

## The Subprime Crisis and Insurers

In view of the dramatic changes and asset write-downs that the US subprime mortgage crisis has visited on worldwide financial markets since our last *Alert* in October, we felt it might be time to turn our focus closer to home and consider how the current crisis has affected insurers. We will also provide an update on some of the latest class action lawsuits and who in the financial markets has been directly affected so far.

The subprime crisis simmered for some time before boiling over in recent months. Once market participants realized their predicament, it was too late to contain the consequences. By the end of November, financial institutions' reported losses resulting from the credit crunch will probably exceed \$100 billion. One of the major questions now is how far will the consequences spread? Who is at risk besides the lenders? Insurers potentially face exposure from two distinct directions: from their own sizable portfolios and through their insurance operations.

### Safe Investments

The good news, according to most analysts, rating agencies and insurers, is that life and non-life companies on both sides of the Atlantic have limited exposure in their portfolios. This is thanks to their historical practice of maintaining conservative investments.

"Non-life companies are typically short term investors with liabilities that pay out within a couple of years. Non-life insurers take risk on the liability side of the balance sheet so cannot afford to take risk on the asset side," said Greg Carter, Managing Director of the Insurance Group at Fitch Ratings. "Life insurers tend to be longer term investors and take slightly riskier allocations of assets, but they are still quite conservative. There is an innate conservatism built into the structure of the [insurance] market."<sup>1</sup>

For those insurers that have maintained their conservative approach to risk, we can also assume

that they were intentionally slow to react to new and riskier investment opportunities represented by subprime mortgage-backed securities. One of the reasons insurers did not invest in these new structured products or take on any riskier investments is because of favorable underwriting conditions of late. Conditions have been profitable over the last couple of years due to low claims frequency and severity. Another reason for insurer caution is that they are in the business of risk. Constantly monitoring insurable events throughout the world makes them risk averse from the start. However, there are some insurers who have a higher risk appetite and some have ventured into higher risk investments. If they were not able to liquidate them in time, they may face their share of asset write-downs.

### Exceptions that Prove the Rule?

Leading insurers continue to reassure the press that they have not been badly affected by the subprime problems plaguing the larger investment banks. JP



Morgan analyst Michael Hutter expects insurers will divide into two camps: "Those companies with very limited exposure to any part of the credit crunch, and those with some." Insurers in the second camp include Allianz and ING, which both have banking subsidiaries, and AIG and Swiss Re, which have operations that are exposed to the credit markets.<sup>2</sup>

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AIG has been hit particularly hard by investor concerns over their subprime exposure. The share price dropped to a 52-week low at the beginning of November. AIG has, however, reported to the press that their third-quarter earnings report should provide a window on the extent of their exposure to subprime loans and justify their recent comments that they were "very comfortable" with their US residential mortgage market holdings. This has not stopped the shareholder derivative suit recently brought against the company after it reported losses of more than a billion dollars due at least in part to mortgage-backed securities.

### Where Insurers Might Be Exposed: *Insurance*

Portfolios may be safe for most insurers, but insurance obligations represent a potentially significant exposure.

Credit default swaps, which function like insurance, are one recently disclosed area of concern for major insurers. These are counterparty agreements that allow the transfer of third-party credit risk. Here is an example. A lender faces credit risk from a third party. A counterparty agrees to insure this risk in exchange for regular periodic payments as premium. If the third party defaults, the insurer will have to purchase the defaulted asset from the insured party. In addition, the insurer pays the insured the remaining interest on the debt, as well as the principal.

Swiss Re recently announced a \$1 billion write-down due to two related credit default swaps written by its Credit Solutions unit. Other major reinsurers are calculating their credit default swap exposures following the Swiss Re announcement.

Another major exposure faces insurers who underwrite a substantial amount of Directors & Officers (D&O) coverage.

Claims in the US against directors and officers of financial institutions have started coming as a result of nearly 40 class actions. There will undoubtedly be more. To put this into perspective, there are roughly 200 securities class actions in a typical year.

These securities class actions emanate from share prices dropping as a result of a financial institution's exposure to the subprime market. At first, these suits were predominantly restricted to US subprime lenders and certain real estate investment trusts (REITs). However, it has become apparent that class actions are now touching financial institutions not directly related to subprime loan default exposures. These cases allege that directors failed to disclose their companies' exposures to losses in the subprime market and misled shareholders.

Even the more benign litigation environment in the UK has been affected. Shareholders of Northern Rock formed an action group in order to bring proceedings against company executives alleging that the executives created a false market and therefore misled investors. This was unprecedented in the UK.



In our last *Alert* we reported one analyst's estimate that a worst-case scenario for D&O losses to insurers emanating from the crisis could be \$3 billion. Another equity research team<sup>3</sup> has indicated that losses from subprime exposure to both D&O and Errors & Omissions (E&O) insurers would be closer to \$1 billion. Another opinion<sup>4</sup> has predicted losses in the region of \$6 billion. Whoever is right, these are substantial figures.

The chief factor influencing the ultimate D&O claims hit is the limits purchased. Typically, subprime lenders have bought low D&O limits (not more than \$50 million). US mortgage brokers do not usually buy D&O insurance at all. Some hedge funds have started to purchase D&O insurance (and some E&O), but most do not. The real issue is how many global financial institutions that

buy much higher limits will have class action lawsuits filed against them. The number is set to grow.

Overall, however, the direct losses that professional risks insurers will suffer are not expected to have a disastrous effect on insurer balance sheets. A secondary wave of losses that could be more worrying involves collateralized debt obligations (CDOs). As it is impossible to see through the underlying assets of CDOs, it is not easy to know how much exposure exists and to what extent subprime loans are attached to them. Until the underlying loans start defaulting, it is difficult to measure how individual CDOs will perform. This situation could take a number of years to unfold.

In the meantime, problems in credit could lead to a continuous decline in bond yields, more equity volatility and a general economic downturn. Some commentators have suggested that the total losses over the next five years could reach \$250 billion, while other estimates have ranged from \$150 billion to \$450 billion.

In our next *Alert*, we will look at the worldwide implications of the subprime crisis as well as provide further updates.

### Timeline: A Lesson in the Domino Effect

Following is a partial list of banks around the world that have been affected this year by the turmoil, according to various reports by Reuters and the BBC.

**February 8** – HSBC: Europe's biggest bank, HSBC Holdings, blames soured US subprime loans for its first-ever profit warning in February. On September 21, it announces the closure of its US subprime unit, Decision One Mortgage, and records an impairment charge of about \$880 million.

**April 2** – New Century: The US subprime lender files for Chapter 11 bankruptcy protection in the biggest collapse of a mortgage lender in this crisis.

**July** – IKB & SachsenLB: Two banks in Germany, IKB and state bank SachsenLB, suffer exposure by investing in the US subprime market. The German banking industry bails out IKB, but SachsenLB almost goes under and is quickly sold to state-backed Landesbank Baden-Wuerttemberg (LBBW).

**August 9** – BNP Paribas: The French bank bars investors from redeeming cash in \$2.2 billion worth of funds, telling the markets it is unable to calculate the value of the three funds due to turmoil in the subprime market.

**August 9** – NIBC: The Dutch merchant bank discloses 137 million Euros (\$189 million) of losses on US asset-backed securities in the first half, and shelves plans for an initial public offering indefinitely.

**September 13** – Northern Rock: The British mortgage lender experiences a bank run following a credit crunch sparked by the subprime crisis. The Bank of England steps in to rescue it.

**October 1** – Credit Suisse: The bank says its results will be "adversely impacted" by the market turmoil, but it will remain profitable in the third quarter of 2007.

**October 15** – Citigroup: The largest US bank by market value says third-quarter profit fell 57 percent due to losses, with net income down to \$2.38 billion from \$5.51 billion a year earlier.

**October 19** – Wachovia: The fourth-largest US bank posts a 10 percent decline in third-quarter profit, to \$1.69 billion from \$1.88 billion a year earlier, having suffered \$1.3 billion of write-downs resulting from credit market turmoil.

**October 24** – Merrill Lynch: The financial services giant stuns Wall Street by reporting the biggest quarterly loss in its history after writing down \$8.4 billion, mostly from bad investments related to risky subprime mortgages.

**October 26** – Countrywide: US mortgage lender Countrywide Financial Corp. posts a \$1.2 billion third-quarter loss after writing down \$1 billion in subprime-lending losses.

**October 29** – Mitsubishi UFJ Financial Group Inc.: Japan's largest bank says it will write down the value of subprime-related investments by as much as 30 billion yen (\$260 million) – six times more than previously announced.

**October 30** – UBS: Swiss bank UBS reports a third-quarter pre-tax loss of 726 million Swiss francs (\$624.8 million) after it took a charge of 4.2 billion francs on subprime-related losses in its fixed income investments.

**November 4** – Citigroup: May write off \$8 to \$11 billion of subprime mortgage losses, on top of a \$6.5 billion write-down in its third quarter.

**November 8** – Merrill Lynch: Its exposure to CDOs is now \$15.82 billion or about \$600 million more than what the company revealed in its third-quarter earnings release on

October 24. The figure is larger because a hedge against potential loss was terminated recently after a dispute with a counterparty, which Merrill declined to name.

**November 13** – Bank of America: Writes off \$3 billion in subprime losses.

**November 14** – HSBC: Raised its subprime bad debt provision by \$1.4 billion (£670 million) to \$3.4 billion.

**November 15** – Barclays: Subprime write-downs at Barclays' capital investment bank arm now total £1.3 billion, taking into account a £500 million write-down in the third quarter.

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1 *Reactions Magazine*, October 2007, "Crisis? What Crisis?" Richard Crump

2 *Reuters*, Nov. 2, 2007, "Insurers to Reassure on Subprime Effects," Simon Challis

3 Lehman Brothers Equity Research as reported on [www.insurereinsure.com](http://www.insurereinsure.com), October 19, 2007

4 William Sturge, a partner at law firm LG, quoted in *The Telegraph*, "Sub-prime claims may run to \$6bn," November 21, 2007