Insurance Benchmarking For Hedge Fund COOs

In association with Baronsmead Partners LLP

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These days hedge funds never seem to be far from the glare of regulators and politicians alike, and it is the Chief Operating Officers (COOs) and Chief Financial Officers (CFOs) that are on the front line. Increasingly they are having to find ways of protecting themselves and their funds.

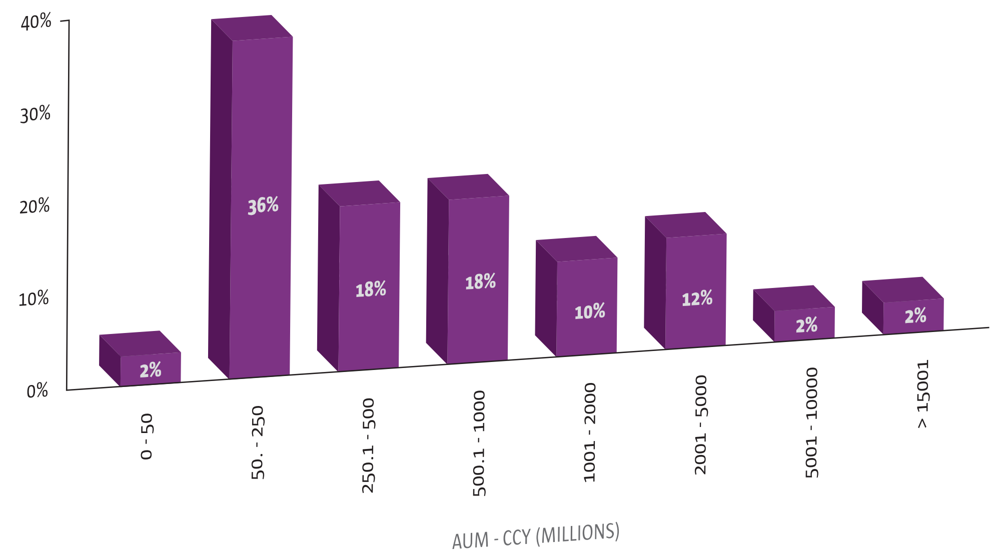
One way in which they are doing this is through insurance cover. Our survey on hedge fund insurance, sponsored by Baronsmead Partners LLP, was conducted with the aim of i) shedding some light on the various insurance strategies that hedge funds deploy and ii) determining satisfaction levels and service standards across the insurance market.

The survey focused on two key areas: Directors' & Officers' Liability (D&O) Insurance and Professional Indemnity (PI) Insurance and the findings are intended to enable COOs and CFOs to benchmark their financial risks cover against that of their peers by comparing limits and premiums. The analysis did not make a qualitative call on whether their cover or policies represent value for money.

Over the last few months, we gathered data and opinions from 50 firms via an online questionnaire and through telephone interviews. These 50 respondents represent a broad range of investment styles and manage assets ranging from US$25 million to US$25 billion.

Almost half of the respondents stated that they were covered by a composite policy. Composite insurance covers both funds (D&O) and the manager (PI) under one single policy and is a popular option as it is considered to keep premium costs down; it is also popular with insurers because it restricts cover. The composite approach creates conflicts of interest between the fund and the manager and in most cases restricts a fund versus manager claim. This is important because the fund is usually the natural claimant against the manager.

Number of respondents as a percentage per AUM banding



Of those respondents who said they purchased either D&O or PI insurance, 86% purchased D&O and 64% purchased PI. It is surprising that the take-up rate for PI cover is not higher although this may reflect a natural suspicion of the insurance industry. Whilst the FSA has not made it compulsory to take out PI Insurance (although there is talk of this happening), there are enough reasons to make it worthwhile, for example, the increased threat of regulatory action and the fact that lawsuits against hedge fund managers are rising, both in number and amount. Smaller fund managers in particular, will be more exposed as they may not have the balance sheet strength to deal with a lawsuit or a significant trade error loss. There is also an emerging trend for potential investors to demand PI cover in addition to D&O cover.

It is also surprising that there is not a 100% take up rate for D&O Insurance. Whilst there have been few claims against directors in the past, this looks set to change as tougher enforcement measures come into play: executive and non-executive directors and senior management may face increased personal exposure to regulatory sanctions.

Overall, most managers were generally satisfied with their broker. However, it was a different story for those funds that had made an insurance claim. In these cases, half of the respondents were unhappy saying they found the claims process lengthy, with the underwriters' lawyers very slow in processing the paperwork.

The reality is that hedge fund COOs and CFOs only get to see the quality of the insurance product, claim management and their choice of insurer when they have a claim. **THFJ**

The difference between PI and D&O Insurance

One of the main differences between the PI and D&O policies is the capacity in which the wrongful act, which gives rise to the claim, is committed. In the case of the PI policy it is whilst professional services are being provided to customers rather than in the D&O policy where it covers the overall management of the companies themselves. In addition, PI cover is a more useful cover than the D&O policy in terms of risk transfer as this is where the majority of claims fall to be covered.

General comments:

"Hedge funds are a difficult area for insurers as uncertainties are high, cyclical, and hard to estimate; inevitably premiums are high"

"Am I still covered if the fund's assets under management change?"

"The claims process focuses too much on negotiation"

"I was surprised by the time delay between contacting a broker and the actual placing of insurance"

"Insurance is costly and there are too many exclusions. I have a natural distrust of the industry"

ABOUT BARONSMEAD

Baronsmead Partners LLP is a leading specialist insurance broker to over 65 fund management groups covering over 400 funds and assets under management in excess of $170 billion with offices in London, Dublin, Guernsey and Jersey.

Insurance benchmarking for hedge fund COOs

Number of respondents: 50

Fig.1 Do you buy Professional Indemnity (PI) Insurance?

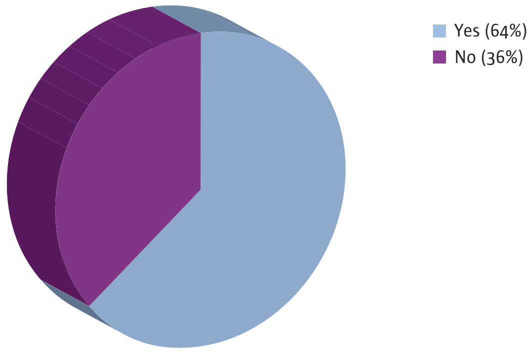


Fig.2 Do you buy Directors' & Officers' (D&O) Insurance?

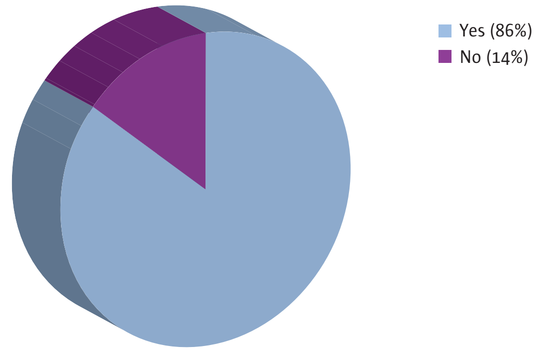


Fig.3 Do you buy PI and D&O? Is this a composite policy?

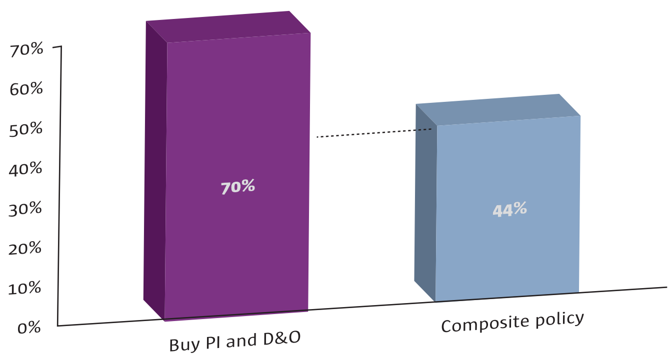


Fig.4 Did you seek advice from a lawyer on the quality of the PI/D&O cover?

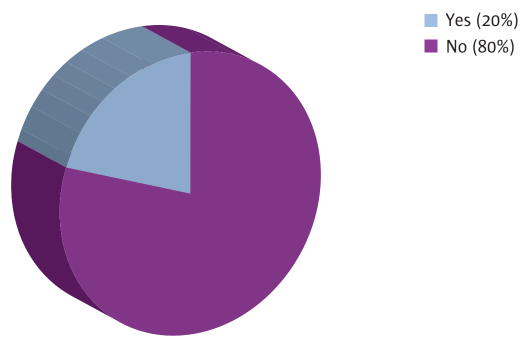


Fig.5A Have you ever had a claim?

Fig.5B Were you happy with the way the claim was handled?

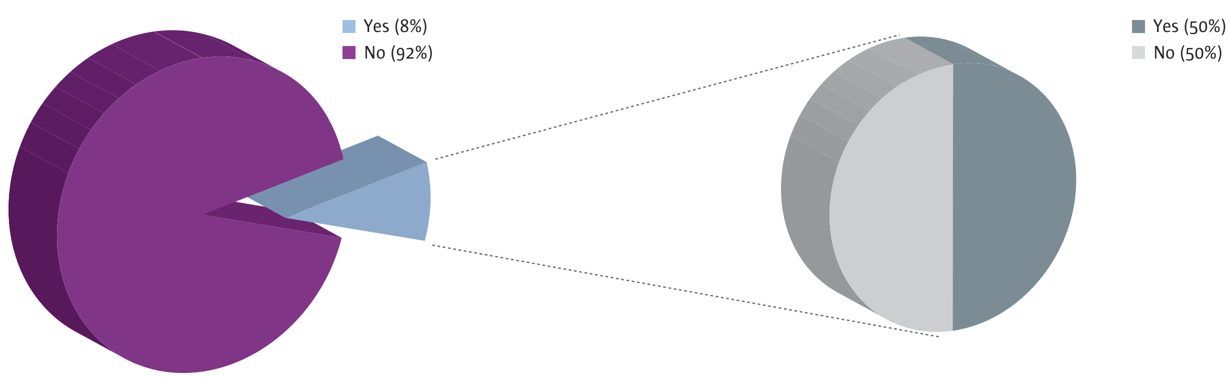


Fig.6 What is your limit of indemnity (PI and D&O)?

(shown as an average within each AUM band)

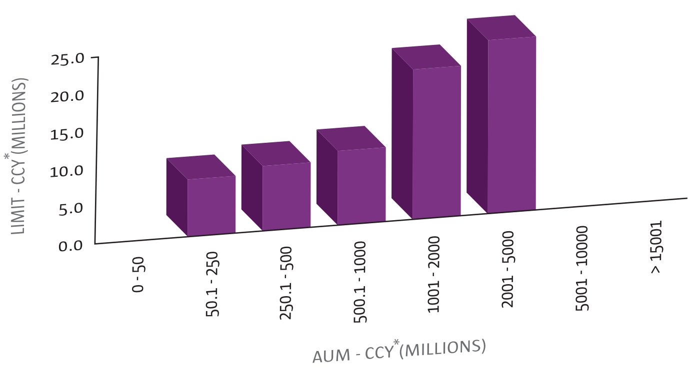
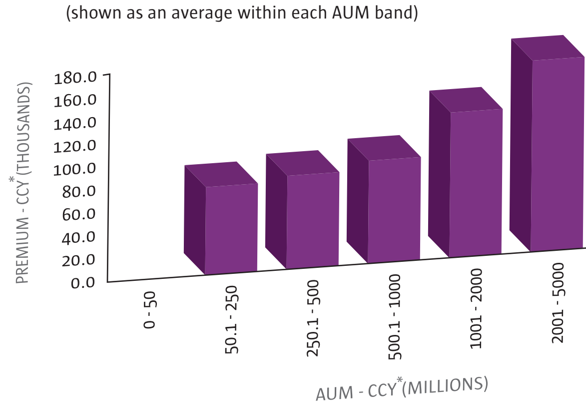


Fig.7 Average premium by AUM (PI and D&O)

(shown as an average within each AUM band)



*amalgamated (£,US$,€) unit of currency