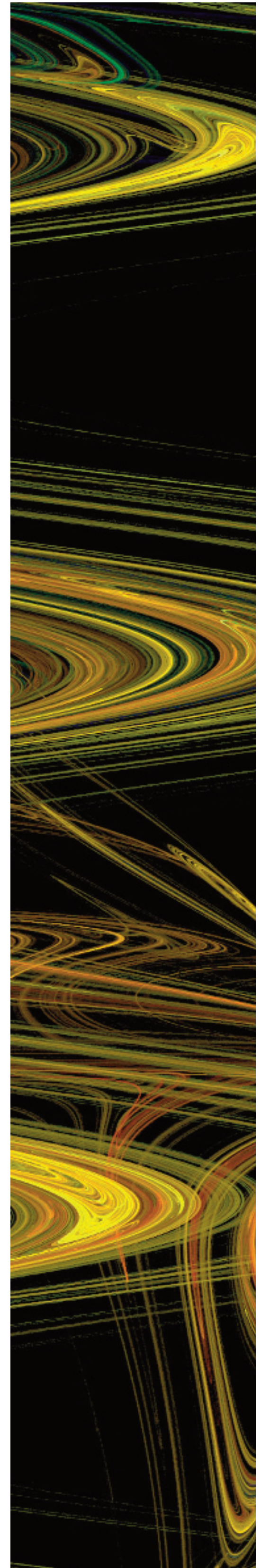
FIDELITY

A CYCLE OF ITS OWN

- **In economic downturns, human nature is revealed: closer scrutiny of internal controls uncovers corporate crime.**
- **The soft Fidelity market will continue into 2009, but probably will not last.**
- **Claims reported to Willis are up 33% over the same period last year.**

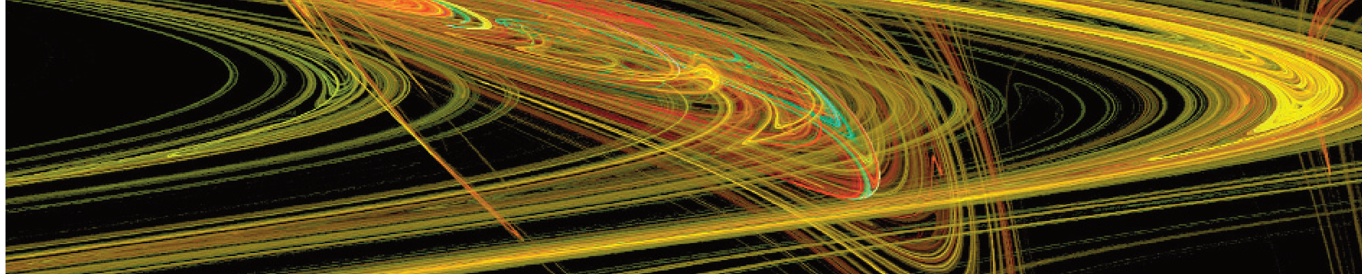


Fidelity market conditions in 2008 closely mirrored those of 2007, with capacity holding steady, pricing remaining flat or softening modestly and the breadth of coverage remaining unchanged. Add to the mix the entry of three new Fidelity carriers and the favorable loss results for the 2007 calendar year, and buyers could easily have expected another favorable marketplace in 2009. It may in fact prove to be the case – at least for the first part of the year.

The stability of the Fidelity market was unquestionably threatened when volatility in the financial markets parked on AIG's doorstep in the form of a multibillion dollar liquidity shortfall. In the days preceding the federal intervention, insureds were suddenly forced to consider a Fidelity market without AIG, the second largest Fidelity underwriter in the U.S. According to the Surety & Fidelity Association of America's 2007 survey, AIG wrote $243 million in direct written premium, second only to Chubb, which wrote $303 million. Travelers was third with $187 million and Zurich was fourth at $105 million.

More important than its share of written premium, however, is the leading role AIG takes on large commercial and financial institution accounts. Although Fidelity capacity is at an all-time high, with up to 16 U.S. Fidelity markets, only a handful of these markets have the appetite to lead on a Fortune 500 account or on any sizable financial institution. Of the handful of markets actively competing in this space, AIG writes primary on a disproportionate share of the larger accounts.

Contrary to initial concerns about the strength of the replacement markets for the AIG portfolio, the competition has proven to be quite vigorous among a handful of competing carriers. While several long-term Fidelity markets have stepped up, much of the competition has come from new entrants into the market. With strong credit ratings and newly hired, seasoned Fidelity underwriters, these new markets carry genuine credibility and present an appealing option to risk managers. However, with few premium dollars in the bank, they are not in a position to take significant hits to their portfolios. As a result, insureds will likely see greater use of



co-surety placements, in which two or more carriers share equally in the first dollar loss, particularly for the larger more complex risks.

Barring a further significant change in AIG's Fidelity position, we would not expect a major shift in the Fidelity market. Pricing will likely remain flat or involve modest reductions for primary placements. We would expect a continuation of the exceedingly aggressive Excess market, particularly for limits above $50 million.

NEW ENTRANTS

Where is the new capacity coming from? StarNet Insurance Company, a W.R. Berkley Company with an A+ XV A.M. Best rating, has entered the Fidelity market with $25 million in capacity. The company will use their capacity for both primary and excess placements, and their appetite for primary tends to be for the Fortune 1000 and large middle-market accounts.

Houston Casualty, another new entrant, is an A.M. Best A+ XIII company with $15 million in capacity and is looking to lead moderate-sized financial institution and commercial accounts, as well as take an excess position on large commercial and financial institutions. We expect that capacity will be increased to $25 million by the first of the year.

AXIS Insurance, with an A.M. Best rating of A XV, has just announced a significant increase in its Fidelity capacity to $25 million and is prepared to write primary and excess placements on both large and moderate-sized financial institution and commercial accounts.

RLI has made a significant investment in the Fidelity market, having just hired a team of experienced Fidelity underwriters based in New York. RLI has an A.M. Best rating of A+ X and has $25 million in capacity for both commercial and financial institution accounts. Like several of their newer counterparts, RLI has expressed an appetite to write primary on both moderate as well as large accounts.

The aggressiveness of these new entrants has yet to be determined, but the added capacity can only serve to assure that the first half of 2009 will likely find a soft Fidelity market – one that is relatively unchanged from the last half of 2008.

FIDELITY CLAIM CYCLES

The most recent Surety & Fidelity Association results reflect a profitable 2007 calendar year for the majority of leading carriers, an indication of a decline in claims. However, while 2008 results will not be available for six to seven months, we have already seen ample evidence of a steady rise in both frequency and severity of Fidelity claims. Certain of these claims have exceeded $100 million. Losses of this magnitude demonstrate just how catastrophic a Fidelity loss can be and should push managers to examine the limit adequacy of their own Fidelity programs.

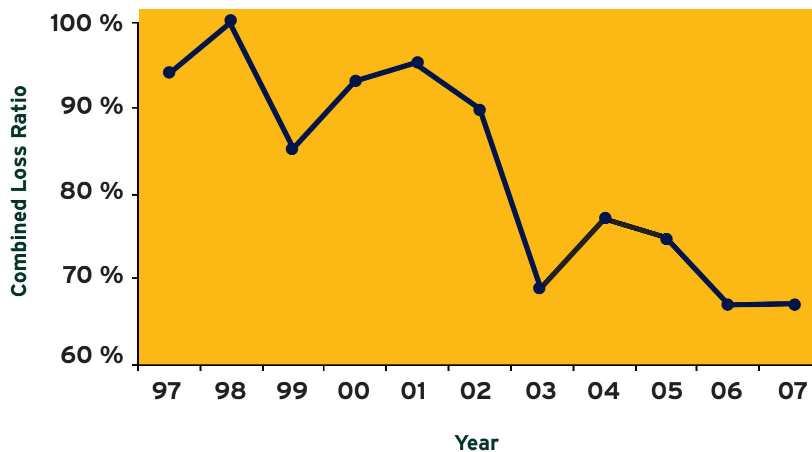
History has repeatedly shown a spike in claims activity during any economic downturn. Some officers and employees not previously predisposed towards stealing corporate assets will now be concerned about their prospects for continued employment and will take advantage of a known weakness in internal controls.

Management, faced with a reduction in revenue, will also be more watchful of corporate spending and, in an effort to improve margins, will carefully review processes and sharpen its focus on books, records and expenses that may have been glossed over during the good times. Unfortunately, these careful examinations often uncover acts of theft that previously fell below management's radar, sometimes revealing substantial losses over the long term.

While underwriting has remained profitable for the past five years, most Fidelity markets are understandably concerned about the current financial crisis, which has not only dramatically affected the financial institution sector, but is already causing a downturn in the U.S. and European economies.

Results for the top 10 Fidelity markets over the past 11 years show that underwriters enjoyed a period of profitability after a cycle of poor results from 1997 to 2002. The poor results reflect the downturn that followed the bursting of the tech bubble, as well as the fact that increased scrutiny of the books that happens in hard times will usually find losses that actually took place a few years earlier in looser, more flush days. Loss patterns and actual carrier results can take years to determine.

Fidelity Loss History of Top Ten Fidelity Markets



Source: Various Surety & Fidelity Association of America Surveys

As in any insurance line, Fidelity markets in 2009 will be forced to achieve overall profitability without the benefit of the strong cash flow previously generated by their investment portfolios. During boom times, a marginally profitable underwriting book will be sustained by strong investment income. Given the impact of the credit crisis on investment portfolios during the last quarter of 2008, profitability will have to come from strong underwriting results. For buyers whose carriers have relied on cash flow to turn a profit, the latter half of 2009 could bring a bump in pricing.

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