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Professional Indemnity & Directors and Officers Insurance: the fallout from Madoff and the financial crisis



Barry Carroll
Managing Director

The PI and D&O Insurance market has been hit by a perfect storm. The first wave came in the form of the global financial crisis, and the unraveling of structured investment products containing sub-prime and toxic assets. The second wave took the form of Bernard Madoff.

The impact of the storm

"The global financial crisis has hit insurers both directly and indirectly," says Paul Richards at risk management and insurance intermediary Willis. "A number of insurance companies themselves have had direct exposure to sub-prime and toxic asset investments that have depleted their balance sheet, at a time when their investment portfolios have already been reduced by the steep drop in equities," he explains.

On top of this, there have been a number of direct claims against insurers underwriting a wide range of financial institutions, including some major banks.

"In total, the market estimate for PI and D&O losses for sub-prime and the credit crunch is approximately US\$10 billion," Richards says.

It was against this challenging backdrop that the Madoff scandal took centre stage – bringing with it insurance-related claims of around US\$2 billion and total losses of US\$65 billion.

"There is a fear that there will be a further wave of litigation as things work down to investor level, and they seek to work out where they could recoup some of their losses," Richards warns.

The reaction from insurers

PI and D&O insurance providers are responding to these challenges by toughening up their underwriting and due diligence procedures. "When capital was freely available and insurers made money from their investment portfolio, they concentrated less on underwriting profit. Now this focus has changed quickly," Richards explains.

As a result, Private Equity and Property Fund Managers can expect insurers to be a lot more discerning about who they insure; the premiums they charge; and the coverage terms they provide. Indeed, "some insurers are seeking 20 to 30% uplifts on premiums compared to last year, due to increased claims activity and reinsurance premiums," says Mike Lobb at insurance brokerage Howden Group. "Your broker must be able to differentiate you from the pack or you will have to wear these increased premiums or unacceptable changes to the policy language," he adds.

How should Private Equity and Property Fund Managers respond?

As a result of these trends, Fund Managers should devote more time than ever to their insurance application process, brokers say. The first step is to start thinking about the insurance renewal earlier than before, and to engage in a closer dialogue with both the broker and the insurers themselves.

"We normally start our renewal conversations with clients 90 days from the renewal date. With financial institution clients, we now tend to start these conversations 120 days from the renewal date," Richards says.

Indeed, Colin West at insurance brokerage Windsor Partners believes that the relationship between broker and client should be an ongoing process. "It's the brokers' job not just to get the best deal for clients during the renewal process, but look after clients throughout the policy year as well," he says.

It is now more important than ever for Fund Managers to be as transparent as possible with their potential insurers, meeting directly if possible. "Any client that meets the Underwriter tends to get a better deal, because the Underwriter will gain a better understanding of how the business is run and can bounce questions off the client rather than just reading from a proposal form," says West.

"Taking the time to read the small print is also more important than ever," says Lobb. "Directors need to understand what they've bought – making sure that the language of the product they are buying provides the cover that they require. Directors should push their brokers to answer questions on the real issues that they potentially face," he says.

Meanwhile, insurers are now trying to exclude Madoff and credit crunch related issues from future cover. As a result, Fund Managers approaching their insurance renewal should look carefully at their exposures in these areas. "If you haven't reported to insurers any claims or circumstances that may arise out of Madoff, sub-prime or toxic exposures, you may find that cover for those matters is excluded going forward," Richards says.



TECHNICAL

LP Defaults



Julian Carey
Managing Director

Is the risk of LP defaults really rising?

Over the past decade, GPs have had few reasons to be concerned about LP defaults. "Before October last year, I could count the number of LP defaults on the fingers of one hand: there was literally one," says Jason Glover, Partner at Clifford Chance.

Even during recent turbulent months, LP defaults may have appeared to remain relatively rare occurrences. But this may change over the medium term. "A number of LPs are significantly cash constrained at the moment. However, because there are relatively few drawdowns taking place, I don't think that the extent of the problem has materialised yet," Glover explains.

Duncan Woollard, Partner at SJ Berwin, adds that there are already clear signs that LP default risk levels are on the rise. "Around half the funds I have worked on in the last few years have concerns with defaults or likely defaults," he says.

What types of investors are most likely to default?

Woollard believes that GPs should focus most attention on potential defaults among Fund of Funds, especially those that have followed a particularly aggressive investment strategy or relied on leverage.

Some Fund of Funds are 'strategically defaulting' – defaulting in funds to which they have the least exposure, or those that they feel are the least likely to deliver strong returns.

"High net worth individuals experiencing financial difficulties as a result of the credit crisis and Lehman-style institutional collapses are other potential sources of defaults," Woollard adds.

How should GPs mitigate default risks?

Woollard advises GPs to talk to their investors to establish whether they have issues with meeting drawdown calls. If they have, GPs can discuss potential ways of dealing with the issue, such as bridge financing, for example.

Drawing down early is another potential default avoidance tactic. "The more you draw down and invest, the less attractive strategic defaults become," explains Woollard. However, he admits that this is easier said than done: "Because of the effects on IRRs, not many GPs want to draw down 10% and have it sitting in cash, even though that might well be all you need to move you sufficiently down the list of funds worth defaulting on."

"GPs could also try to assist the defaulter with a secondary transfer," says Glover.

What if such default avoidance measures prove unworkable? "If potential secondary acquirers are not available, the only remaining option may be to begin legal proceedings for breach of contract," says Woollard, who admits that this is not an easy route:

"The last thing you want to do as a GP is get involved in litigation with LPs. But in this market, where the potential acquirers of secondary interests are moving quite slowly, and where there is unlikely to be an appetite from the GP to take over the commitment of a defaulting

investor, you are almost forced into a situation where legal proceedings are the only meaningful way of dissuading an investor from defaulting."

Indeed, there have already been a number of examples of such proceedings in the US. "I suspect that it won't be too long before we see some in the UK," Woollard predicts.

At this point, it is very important for GPs to take legal advice to ensure that they are in compliance with all relevant documentation and legal protocols, Glover says: "Once you have reached a particular point in the default procedures, your discretion as a GP ends, and you are obliged to take certain actions." Failure to do so could leave the GP itself exposed to accusations of breach of contract or a failure to meet its fiduciary obligations. "The biggest danger for a GP is failure to comply with the LP agreement," Glover explains.

Mitigating default risk in the long term

"LPs conduct a huge amount of due diligence on GPs before they commit but there has often been very little commercial due diligence conducted by the GPs on the LPs they bring into the Fund," explained Woollard.

Why has this been the case? "It has always been the assumption of GPs and Placement Agents that if an LP signs the subscriptions agreement, they will be able to pay," says Woollard. "Going forward, some of the smaller, less well-known investors will have to undergo a lot of scrutiny before they are allowed into Funds."



MORE INFO

For further information on Augentius Fund Administration please contact:

Mr. Barry Carroll, Managing Director
Augentius Fund Administration (Singapore) Pte Limited
4 Robinson Road #05-01
Singapore 048543
Tel: +65 6223 1788
Email: barry@augentius.com

Mr. Julian Carey, Managing Director
Augentius Fund Administration (Hong Kong) Ltd
28/F Tesbury Centre
28 Queen's Road East
Wan Chai Hong Kong
Tel: +852 3793 2688
Email: julian.carey@augentius.com