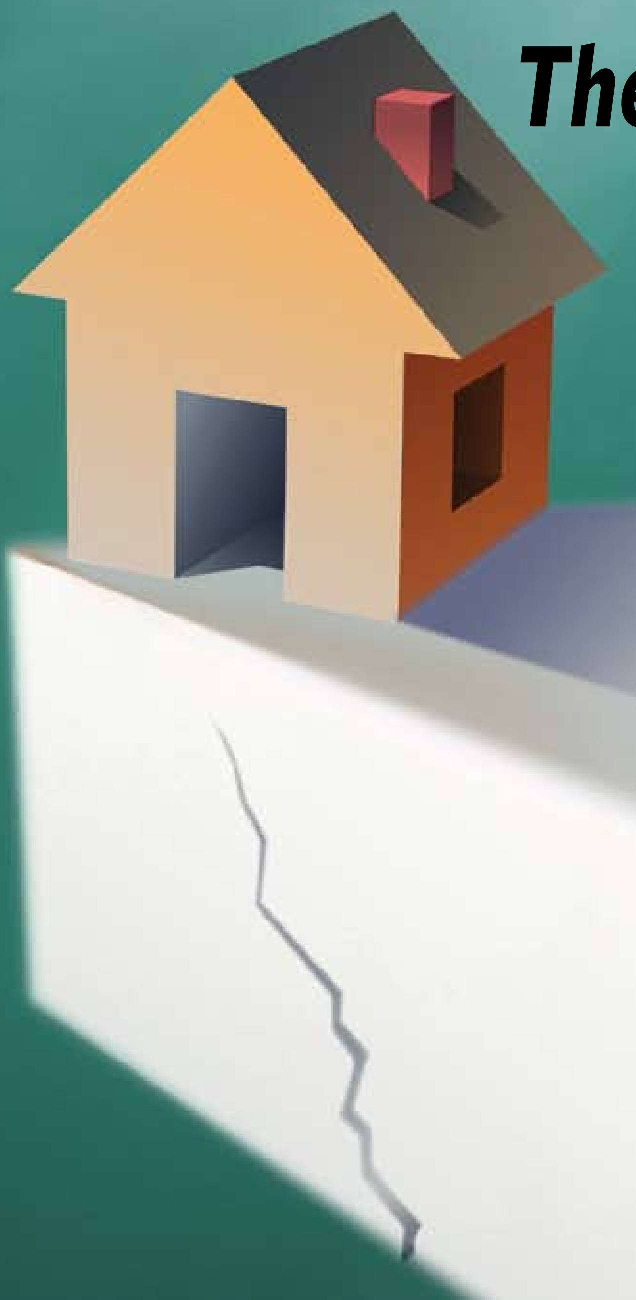
FUTURE

The Subprime Crisis



BY CHRIS NELSON

WHILE MOST P/C INSURERS ducked serious losses this time, all will feel the effect as a reeling financial services sector struggles to recover its equilibrium.

SHOCK
and Property/Casualty Insurers

Until recently, few people beyond those working in the financial services industry had any idea what Fannie Mae or Freddie Mac did or what the acronyms MBS (mortgage-backed security), CDO (collateralized debt obligation), or CDS (credit-default swap) meant.

However, most people knew that part of the American dream was to buy and live in one's own home and understood that for the vast majority of homeowners, a loan or mortgage was necessary for financing this purchase. Prior to the savings and loan crisis in the 1980s, the typical mortgage model involved banks, savings and loans, and other thrift institutions generating funds via deposits to checking and savings accounts and lending out these funds in the form of mortgages. Banks would make money by crediting funds collected with a lower interest rate than the amount that was charged for mortgages (i.e., earning a spread). However, the potential of short-term interest rates credited on deposits to exceed longer-term interest rates collected from mortgages, and any resultant asset-liability mismatches, contributed to the factors that precipitated the S&L meltdown and its hundreds of billions of dollars of losses.

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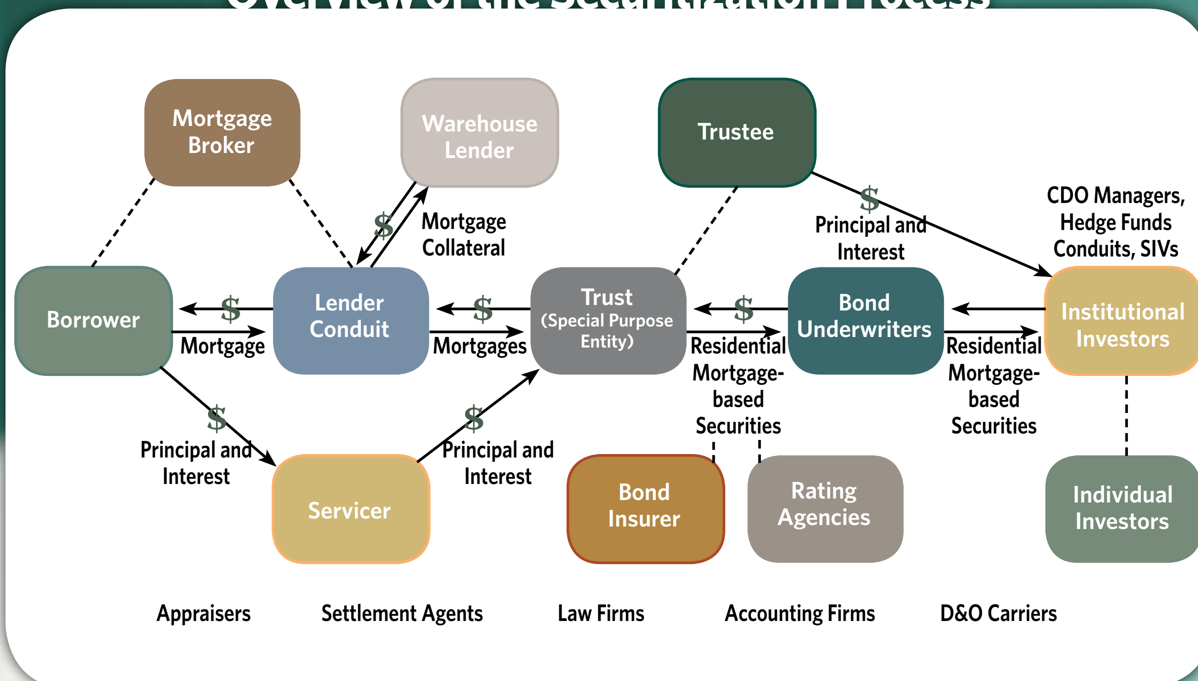
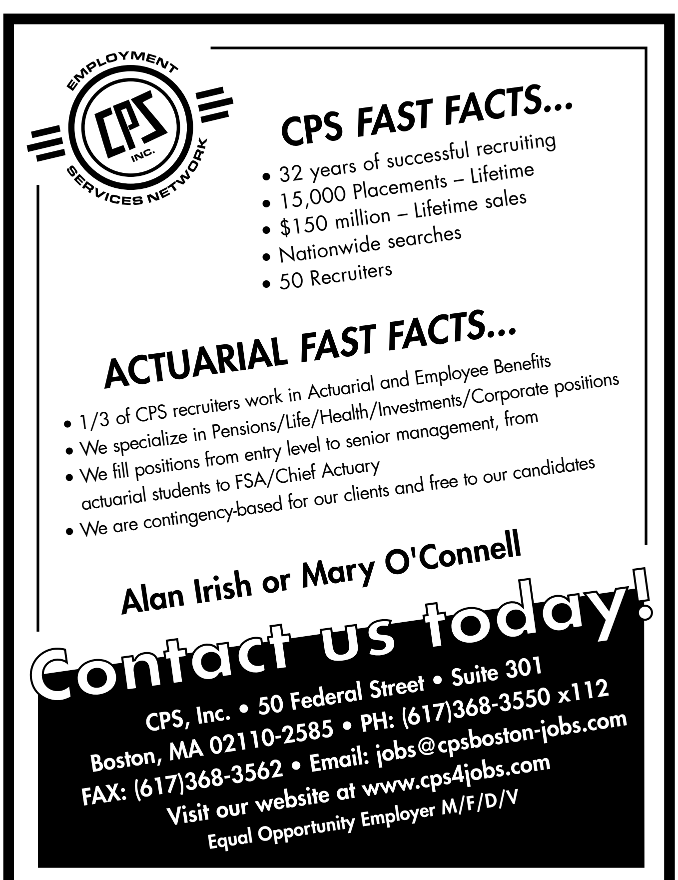
FIGURE 1

Overview of the Securitization Process





The S&L crisis was driven primarily by commercial, rather than residential, real-estate loans. But in its aftermath, there was a fundamental move away from the simple mortgage-lending model to a more complex model in which the number of interested parties increased significantly beyond borrower and lender. Figure 1 depicts the general mortgage origination and securitization process and some of the many parties involved.

In addition to the borrower and original lender, conduits such as the Federal Home Loan Mortgage Corp. (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and nongovernmental sponsored entities such as commercial banks bought individual mortgages, packaged (or pooled) them together, and used them as collateral in connection with the issuance of securities (called mortgage-backed securities) to be sold to investors. Collateralized mortgage obligations and collateralized debt obligations took the packaging process one step further, pooling mortgage-backed and/or other corporate debt securities and parceling the underlying interest and principal payments into different tranches with varying risk/reward characteristics.

These securities were often credit enhanced, either through external means (such as pool insurance provided by mortgage guaranty insurers, financial guarantee insurance products, and credit-default swaps) or through internal means (such as over-collateralization and the creation of senior and subordinated tranches of securities). Additional parties involved included rating agencies and numerous other service providers. At the very end of the process were the institutional and individual investors who were willing to take on the risks associated with these mortgage-related securities (including default/credit, interest rate, and prepayment risk) in exchange for the attractive coupon rates that they provided.

Driven by both demand-side pressure from investors hungry for attractive yields at (seemingly) low risk and supply-side pressure from an expanding group of aspiring homeowners and speculators trying to take advantage of rising property values, the size of the mortgage securitization market increased exponentially over time. As a result, underwriting standards were relaxed (resulting in a distinct subprime market) and affordability products, such as hybrid and optional-payment adjustable-rate mortgages, were introduced.

For a time, rising home prices and low interest rates masked the significant credit risk—and sometimes fraud—to which investors at the end of the process were exposed. However, by the end of 2007—as housing prices declined and home delinquencies soared—the value of the subprime-mortgage-related securities declined significantly. As a result, investors holding the risk took hundreds of billions of dollars in write-downs. The subprime crisis caused a ripple effect (or tsunami) across the global financial services industry throughout 2008 and is still being felt in 2009. Ratings for many other securities have been downgraded, plunging market prices have caused additional mark-to-market write-downs, and collateral requirements triggered in credit-default-swap contracts have resulted in severe liquidity issues for their sellers.

Fallout for Specialty p/C insurers

Except for two important categories of specialty insurance companies and a few individual companies, the P/C insurance industry has suffered less damage than the rest of the financial services industry. Among the specialty companies affected are the monoline financial guarantee insurers and the mortgage guaranty insurers. In the U.S., nine financial guarantee insurance groups wrote approximately $3.5 billion in direct premium in 2007 and had GAAP surplus of over $11 billion as of Dec. 31, 2007. These companies guaranteed the payment of principal and interest on bonds and other securities in the event of the default of the issuer. The guarantee is usually provided as an insurance policy, although similar protection was also provided through credit-default-swap contracts.

Most of these companies started out insuring only municipal bonds. Over time, however, they started to insure/guarantee structured finance issues (such as mortgage-backed securities, collateralized mortgage obligations, and collateralized debt obligations) and international issues. Since most of the financial guarantee companies were rated AAA by Standard & Poor's (or its equivalent from other ratings agencies), the insurance protection provided a credit enhancement for a bond or security that was rated lower than AAA but at a cost (or premium) less than the spread between the AAA level and the uninsured bond rating level. The maintenance of an AAA rating was paramount to attracting business as it allowed issuers to set their coupon rates at AAA levels.

Unfortunately, many of these insurers have suffered losses that significantly eroded their capital through the third quarter

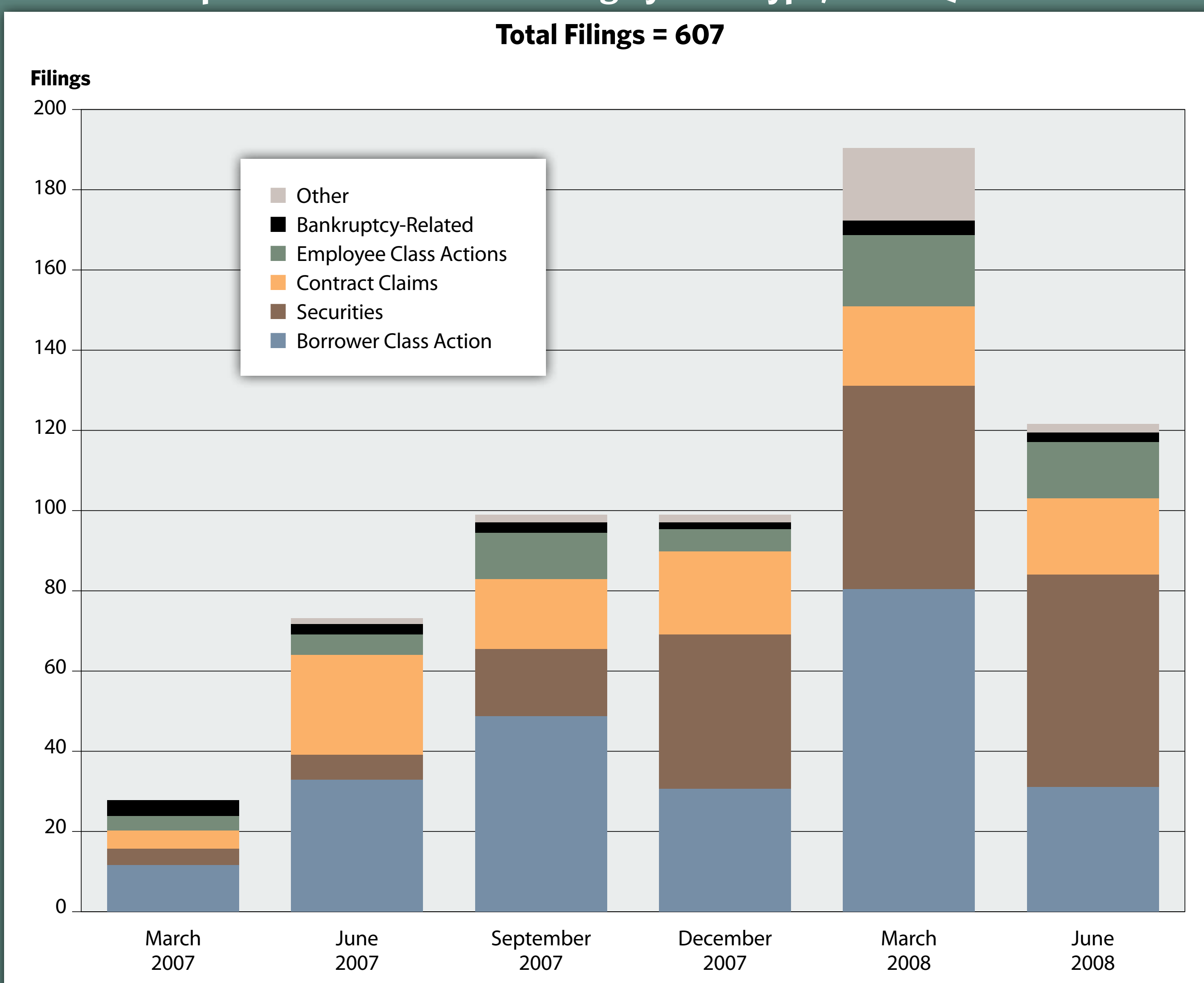
Litigation Risk

Not surprisingly, the write-downs and deterioration in the credit markets have led to significant litigation. In the 18-month period between January 2007 and June 2008, there were 607 subprime-related cases filed in federal courts, well in excess of the 559 S&L-related lawsuits that were filed from 1990 to 2000. Of these suits, 310 were filed within the first six months of 2008, exceeding the 297 suits filed in all of 2007. By any measure, it's safe to say that the subprime-related credit crisis has now surpassed the S&L crisis, the previous poster child for litigation related to a major financial crisis.

The suits filed can be classified into six major categories of civil litigation, as shown below.

Who's being sued? The short answer is everyone along the mortgage-origination-and-securitization chain. From a P/C insurance perspective, it's significant that directors and officers of companies have been named as defendants in 63 percent of the securities cases filed (or 94 percent if auction-rate cases are excluded).

Subprime-Related Federal Filing by Case Type, 2007–Q2 2008



SOURCE: NAVIGANT CONSULTING

Current estimates of industrywide subprime-related losses related to directors-and-officers and errors-and-omissions insurance are in the $10 billion range.

of 2008, and all but two insurers have been downgraded below the AAA level. This effectively put some into runoff and forced a significant curtailment of premium writings for others. In addition to considering capital-raising efforts and changes in strategic operating plans, some of these companies have been in discussion with the Treasury Department about participating in the $700 billion Troubled Asset Relief Program (TARP). Interestingly, TARP originally included provisions to establish a guarantee program for mortgage and mortgage-related securities, in effect creating a governmental financial-guaranty insurer.

Mortgage guaranty insurance, also known as private mortgage insurance, protects the lender if a homeowner defaults on a loan. Lenders typically require the homeowner to buy private mortgage insurance if the equity on the mortgage (initially represented by the down payment) is less than 20 percent of the value of the home (or using the industry's terminology, if the loan-to-value is greater than 80 percent). In 2007, eight insurance groups in the U.S. provided private mortgage insurance, with direct written premium of nearly $6.2 billion. (GAAP surplus is difficult to isolate because some insurers offering private mortgage insurance are part of larger insurance organizations.)

The current crisis was not the first challenge in the history of private mortgage insurance. In the 1980s, these insurers suffered losses from exposure in energy-related areas (such as Texas, Colorado, etc.). As they have with financial guaranty insurers, the Standard & Poor's ratings on private mortgage insurers have been downgraded over 2008. As of September 2008, only three of the eight groups were rated AA- or better, compared with eight of eight at the beginning of the year. Since losses are incurred based on mortgage delinquencies, private mortgage insurers expect to see continuing losses in the

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near future as housing prices decline and adjustable-rate-mortgage interest rates reset. With the potential of additional delinquencies in the future, the Treasury Department is also investigating ways in which TARP could help private mortgage insurers.

Impact on Traditional P/C Insurance

While most traditional P/C insurers seem to be weathering the storm, American International Group (AIG) is the significant exception. The Nov. 10 provision of governmental relief to AIG was front-page news around the world. AIG had subprime/credit exposure from a number of areas, most significantly from a noninsurance unit that wrote credit-default-swap contracts but also from other units involved in mortgage origination, private mortgage insurance, and underwriting directors-and-officers and errors-and-omissions insurance for financial institutions. A small number of other insurers and reinsurers have also announced mark-to-market losses resulting from writing credit-default-swap contracts.

Current estimates of industrywide subprime-related losses related to directors-and-officers and errors-and-omissions insurance are in the $10 billion range. These estimated losses are significant and may be understated as the number of lawsuits continues to grow and threatens to spread to nonfinancial institutions (see Page 30). But they remain relatively small compared with losses in other sectors. Owing to size and capacity constraints, many of the large financial institutions did not buy directors-and-officers coverage. Those that did limited coverage to nonindemnifiable losses. Most of the exposure from litigation is expected to be self-insured and will not reach the commercial insurance market.

More generally, Standard & Poor's reports that the P/C insurance industry suffered realized and unrealized capital losses of $1.1 billion and $18.5 billion, respectively, for the six months ending June 2008. Sizable amounts, to be sure, but to put these amounts in perspective, Hurricanes Gustav and Ike resulted in industry losses of $10 billion and $23 billion, respectively, according to the Insurance Services Office.

Fortunately for P/C insurers, a more conservative investment strategy relative to others in the financial services industry has somewhat insulated them from larger write-downs on equities and other structured finance investments. As a result, the industry has indicated that it's unlikely it will need Treasury assistance as part of TARP.

Future Shocks?

Although the subprime crisis has had a minimal direct financial effect on the P/C insurance industry so far, I suspect there will be further reverberations down the road in the form of regulation, rating, and internal management changes.

First, any discussion of increased regulation of the entire financial services industry will most likely include insurance regulation, especially considering the highly publicized troubles of financial guaranty insurers and AIG. The debate between the merits of the current state-based system and a federal regulatory system will continue, and questions of what (and how) to regulate will need to be settled for such things as credit-default-swap contracts and the expanding role of governmental departments that provide insurance and guarantees.

Since ratings agencies have come in for their share of the blame in this crisis, I expect the ratings process will continue to evolve to include more consistent and thorough consideration of downside risk, including scenario testing. Most rating agencies have indicated that enterprise risk management will become a larger and larger factor in their ratings assignments in the future.

From an internal perspective, I will mention just two of a number of indirect effects that the current crisis will have on P/C insurance companies. The first is the heightened need to implement proper internal controls to reinforce the best practices of understanding what risks the company is underwriting and properly aligning the incentives. As Figure 1 demonstrates in the mortgage securitization process, production-oriented incentives on the left-hand side, combined with the increased complexity as the process moved from left to right, masked the underlying risk borne by ultimate bearers of risk on the right-hand side of the process.

Second, there will be continued emphasis on the enterprise aspect of enterprise risk management. Much of the financial impact for traditional P/C insurers came not from insurance underwriting risk but from credit-related risk. P/C insurers will need to continue to analyze all risks (not just underwriting risks) and their dependencies and interrelationships, including more scenario testing of events that may not surface when relying solely on stochastic modeling of required economic capital. ●

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