**Senate Standing Committee on Economics**

ANSWERS TO QUESTIONS ON NOTICE

**Treasury Portfolio**

Budget Estimates 3-5 June 2008

## Question: bet 120

**Topic:** **Public Companies – Insurance Cover**

**Hansard Page:** **E120**

## Senator Bushby asked:

**Senator BUSHBY**—Thank you; that was very helpful. There was a report in the *Australian Financial Review* recently—I apologise that I do not have a date for that—that directors of public companies are facing financial problems in obtaining suitable insurance cover. Can you tell the committee whether you consider those fears are well founded. Is that an issue?
**Mr D'Aloisio**—We could take that on notice. I am not personally aware that there are difficulties.

## Answer:

No. We cannot verify or otherwise the article's claims using official data.

APRA data on general insurance is only available with a very substantial lag. (For example, APRA's half yearly general insurance bulletin for the year ended June 2007 was updated in February 2008.)

This is the publication that contains some detail on premium rates. In any case, however, D&O insurance rates are not separately identified. APRA probably lumps D&O with professional indemnity.

The newspaper apparently obtained the information (before the renewal season) by directly contacting practitioners. It is unclear as to how many practitioners were consulted or whether the sample was representative of the whole sector.

Following are some observations that might be of assistance. To take the matter further, however, ASIC would need to conduct an industry survey.

D&O insurance protects directors and officers from the costs of compensation claims by shareholders and other stakeholders that have been harmed by directors' decisions. Policies normally cover unintentional breaches of directors' duties, but stipulate clear exclusions especially relating to fraudulent misrepresentation, non-disclosure, blatant negligence etc.

There are many legitimate reasons for the D&O premium rates increasing in the 2008 renewal season. These are discussed below.

- The **number of class actions** filed or proposed against company directors appears to have increased recently. Class actions were already launched against Westpoint and Centro Properties Group. Others are being considered against Octaviar (formerly MFS), Allco Finance, Opes Prime and ANZ.

- Market participants have suggested that **"a more Active Australian Securities and Investments Commission could push premiums higher."** [1] Robert Johnson, partner at HWL Ebsworth, suggested that ASIC's running of the class action on behalf of Westpoint shareholders sent a signal that the frequency and severity of compensation claims on directors would increase.

- A continuation of the current scenario of **weak equity markets**, asset write-downs and corporate collapses is likely to lead to more claims for compensation (including in regards to breaches of continuous disclosure duties).

- Weaker equity and bond prices have also resulted in **investment losses to general insurers**. This contrasts with the situation up to the financial year 2006-07, when investment returns comprised a significant proportion of insurers' revenues. Without the investment income, insurers might turn their focus to underwriting operations and seek to increase premium rates and tighten underwriting standards.

- **M&A activity has reached record levels** in recent years. D&O cover is extremely important during a takeover because the successful bidder will effectively control all D&O policies taken with the target directors as beneficiaries. A number of D&O policies contain exclusion clauses that allow the insurer to reduce its exposure (or even renege on claims) when the claim is made by the company itself against the directors, or by "large shareholders" against the directors. When subject to a takeover (or merger), directors of the target are often advised to upgrade, update or top-up their D&O cover. Similarly, the directors of the bidder also have to review their policies, as a number of D&O policies openly exclude newly acquired subsidiaries. Thus the increased M&A activity of recent years may lead to higher demand for D&O cover.

However, one important factor to consider is the current stage in the insurance cycle. Premiums in commercial lines have been falling continuously for some years now as a result of competition within the sector.

A survey by ABN Amro found that D&O rates have fallen in recent quarters - though not by as much as other commercial lines.[2] Similarly, a report by JP Morgan Deloitte suggested that D&O premium rates fell by 8 per cent in 2007, after equally substantial falls in previous years.[3] When this report was published late last year, JP Morgan Deloitte forecast at least two more years of significant premium rate weakness: a fall of almost 10 per cent over the two years to 2009. This projection was predicated on the high degree of competition prevailing in this segment.

Even with this level of competition, D&O insurance had remained a profitable business in 2007. JP Morgan Deloitte estimated the market's combined ratio (claims and underwriting expenses as a share of premium income) to be around 76 per cent in 2007. This means that the expenses incurred by writing policies and paying out claims equalled only 76 per cent of the premium income received by insurers in that year, indicating a profitable market (subject to tail risk) even before income from investment assets is taken into consideration. This low ratio compares well with other insurance markets – 92 per cent for professional indemnity, 93 per cent for commercial property insurance and 103 per cent for commercial motor insurance in 2007.

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[1] Quoted in the Australian Financial Review, *Directors face higher premiums*, 20 May 2008

[2] ABN Amro, *The Commercial Insurance Broker report*, 14 May 2008.

[3] JP Morgan Deloitte, *2007 General Insurance Industry Survey*, 05 November 2007