

Subprime Crisis: Possible D&O Impact

A look at how insurers react as the mortgage credit issue shakes up the financial markets



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Some insurance professionals who trade in the financial services sector have fears that the subprime mortgage induced market turmoil will generate significant new Directors' & Officers' Liability and Professional Liability claims. This sector of the insurance market is currently defined by low premiums and broad terms so the potential upset and reversal of that softening trend has many, as Tony Soprano might say, "heading for the mattresses."

While it is true there has been some recent litigation, particularly Securities Class Action lawsuits against the public mortgage companies, the rating agencies and their credit enhancement and financial guaranty insurers*, it is very early to declare this a Katrina-like event.

So what *does* the future hold? If we look at the recent past, we will see some noise and upset in the market. We are already witnessing underwriters asking probing questions of companies about their investment portfolios and, based on the ironclad law of Professional Liability, if someone has a bad outcome, litigation is sure to follow. To date however, while Hedge Funds and SPACS invested in Collateral Debt Obligations (CDO's) have incurred substantial losses, plaintiffs attorneys are not yet standing on their doorsteps.

With insurance rates down about 10% from last year, the market is soft and there is plenty of capacity in the professional indemnity financial institutions market sector, even if we are starting to see underwriters measuring their risks more precisely and asking more questions.

The devaluation of the subprime mortgage securities market will be an issue for major institutions and investors, perhaps even spawning lawsuits that accuse management of negligent activity in this market. But, for smaller commercial banks in the United States and overseas, the biggest risks are investment transparency, debt ratings and liquidity. These banks are concerned that they will not be able to meet their communication responsibilities to nervous depositors so they can overcome their market jitters. Similarly, mutual funds who do not handle inquiries from their investors well may be forced to sell shares into a market where values are falling, imposing pressure and potential litigation if they do not manage the crisis well. This "run on the bank" mentality is fed by overall market weakness, and confidence is undermined in general.

Nevertheless, rates for Professional Liability for financial institutions are down 10% to 15% from last year, and we have not yet seen anyone that either is an investor or just peripherally involved in the crisis penalized on rates because of the subprime mortgage securities situation. Lenders or bankers directly involved in subprime debt will be penalized, but they are a small minority within the overall financial institutions universe.

* According to the *The D and O Diary* (dandodiary.blogspot.com) some dozens of claims over the past six months.

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Things may change, however, as investors have filed a securities class action suit against public mortgage giant Countrywide and earlier, New Century Financial Corp. Potential claims allege that misleading financial statements and failed internal controls have resulted in investors having been misled. The biggest issue for financial institution clients is the valuation of securities with holdings in CDOs or derivative instruments which are not marked to market appropriately or in a timely fashion. Even getting accountants and brokers to agree on a current value is sometimes problematic. With that as background, it is not surprising that plaintiffs' lawyers will smell blood and allege a wanton disregard for transparency.

Prior financial crises like Long Term Capital Management in 1998 and the Russian and Asian currency disruptions during the past ten years caused similar small hiccups in the insurance industry. It is worth noting that these crises did not affect insurers directly, while this subprime crisis may pack a one – two punch: 1. Insurers' investment returns may be negatively impacted by their subprime investments, and 2. Ensuing D&O litigation against them due to poor returns. However, pending no further adverse developments, we see the turmoil around the financial services market as a cause for a watchful eye, but no cause for alarm yet.

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