FIDELITY

So far, 2009 has turned out mostly as expected: relatively flat from a pricing and coverage perspective. Insureds with no losses and a strong balance sheet have been able to retain breadth of coverage and deductibles with little or no price increase. Looking toward 2010, we do not anticipate a major shift from what we are currently seeing in the market.

Rumblings from some leading Fidelity underwriters have begun, sending out signals that market pricing is too soft, particularly in the FI Bond market. The 2008 underwriting year produced poor loss ratios for some of the bigger names in the industry, while some new capacity was also severely hit with unexpected losses. Based on Surety Association figures for 2008, four of the major Fidelity markets had very high loss ratios, which, when combined with an estimated 30% expense factor, resulted in combined loss ratios well in excess of 100%. The remaining Fidelity markets had considerably more favorable combined loss ratios in the range of 65-75%, which may mean that the year ahead will prove to be varied and unpredictable.

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FEAR-INSPIRING FRAUD

The Financial Institution (FI) Bond market, however, is still not over the shocks of the past two years. The unthinkable overnight collapse of leading institutions, not the least of which included Bear Sterns, Lehman Brothers, Fannie Mae, Freddie Mac and AIG, left underwriters genuinely concerned about the potential for uncovering massive fraud within these and other financially strapped organizations. While underwriters' concerns were largely unfounded, the Ponzi schemes uncovered throughout the year left senior underwriters second guessing their earlier commitments to certain types of FI accounts.

Coupled with the recession, these large fraud losses have, to no one's surprise, resulted in a spike in FI Bond claim activity. Amidst this bad news, the industry was somewhat relieved to learn that many of the institutions did not carry large FI Bond limits, which would have compounded the effects already being felt by those underwriters that did insure these firms. On the other hand, the instances of enormous fraud that did come to light demonstrated the inability of regulators and outside auditors to discover fraudulent activity in a timely fashion. Fidelity underwriters – along with the rest of the world – were not prepared for schemes of such magnitude. Traditionally, Fidelity underwriters viewed the first $5 million to $10 million of limit to be the burn layer for a mid-sized financial institution. The size of the Madoff and baby Madoff Ponzi schemes shattered underwriters' preconceptions about the potential size of Fidelity losses.

Most affected by these losses were the excess FI Bond underwriters, who frequently offered their full capacity at rates of 60-70% of the underlying layer. Anything excess of $10 million to $15 million was widely deemed a “safe write” and priced accordingly. Since mid-2009, underwriters on both primary and excess layers have been carefully reviewing both their pricing and capacity. The handful of markets willing to lead mid-sized and larger institutions have been pressing for increases of up to 10-15% in London. Furthermore, both primary and excess markets have been much more judicious in their use of capacity. Many underwriters now offer something less than their full capacity for larger FIs, resulting in the need to introduce additional markets to complete a program.

On paper, capacity has never been stronger. The addition of HCC, RLI, Berkley, Endurance, CV Starr and Everest Re to the market in the latter half of 2008 and in 2009 has added $90 million to a market built on $255 million in U.S. capacity and $130 million in London capacity. With one exception, however, this new capacity is focused on predominantly excess lines and/or middle market business. Only a handful of leading Fidelity markets remain able to lead on the mid-sized and larger FI accounts and on Fortune 500 companies.

Partly balancing the addition of new capacity, the Fidelity market lost some old line capacity this past year. Most notable was Crum & Forster, which coming into the 2009 year had $25 million in capacity, but sustained some bad losses and found itself reducing capacity to $5 million. The carrier withdrew from the FI Bond market entirely and increased its focus on Commercial Crime accounts.

THE YEAR AHEAD

Looking toward 2010, we do not anticipate a major shift from what we are currently seeing in the market. Several of the largest writers of FI business stand by their warnings of premium increases, particularly on the FI Bond product. Although we do not expect a material shift in the breadth of coverage offered to either commercial or FI clients, we do expect underwriters to continue using something less than their full capacity on FI business.

In an effort to offset the lack of primary capacity on many larger risks, we expect to see the greater use of co-surety programs on a primary basis. Although co-surety programs have the disadvantage of involving more than one claim department on even the smallest losses, some insurers are far more comfortable these days taking only a percentage of the primary layer. As a result, a co-surety structure can be a very useful tool to generate competition within the industry, where limited competition might otherwise prevail.

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