

The Real Subprime Problem A Symptom of Lax Regulation and an Overheated Real Estate Market



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Every 10 years the insurance market flirts with sanity. Underwriters try to make money selecting and pricing risks profitably. Although today we are not yet fully into one of those periods, the “subprime” mess may make underwriters (at least in some industry segments) demand higher rates in search of profit.

The subprime debacle and the associated debt and liquidity crisis may be the stated excuse for a harder insurance market, illogical as that position may be. It is illogical because the dollars paid out in losses are still fairly modest, all things considered. But industry observers persist in their fear that things could turn far worse with over 40 securities liability and other claims being fired at not just the loan originators but their bankers, arrangers, guarantors and other intermediaries in financial markets. But so far the right mix of reasonable knowledge on the part of management (*scienter*) and related stock damage is missing in many of the securities cases filed. The first subprime related securities claim brought in the current crisis (New Century Financial Corp, February 2007) has just been sent back for insufficient particularity in the claims of fraud and many of the cases filed are going to have trouble proving guilty knowledge.

Perhaps it is the rookie plaintiffs’ enthusiasm that is causing these errant missiles but they seem to smell the blood in the water if they can't see the wound. If these cases strike legal pay dirt it could be the beginning of a gold rush. Many managers, however, were making the same mistake in an arena where no one was getting it right and, as individuals, most did not profit from the events. They didn't know enough generally to even consider fraud.

But "subprime" is not the problem. Actually this debt and liquidity crisis is just part of a lax regulatory environment, an overheated real estate market and an overall economic downturn, which taken together show “perfect storm” signs.

Most underwriters have avoided direct damage issues facing the banking world. They do not, as a rule, hold CDO or other mortgage derivative instruments or participate in "auction market" securities for one very sensible reason. They did not understand them or could not measure the risk they represent. Most insurers are broadly conservative investors and have regulatory restrictions on where they can deploy their capital.

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What appears to be immeasurable is the affect on value of the collapse of a market appetite for these exotic mortgage related securities. This has little or nothing to do with the financial structure's response to the default risk in one segment (a non-performing loan or mortgage) contained in a packaged security and more to do with the market's "perception" of the investment segment overall. The rating agencies were characterizing the "structure risk" and not the market risk. They could not/did not factor in the "run on the bank", illiquidity scenario which resulted from a lack of confidence in the system.

Some insurers like AIG, XL, Swiss Re and various small fry have showed direct and indirect damage from the contagion. Securitization market failure was sign enough to them to lead the flight from mortgage bankers and once again prove their long held belief that underwriters are not smart enough to share risks with investment banks. They go so far as to ask questions about the exposure in practically every D&O renewal even if the client is a chain of clothing stores. They are in full scale run and hide mode. This may be because even AIG admits it cannot agree with their auditors whether their credit default portfolio was \$1 or \$5 Billion under water.

The insurance market is also getting a nudge toward hard from the Fed and the recession warnings. Smart carriers (WMIG and Berkshire, for example) have segregated investment operations from underwriting but many are still influenced by a weak money market to tighten underwriting standards. All we need is a claim blip for a full scale return to the insurance market of 1985. The subprime securities litigation could catch fire or the Florida wind roulette wheel could come up "00" a few times this season and things would get interesting in a hurry.

But even failing a series of large losses, some other signs do point to firmer conditions later this year. It is true capacity is overflowing in the D&O world. Another new D&O facility, this one Nationwide-backed, just opened recently adding another block of aggressive capacity. So there is pressure against rate, but there is talk of retrenchment. Call it a gut reaction, but the signs are there and clear. At the high end of the risk scale, the investment banks and commercial banks involved in the subprime world directly have already started to see major impact on the availability of and price for management liability insurance capacity. Major jumps in cost and restrictions of limits available are the norm in this world today. How far this contagion is to spread is the question.

Start your renewal process earlier and lock up terms soon if you don't want the pall of the Florida wind season to influence thinking about your renewal. Recent experience suggests that the hardening of the market generally can come from losses which come from any line.

Next think a little about the coverage free lunch before you. Dan Bailey, who has been watching this stuff for a while, suggests in a recent piece that some exclusions might be good for you. Do you want you side A limits eroded by one v. one claims or to allow a single bad actor to take all of the coverage from the rest of you, the innocent insureds?

And the real subprime problem is that it is just a symptom. The real contagion, the underlying complaint, is the economic slowdown. It is very difficult to value the assets carried by some investors (on or off their balance sheets). Just from the way reporting of steepening losses on portfolios of collateralized mortgage obligations (CMO's) and other securitized mortgage debt instruments has rolled (slowly) out of the major banks (Citibank and UBS, for instance), it should be very clear one of two things is happening. Either they really don't know what these things are worth or, having a choice between reporting now and reporting later (which choice was theirs until fairly recent direction was given by the SEC), they decided to hold their breath and report later. Today with the changes in accounting rules and the closer scrutiny, they will be less able to hide and wait.

But in the past was hoping for a good outcome an offense against clear corporate communication with shareholders, accountants or regulators? Unfortunately, when things continue to go south (as a Southerner by birth, this locution offends me deeply, so perhaps I should say "continue to worsen"), the bad news draws second guessing and lawsuits.

Looking in the rearview mirror, with the full benefit of hindsight, it seems clear that mistakes were made in reporting or risk assessment. One must wonder, however, why managers have to be liable for investing in (mostly) highly rated investment vehicles, falling out of favor because of an across the board readjustment of housing prices and a spooked market for complicated assets that were very widely held suddenly starved for liquidity.

And it wasn't just a problem for investment bank gunslingers as even the top commercial banks got caught by this. Citibank and UBS both posted multibillion dollar losses, which still seem to be evolving. But the engine of capital creation though securitization of mortgages was and is a key reason for the growth of the American GNP.

In the end, it is this writers opinion that many judges and perhaps a jury or two (although juries are unlikely to hear these securities claims, since upwards of 95% of the cases settle out of court) will find that most managers who held these investments did their diligence, to a fairly high standard. They depended on a group of competent advisors and were dealing in secure, rated debt structures. This is hardly the reckless action of the ENRON or WorldCom ilk so the claims will not be great in the D&O market from this source. Without a few catastrophic claims to rock the market, even the economic downturn will not be enough to harden market prices for D&O this year except for the bankers, arrangers and guarantors involved directly in the Mortgage Backed Securities who are being hammered.

