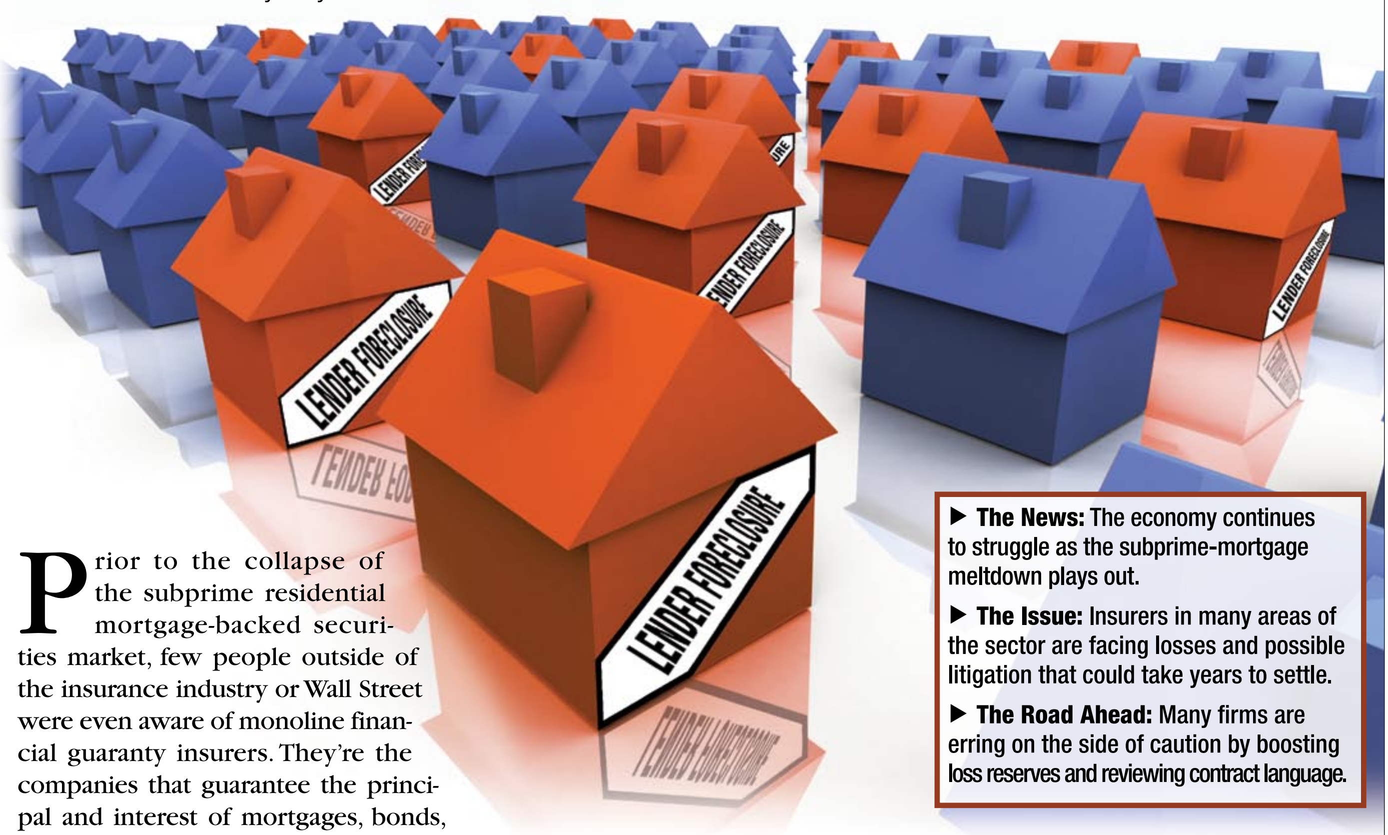
The Ripple Effect

The subprime meltdown has impacted the insurance industry—and more trouble might be lurking.

by Joy A. Schwartzman and Michael C. Schmitz



▶ **The News:** The economy continues to struggle as the subprime-mortgage meltdown plays out.

▶ **The Issue:** Insurers in many areas of the sector are facing losses and possible litigation that could take years to settle.

▶ **The Road Ahead:** Many firms are erring on the side of caution by boosting loss reserves and reviewing contract language.

Prior to the collapse of the subprime residential mortgage-backed securities market, few people outside of the insurance industry or Wall Street were even aware of monoline financial guaranty insurers. They're the companies that guarantee the principal and interest of mortgages, bonds, and other financial debt instruments.

Today, it is difficult to pick up a newspaper without seeing something about the "meltdown" in the subprime RMBS market. The spreading crisis now threatens the financial stability of not only the insurers that guarantee mortgages, but also the entire debt market—everything from credit cards to student loans to public works projects.

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The sudden illiquidity of investment bank Bear Stearns, the associated buyout by JPMorgan Chase and the federal backstop of certain Bear Stearns' underperforming assets have further roiled the global markets.

What Happened to Subprime?

How did this happen, and how deep will it go? What might it mean for financial markets and the economy in the long term?

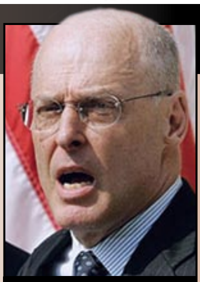
The crisis came about because residential real estate markets in the United States became overheated due to a persistent low-interest-rate environment. Mortgage loans were inexpensive and easy to obtain, so home prices kept rising.

But these low rates meant that many borrowers, who previously did not qualify for a traditional mortgage, fell victim to the teaser interest rates of new-style, adjustable-rate mortgages, known as ARMs. These mortgages start out with low interest rates for the first year or so; after that, they readjust based on prevailing interest rates, which are usually higher.

As homes continued to rise in value, mortgages appeared to be a low-risk investment. Adding to the sense of security, debt insurance was cheap and readily available. At the same time, the debt market was becoming more complex and securitized, with a sharp rise in the number and variety of structured credits such as CDOs—collateralized

Regulatory Renaissance?

Four issues are raised by Treasury Secretary Henry Paulson's optional federal charter proposal.



Treasury Sec. Henry Paulson Jr.

As part of his blueprint for financial services reform in the wake of the subprime meltdown, Treasury Secretary Henry Paulson Jr. proposed an optional federal charter for the insurance industry. Many observers called the proposal an intermediate step that would lead to the creation of a new Office of National Insurance within the Treasury Department. The ONI, Paulson said, would have broad powers to address "international issues" and "competitiveness." Contributors Joy A. Schwartzman and Michael C. Schmitz, of actuarial and consulting firm Milliman, analyze four areas of concern about the OFC:

1 Wasn't legislation similar to Secretary Paulson's proposal introduced in Congress last year, before subprime became an issue? What's the connection to subprime?

Neither the issue nor the proposal is new, and the relationship to subprime is tangential at best. Paulson's proposal is the latest pull in a tug of war that has been going on for more than 100 years between those who favor the existing state-based system of insurance regulation and those who would like to see greater federal involvement. In 1869, the U.S. Supreme Court held in *Paul vs. Virginia* that insurance was not interstate commerce and should be regulated by the states. In 1944, *Paul* was overturned, prompting Congress to pass the McCarran-Ferguson Act, giving insurers limited exemption from antitrust laws and preserving the states' role as primary regulators. The solvency crises of the 1980s and early 1990s, and the passage of Gramm-Leach-Bliley in 1999, added fuel to the debate. More recently, growing criticism that the current system is out of date and stifles competition has led to increasing pressure for some kind of overhaul.

2 What kind of regulatory impact can we expect from Secretary Paulson's proposal, assuming it goes forward?

Very little in the short term; the process will take some time. Ultimately, the proposal calls for a dual regulatory scheme with oversight shared between the states and the federal government, much like the current banking system. Under Paulson's proposal, state-based regulation would continue for those companies electing not to be regulated at the national level.

3 What has been the industry's response to Secretary Paulson's proposal?

Mixed. Large national companies tend to favor a federal system; smaller companies and trade groups representing brokers and individual agents generally would like to keep the state system. Both groups admit there are competitive and international issues that need to be addressed, but OFC's opponents would like to see the state system revamped and made more competitive before bringing in a federal component.

4 What are the competitive and international issues driving the proposal? What effect could an OFC have on competitiveness?

Proponents point out that responding to 51 different sets of regulatory requirements is burdensome for national and international companies doing business in the United States. Those opposed suggest that competitiveness will actually suffer under a federal scheme, since it could lower the regulatory burden for large and international companies, encouraging them to enter state markets they have heretofore avoided, thereby undercutting costs and putting smaller insurers out of business.

Regardless of whether Secretary Paulson's proposal becomes law, the meltdown in subprime will earn the status of a highly improbable event if, in its wake, the U.S. insurance regulatory system finally adopts the federal oversight it has been considering for decades.

debt obligations—and credit derivatives such as credit default swaps.

The more mortgages were issued, the higher home prices soared, encouraging still more euphoric borrowing and further investing in the mortgage-backed securities market. The mortgage/housing bubble was born.

The situation fostered undisciplined lending and instances of outright fraud in the residential mortgage market. Subprime loans—mortgages issued to borrowers with less-than-favorable credit histories—multiplied.

ARMs and interest-only and payment-option loans (where unpaid interest can be added to the principal) proliferated. Nearly 23% of all mortgages taken out in 2005 were interest-only ARMs, and more than 8% were payment-option ARMs. These risky products were a negligible share of the mortgage market prior to 2004.

Subprime loans also were bundled together and sold, divided into tranches comprising different levels of risk and interest rates. The higher-level tranches of subprime mortgage pools could be rated AAA and were attractive to pension funds. Meanwhile, the lower tranches were attractive to hedge funds and other investors inclined to take on greater risk in order to capture a higher yield in a low-interest-rate environment.

According to Brown Brothers Harriman, the total quantity of subprime securitized loans, including CDOs, as of July 2007 had grown to roughly $1 trillion. That's 17% of all U.S. mortgage-backed securities and 6% of the U.S. bond market.

As long as housing prices continued to rise, the situation appeared to be a good deal for all concerned.

It all started to unravel in 2006, however, at the peak of the housing bubble, once ARMs began to reset to higher interest rates. Bad-credit borrowers, unable to borrow further against their properties, began to miss payments and slip into default. Threatened by bank foreclosure, many walked away from their properties.

Housing prices began to fall. Banks and mortgage companies could not recoup their losses by selling reclaimed homes in a real estate market that was rapidly losing value. Wall Street investment firms and hedge funds saw the value of their CDOs plummet.

Total write-downs and other credit losses for the largest financial services firms thus far total an estimated $163 billion, according to the *International Herald Tribune*. These losses have led to the sale of other assets to meet margin calls and cash needs, resulting in the de-leveraging that is customary during the bust phase of bubbles.

Bond Insurance Tremors

Currently, financial guaranty insurers, also referred to as bond insurers or monoline insurers, have been particularly hard hit, writing off billions of dollars in losses. The losses have included reserves for credit impairments, in which they expect to pay claims, and even larger mark-to-market losses on their credit derivative portfolios, which include credit default swaps on CDOs.

These factors are calling the financial guaranty insurers' AAA ratings into question. Rating agencies have begun downgrading some of the largest financial guaranty insurance companies and threatened others with similar actions. Coupled with market conditions, the downgrades have triggered liquidation of collateral assets by financial institutions holding securities backed by mortgages and insured by the companies. This has forced companies to dump even more assets onto a market with little demand for risky assets.

Downgrades also have put pressure on municipal bonds, which are more stable but are insured by the same financial guaranty insurance companies. It's now more expensive and more difficult for states and localities to raise money for public projects.

Monoline mortgage guaranty insurers also have taken billion-dollar losses, both from direct payments on defaulted mortgages and large reserve set-asides for expected future defaults. These insurers typically maintain a minimum AA- rating in order to insure loans purchased by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac).

However, the rating agencies recently downgraded several mortgage guaranty insurers to levels below AA-. In response, Freddie Mac requested that those companies submit a remediation plan within 90 days of the downgrade to restore their AA- ratings. Such plans must be submitted by early July. Ironically, the demand for mortgage insurance has surged as alternative forms of credit enhancement have largely disappeared and the mortgage insurers have tightened their underwriting guidelines.

Pacific Investment Management Co. expects resets of certain rates to total $30 billion to $60 billion per month throughout 2008. PIMCO indicates that some resets could range from 400 to 700 basis points, and that the economy may be affected into 2009 as potentially more homeowners default.

Some insurers are considering radical surgery to isolate the damage—for example, cutting off the CDO and mortgage-backed segments of a financial guarantor's books from their more stable municipal bond businesses and splitting into two companies. At least two monolines are claiming the right to cancel payments on some guarantees they wrote, saying their counterparties fraudulently entered into the credit default swaps. Warren Buffett, chairman of Berkshire Hathaway Inc., has started his own bond insurance company to help municipalities and states insure their public debt, offering up to $800 billion in secondary insurance.

Other Areas Affected

One thing is certain: The meltdown has rippled from financial- and mortgage-guaranty insurers to companies throughout the sector. Many insurers have investments with different levels of exposure to asset-backed securities. And lines including directors and officers, professional liability errors and omissions, life, title and others are now being affected by litigation and the continuing free-fall in the housing markets.

Here's how some other types of insurance are faring:

D&O and E&O: Industry insiders' have mixed views about the impact of the subprime situation on D&O and E&O. The collapse of Bear Stearns is certain to prompt lawsuits, on the heels of a sharp uptick in securities class-action suits in 2007, when 100 companies were sued from July through December. This reversed a trend of eight consecutive quarters of below-average litigation, according to Stanford Law School.

The financial services sector was hardest hit, with 47 companies sued in 2007, more than quadruple the number from 2006; 68% (32) involve allegations related to the subprime market. D&O rates for financial services firms rose almost 20% in the fourth quarter of 2007 when compared to fourth-quarter rates for 2006.

Any optimism is based partly on the long-term trend of fewer securities class-action suits over the past decade, related in part to the 1995 Private Securities Litigation Reform Act. Even with the recent spike, total activity in securities class-action filings is still 14% below the average for the period 1997 to 2006.

Others note that when it comes to D&O/E&O, "the sting is in the tail"—it could take years for subprime's full effects to hit the market. Reinsurance broker Guy Carpenter's Specialty Practice Briefing from November 2007 said total subprime losses in D&O alone could top $3 billion, while other analysts have estimated that the damage could reach $9 billion.

Title Insurance: According to Paul J. Struzzieri, a principal and consulting actuary in the New York property/casualty practice of Milliman, the primary effect of the subprime mortgage market on title insurance companies is the loss of business and revenue as the housing market softens and fewer homeowners refinance. Struzzieri said that lenders increasingly are trying to recover their losses by filing claims against title insurance companies.

Struzzieri points out one trend in the

title insurance industry that highlights increased efforts by lenders trying to recover losses from insurance policies. Title insurers issue closing protection letters to reimburse lenders for losses incurred in connection with real estate closings conducted by an agent of the insurer, he said. Most CPL claims involve fraud, dishonesty or negligence by the agent handling the lender's funds, or when the agent fails to comply with the lender's written closing instructions.

Recently, however, lenders have begun using the "failure to comply with written closing instructions" portion of the CPL coverage with increasing frequency, Struzzieri said. For example, title insurers have seen sharp increases in CPL claims seeking recovery for lenders' losses involving foreclosures and defaults, alleging that agents didn't follow every single instruction to the letter.

"Often, the claims are made even when the failure to precisely follow the closing instructions did not lead or contribute to the loss," he said. It's too early to tell if the lenders' strategy will be successful, Struzzieri said, but title insurers have responded by tightening the CPL language to allow recoveries only where the failure to follow instructions relates to the status of the title or the priority of the mortgage.

Life Insurance: An article by Milliman principals Steven I. Schreiber and Philip Simpson titled *Insurance-Linked Securities: A Bump in the Road* notes that as much as $15 billion in securities has been issued to capital-market investors on transactions involving life insurance risks. Most of these deals included a "wrap" from a financial guarantor, making the securities more attractive to investors.

The availability of these wraps has been reduced significantly. Is this the end of the road for the life securitization market or just a bump in the road? Schreiber and Simpson come down on the side of the bump.

"The difficulties the financial guarantors are facing do not change the fact that there are real benefits to insurers from these transactions," they write. Short term, Schreiber and Simpson expect to see insurers placing more business in private transactions, which may entail banks providing the funding; the wrapped market coming back in the long term; or more transactions being placed in unwrapped tranches.

The causes and ramifications of the subprime meltdown are complex. The initiating event—the collapse of the subprime mortgage market itself—has caused a housing recession, a tightening of credit, better chances for more federal regulation and less inclination among investors to buy into complex debt instruments, at least for now. The indirect consequences are too complex to predict with any confidence.

The upshot is that the insurance industry, along with the entire financial community, will emerge from the subprime debacle with a renewed awareness of risk, and may even end up being stronger for the experience. BR