market. Discussions here seem to reinforce the claims findings as only two insurers have reported any “Madoff effect” on their reinsurance treaties. All insurers purchase reinsurance to offset some of their risks and a high proportion of reinsurance programmes are renewable on 31st December. Those with reinsurance treaties due for renewal later in the year have not experienced any mid term adjustments at this stage.

Figure 1. Reinsurance results of insurers in our study



Reinsurance affected = rigid underwriting policy

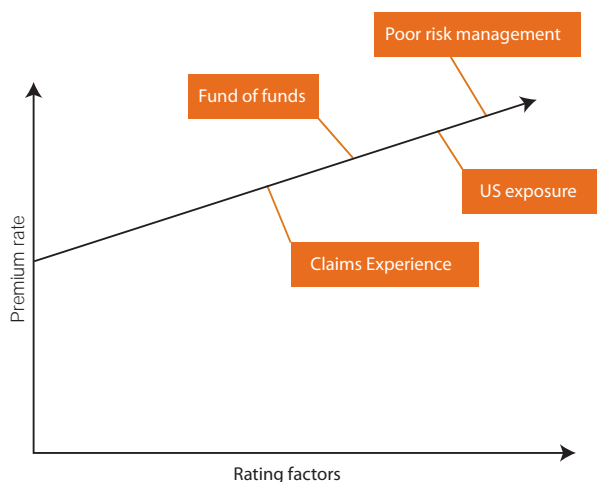
Those insurers that have suffered adverse reinsurance renewal terms cited either premium increases averaging 35% or reductions in the amount of reinsurance they purchased due to increased premium requirements.



This latter fact could lead these insurers to reduce their maximum lines on risk and some evidence of this was uncovered in relation to risks with a US exposure. One view expressed was that the changes in the market had created a more level playing field for smaller niche underwriters, as larger insurers exposed to global financial institutions are forced to adopt a more rigid underwriting approach.

Insurers that have suffered reinsurance cost increases will undoubtedly seek to pass these additional costs onto their clients, with suggestions of rate rises ranging from 20% to possibly 200% or more where risks have an adverse claims experience, are poorly managed or, more particularly, have a US listing or exposure.

Figure 2. Key factors leading to higher insurance rates



Insurers facing higher reinsurance costs or more adverse conditions were not aiming to grow their market share or volume of business. This will undoubtedly lead them to reduce their share of the fund and investment management market, most likely through natural loss as they choose not to compete for new business and certain existing accounts. To our knowledge no insurer has withdrawn entirely from any sector of the market at this stage.

Reinsurance unaffected = flexibility

Insurers whose reinsurance treaty renewals were not adversely affected cited two key reasons. Firstly, they had not adopted an aggressive growth strategy for financial institution business during the recent soft market. Secondly, they did not have a large US account and exposure to the types of institutions that have suffered Madoff and sub-prime losses.

This puts them in a strong position to be flexible, taking advantage of market conditions to compete for business on a selective basis. Options range from selection based on risk management and claims profile, fund management activities or targeting specific sub sectors of the investment management industry.



These insurers expect rates generally to remain unaffected for the best risks. However, with a number of them seeking to compete for certain business this is bound to create competition and, thus, opportunity for many fund managers especially those without US, sub-prime or fund of funds type exposure.

To take advantage fund managers will have to carefully design their renewal strategy. A complete and attractive risk profile will be essential and we would urge all fund managers to start their renewal negotiations much earlier than normal i.e. at least 90 days before expiry.

Information requirement growing

All insurers were consistent in one area - they are going to be seeking much greater levels of information:

- Investment mandates and how the insured ensures they trade within their mandates
- In respect of issues such as gates, redemptions, credit facilities and prime brokers.
- How the desire for cash is affecting trades
- How regular contact is being maintained with investors
- Potential exposure to Madoff or similar Ponzi schemes

- Enterprise risk management processes:
 - Whether any new operational risks have been identified
 - The new investment due diligence process. Fund of funds in particular will be asked how their processes would have helped them avoid a Madoff type investment
 - Controls over mandates, compliance function and complaints register
- Evidence that management recognise the importance of risk management and take insurance more seriously



Madoff consequences

Two effects of the Madoff fraud were evident during discussions, but they did not apply to all insurers:

1. Madoff exclusion – many reinsurers are applying this exclusion, causing direct insurers to do the same to mirror this. This makes it essential for fund and investment management companies to carry out a thorough check before expiry of the current insurance and where necessary to make a claims notification as protection. It is recommended that companies liaise closely with their brokers at this point. Wording such a notification incorrectly can prejudice the insured's chances of recovering a claim.
2. More caution regarding organisations that are “funds of funds” or which can be identified as feeder funds

Funds should consider increasing insurance limits

The sub-prime crisis and Madoff fraud has shown that a number of fund and investment managers purchase insufficient levels of insurance. Whilst insurers have reported a high incidence of quotations for mid term indemnity limit increases, most have been driven by the insurance broker advising clients to purchase higher limits ahead of rating increases.

More specifically few organisations insure their funds against direct fraud losses and we have found little evidence that this has changed since the losses have emerged. With the expectation that more frauds are likely to be revealed, perhaps this should form part of any fund manager's risk financing consideration.



4. Conclusion

Our qualitative study of the insurance market for Directors' & Officers' and Professional Liability insurance for fund and investment managers has revealed the emergence of a two tier market:

Tier 1 - insurers with poor claims records as a result of having exposure to global financial institutions and the US-domiciled market. These insurers are generally adopting a rigid underwriting policy which will see all fund and investment managers penalised for the Madoff fraud and sub-prime crisis irrespective of their claims experience or whether their risk profile exposes them to these types of loss

Tier 2 - those insurers that have either been more conservative or have historically had less international exposure - as a result they now enjoy more flexibility as they benefit from continuing reinsurance support and less management pressure to increase rates and reduce market share. This enables these insurers to differentiate, effectively providing an opportunity for the well presented, well managed fund and investment manager.

We support the approach taken by these niche insurers that are willing to underwrite the risk presented. However, to take advantage fund and investment managers must do more to differentiate themselves in the insurance market, demonstrating senior commitment to insurance and risk management. Broker expertise is essential to present the best case and enable a fund or investment manager to overcome the one size fits all attitude of some insurers.

Furthermore, fund and investment managers should not automatically assume that cheap premiums and wide coverage mean that an insurer fits into Tier 2 - a number of other factors apart from underwriting profit drive insurers, such as competition for market share - in certain cases bordering on a fight for brand survival - and this can distort the picture. Some of the more aggressive underwriters may still be under-reporting the extent of their financial institutions losses and may not in fact be a very good long-term partner. This means that the cheapest price is not necessarily the best deal in the long run, and the guidance of a broker is essential.

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