

## The Crisis in the Subprime Mortgage Market and the Global Credit Markets: The Impact on E&O Insurers

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### Executive Summary

During February and March 2007, the subprime mortgage industry collapsed. More than 25 subprime lenders announced significant losses, declared bankruptcy, or put themselves up for sale. Now, more than eighteen months later, losses continue to mount. Mortgage delinquencies and defaults have reached record levels and 418 lawsuits have been filed against mortgage brokers and lenders, investment banks, companies investing in securities backed by subprime mortgages, and others involved in the subprime mortgage origination and securitization process. Moreover, the meltdown of the subprime mortgage market has triggered a global credit crisis, which has caused the collapse or near-collapse of several leading financial institutions and has required aggressive intervention by central banks around the world. Losses to directors & officers liability (D&O) insurers are projected by Advisen to be \$5.9 billion, spread over accident years 2007, 2008 and 2009. Losses to errors & omissions (E&O) insurers are expected to be approximately \$3.7 billion. D&O losses will fall most significantly on large publicly traded financial institutions, but E&O losses will be far more widely distributed, with insureds ranging from small mortgage brokers to the largest global diversified financial services companies. Subprime-related E&O losses will add approximately 149 points to the aggregate 2007-2009 financial institution E&O loss ratio, with the greatest impact in 2008.

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### **Findings:**

- **More than \$750 billion in writedowns by companies worldwide**
- **418 subprime-related lawsuits (excluding borrower suits)**
- **\$3.7 billion in expected E&O losses over accident years 2007, 2008 and 2009.**
- **Subprime/credit crisis losses to add 169 points to FI E&O loss ratio in 2007, 233 points in 2008 and 49 points in 2009.**
- **Losses will be borne substantially by a small number of large FI E&O insurers.**
- **Subprime losses are driving up premiums for some segments of the E&O market, but are not sufficient to reverse overall soft market conditions.**

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**About the report:** Primary research for this report was conducted using the Advisen.com information and analysis platform and its underlying databases. Advisen is currently in use by nearly 450 firms including the leading underwriters and brokers of commercial insurance. For more information about Advisen, please contact [info@advisen.com](mailto:info@advisen.com) or +1.212.897.4800 in New York or [London@advisen.com](mailto:London@advisen.com) or +44 (0)20 7929 6929 in London.

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## Introduction

A wave of defaults by US homeowners with tarnished credit histories cascaded through the global financial markets in 2007 and 2008. Mortgage lenders "imploded," hedge funds were forced to close their doors, investment banks collapsed under the weight of subprime mortgage-related losses, a leading insurer was driven to the brink of bankruptcy, and government sponsored mortgage giants Fannie Mae and Freddie Mac were seized by regulators. Forced to write down three-quarters of a trillion dollars in securities backed by subprime mortgages, and with further writedowns likely, financial institutions around the world became far more cautious in their lending, sparking a global credit crisis unparalleled since the Great Depression. Hundreds of lawsuits have been filed, with almost every participant in the subprime mortgage origination and securitization process a potential target.

Media attention has focused on a surge in securities class action suits arising from the subprime mortgage market meltdown and the resultant global credit crisis. To date 124 subprime-related securities class action suits have been filed. Advisen estimates these and other lawsuits resulting in D&O claims will cost insurers \$5.9 billion. Far less attention has been given to the impact of the crisis on E&O insurers. Settlements resulting in E&O losses will, on average, be much smaller than subprime-related securities class action settlements, but in the aggregate, the impact on the insurance industry will be significant: Advisen estimates total insured E&O losses of \$3.7 billion spread across accident years 2007, 2008 and 2009.

An assessment of the impact of the subprime mortgage crisis on the E&O market is more complex than a similar assessment of the D&O market. The broad array of E&O coverages corresponding to the diversity of the entities exposed to liability, differences in insurance buying practices among the classes of insureds, yet-to-be-resolved insurance coverage issues, and uncertainty as to how courts will respond to cases arising from an unprecedented global financial meltdown are among the factors that need to be taken into account. Lawsuits that could trigger coverage under E&O policies are being filed against players in both the mortgage origination process and the securitization process, with defendants ranging from small mortgage brokers to global financial conglomerates. Lawsuits resulting from the subsequent credit crunch also may trigger coverage under E&O policies.

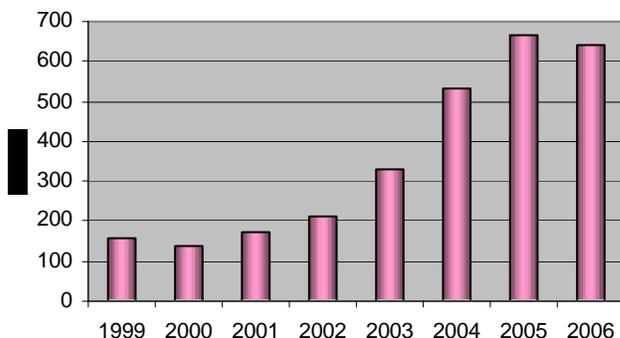
Losses will be largely concentrated in a small number of financial institution E&O insurers: more than 50 percent of the total financial institution E&O volume is written by just three carriers. Losses have sparked rate increases in the FI and real estate E&O sectors, but other parts of the E&O market remain very competitive. Overall soft market conditions throughout the commercial insurance market have been driven by a state of overcapacity, but the combined impact of underwriting losses due to plummeting rate levels, subprime-related losses and higher-than-average natural catastrophe losses, and investment losses resulting from the current global financial crisis has destroyed much of the excess capacity. It now appears that the soft phase of the overall commercial lines market cycle will bottom out by the second quarter of 2009, and a period of rising premiums for all commercial lines including E&O will ensue by the end of the year.

## **The subprime mortgage meltdown and the global credit crisis**

An unprecedented number of defaults by subprime borrowers with adjustable rate mortgages sparked the present crisis in the global financial markets. Subprime mortgages are loans made to borrowers with weak credit histories. Most of the problem

mortgages were originated in 2005 and 2006 when lenders significantly relaxed underwriting standards: between 2001 and 2005 subprime mortgages grew from less than 10 percent of all mortgages originated to more than 20 percent. (Exhibit 1) These adjustable rate mortgages often were structured with low initial “teaser” rates, which ratcheted up to much higher monthly payments after, typically, two years. The expectation was that homeowners would refinance before monthly payments were reset, but falling real estate prices made refinancing impossible for many subprime borrowers,

**Exhibit 1. Subprime mortgage originations**



Source: Hammond Associates

who had little or no equity in their homes. Unable to pay the higher monthly payments, many borrowers defaulted.

Defaults in U.S. mortgages reached record levels in the second quarter of 2007, forcing a large number of subprime mortgage lenders to shut down or file for bankruptcy. The fallout spread quickly throughout the financial markets. Securities whose values were based on the performance of pools of subprime mortgages – typically residential mortgage backed securities (RMBSs) and

collateralized debt obligations (CDOs) – plummeted in value, leading to losses for investors, including investment banks, commercial banks, pension funds, mutual funds, REITs, insurance companies and hedge funds.

Financial institutions and other companies around the world have reported more than \$750 billion in writedowns, and the total continues to grow. In addition to losses stemming from RMBSs and CDOs, companies were forced to write down investments in mortgage lenders, hedge funds, bond insurers and other companies deeply – and sometimes fatally – wounded by the subprime mortgage crisis. Another significant source of losses has been credit default swaps. A credit default swap is much like an insurance policy guaranteeing the performance of another security. Collateral calls under credit default swaps tied to subprime mortgage-backed securities drove insurance giant American International Group (AIG) to the brink of bankruptcy in September before the federal government stepped in with an \$85 billion loan. Although subprime mortgage defaults were largely a US phenomenon, the financial impact has been global. More than 60 percent of the companies reporting writedowns are non-US.

The damage hasn't been limited to losses arising directly from the meltdown of the subprime mortgage market. Nervous lenders, shaken by massive writedowns and a lack of liquidity for securities tied to mortgages, have tightened lending criteria for all customers, leading to a credit crunch, global in scope, and of a magnitude not seen since the Great Depression. Venerable firms are now defunct or have been acquired, while others sit on the brink of collapse, holding on through the support of the Federal Reserve and Treasury Department. Some of the major events of 2008 include:

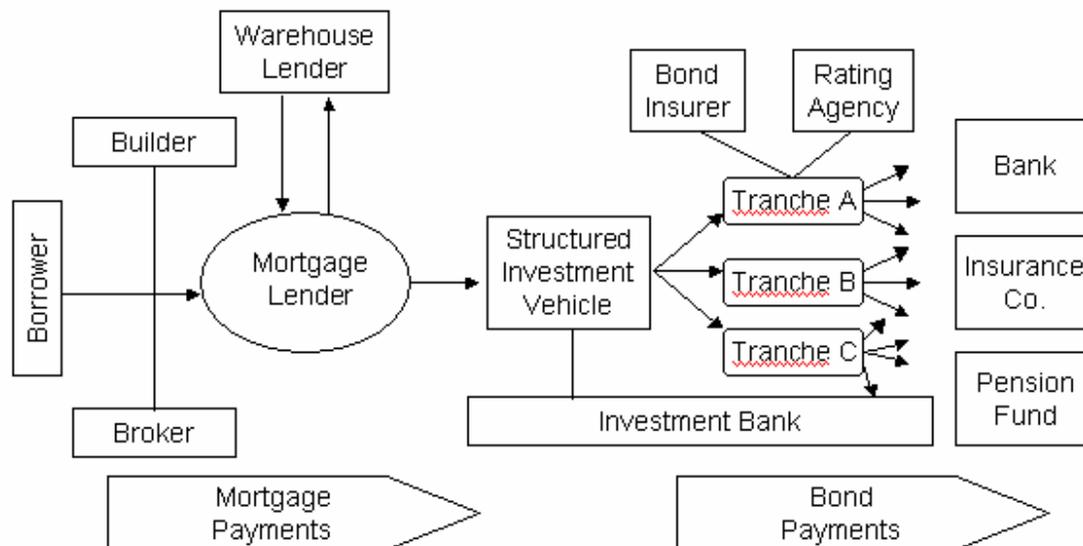
- March – JP Morgan Chase acquired Bear Stearns for \$1 billion, supported by a \$30 billion line of credit from the Federal Reserve.

- September – Fannie Mae and Freddie Mac, government-sponsored enterprises, were taken over by a conservatorship created by the Treasury Department.
- September – Lehman Brothers filed for bankruptcy.
- September – Bank of America acquired investment banking giant Merrill Lynch for \$50 billion.
- September – The Federal Reserve gave an \$85 billion bridge loan to troubled insurer AIG, saving it from bankruptcy but requiring it to sell most of its operations.
- September – Goldman Sachs and Morgan Stanley, the remaining independent large investment banks, applied to the Federal Reserve to act as commercial banking holding companies.
- September – As Washington Mutual failed, the Federal Reserve brokered the sale of its assets and deposits to JP Morgan Chase for \$1.9 billion.
- October – Wells Fargo acquired the ailing bank Wachovia for \$15.1 billion.
- October – The U.S. Congress approved a \$700 billion rescue plan.
- October – The Federal Reserve and Treasury Department helped to broker the final agreement by Mitsubishi UFJ Financial Group to invest \$9 billion into Morgan Stanley.

## Mortgage origination and securitization processes

Exhibit 2 is a graphic representation of the mortgage origination and securitization process, beginning with individual homeowners and ending with institutional investors that purchased securities with values based on the performance of pools of subprime mortgages.

**Exhibit 2. The mortgage origination and securitization process**



In the past, mortgage lenders were likely to be community banks or savings & loan associations that not only originated loans, but also serviced them and kept them on their own books. In the typical scenario underlying the subprime mortgage market meltdown, mortgage lenders finance loans with short-term debt from so-called “warehouse lenders,” knowing that the mortgages will be quickly sold. The mortgages are pooled in mortgage trusts, and securities based on the performance of these pools of subprime mortgages are created and sold by investment banks. These securities are typically structured in tranches: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). The top tranches are frequently insured by bond insurers – “monolines” – to assure their AAA rating. Buyers of these securities included commercial banks, pension funds, mutual funds, insurance companies and hedge funds. In many cases investment banks kept the equity and lower rated tranches to make the vehicles work.

## Sources of E&O claims

Almost every party involved in the loan origination and securitization machine that financed the housing boom of the recent past is a target for lawsuits including:

- mortgage brokers who solicited borrowers,
- mortgage lenders who originated the loans,
- warehouse lenders that financed mortgage lenders,
- investment banks that pooled the loans and transformed them into securities,
- rating agencies that rated the securities, and
- bond insurance companies that guaranteed the securities.

Lawsuits against brokers and lenders often allege violations of the Truth in Lending Act, the Fair Housing Act, the Real Estate Settlement Procedures Act and state consumer protection laws, to list but a few. Many of the lawsuits relating to the loan securitization process allege misrepresentation of the type or quality of the assets backing a security, or misrepresentation of the liquidity of the market for a security. Subprime borrowers at one end of the chain, and investors in CDOs and other mortgage backed securities on the other, comprise a substantial number of the plaintiffs in subprime-related lawsuits, but the various players in the loan origination and securitization processes are also suing one another.

### *Mortgage brokers*

The number of lawsuits by borrowers against mortgage brokers may ultimately total in the thousands. Many of these suits allege some form of inadequate disclosure; typically some supposed failure by the broker to fully disclose the way a loan operates and the risks being assumed by the borrower. In suits against two mortgage brokers, Illinois Attorney General Lisa Madigan accused the brokers of putting borrowers in mortgages knowing that the borrowers would be unable to repay the loans. According to the suits, homeowners were enticed by low monthly payments and teaser interest rates, but were not told that making the advertised payments would actually lead to an increase in the loan balance, or “negative amortization.” In some cases plaintiff attorneys argue that mortgage brokers have a fiduciary duty to explain all purchasing and borrowing options, and to give homebuyers recommendations based on the buyers' best interests. Recently,

a number of suits against mortgage brokers allege they took advantage of desperate subprime borrowers through bogus "rent-to-own" and "foreclosure rescue" deals.

Broker motivation and compensation structures have come into the spotlight with the meltdown of the subprime mortgage market. Mortgage lenders often pay brokers a bonus for steering customers into above-market interest rate loans, and it has been alleged that some brokers encouraged borrowers that could have qualified for more favorable prime mortgages to accept punitive subprime loans.

Mortgage brokers also may be targeted in lawsuits by lenders. In one case a mortgage lender allegedly based a loan decision on forged loan documents, including bank statements and tax returns, from a prospective borrower. The borrower defaulted and the lender sued the broker, claiming the broker was negligent by not validating bank statements and other documents provided.

Mortgage brokers, which operate in the loan origination world, are also being dragged into litigation in the realm of loan securitization. Lehman Brothers, a major player in the securitization market, is suing several mortgage lenders and brokers, claiming loans acquired by Lehman were of dubious value. Lehman alleges that borrowers' incomes were overstated, appraisals were inflated and the homes were in poor condition.

#### *Mortgage lenders*

The Mortgage Lender Implode-O-Meter (<http://ml-implode.com/>), a favorite website of those morbidly obsessed with the on-gong train wreck of the subprime mortgage market, lists 299 major US lending operations that have "imploded" since late 2006. According to Aaron Krowne/Krowne Concepts Inc., which maintains the site: "The 'imploded' status is somewhat subjective and does not necessarily mean operations are ceased permanently: it can mean bankruptcy filing, temporary but open-ended halting of major operations, or a 'firesale' acquisition." An important cause of mortgage lender implosion is a requirement of investors that the lender buy back loans that go bad within a specified period of time. With the rash of defaults in 2007 and 2008, many subprime mortgage lenders were unable to fulfill repurchase provisions and were forced out of business.

Subprime mortgage lenders have been targeted in lawsuits concerning both the loan origination process and the loan securitization process. Plaintiffs include borrowers, state attorneys general, investment banks, investors in mortgage-backed securities, municipalities and even the National Association for the Advancement of Colored People (NAACP). Allegations range from deceptive or unfair trade practices to racial discrimination to violations of contractual repurchase agreements to misrepresenting the quality of mortgages sold to sponsors or arrangers of mortgage-backed securities.

Lawsuits brought by borrowers against lenders frequently allege misrepresentation or failure to disclose critical loan provisions in violation of common law and various state and federal statutes. According to Daniel J. Callahan and Edward Susolik of law firm Callahan & Blaine: "We are currently seeing a new wave of claims of non-disclosure or late disclosure of loan details such as ARM terms, interest rates, negative amortization, and more. The current trend in unlawful foreclosure litigation is shifting towards problems with the origination of a loan that made it 'unsuitable' for the borrower in the first place. Class actions are pending against lenders on behalf of consumers who say they were duped by the loans' terms and ended up facing foreclosure or unexpectedly high mortgage payments."<sup>1</sup>

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<sup>1</sup> "The Mortgage Lending Meltdown: Pending Litigation and Insurance Issues," p.2

Allegations of predatory or discriminatory lending practices are at the core of a number of suits filed against lenders. The NAACP filed a federal class action lawsuit against 14 large subprime mortgage lenders, citing studies that conclude blacks receive higher-interest subprime loans much more often than their white counterparts. The City of Baltimore filed a lawsuit alleging that Wells Fargo targeted minorities for subprime loans in violation of federal fair housing laws, leading to a spate of foreclosures in the city. The city of Cleveland sued 21 banks, claiming subprime mortgage lending in inner-city neighborhoods created a public nuisance that hurt property values and city tax collections. Massachusetts Attorney General Martha Coakley filed a lawsuit against Option One Mortgage Corp., charging the subprime lender with discrimination against blacks and Latinos by targeting them for subprime mortgages and by charging higher application fees than it charged white customers. The lawsuit also claims that Option One engaged in unfair and deceptive lending practices when selling the loans.

Mortgage lenders have been sued for allegedly failing to fulfill loan repurchase provisions, and for misrepresenting the quality of loans sold into the securitization market. Repurchase provisions apply if a borrower defaults within a specified period of time or if a loan fails to meet agreed upon underwriting standards. In addition to buyers of mortgages, bond insurers and mortgage insurers also are putting pressure on lenders for faulty or fraudulent underwriting. Bond insurer Ambac Financial Groups is analyzing home equity loan deals to see whether it has grounds to demand that banks repurchase loans in those pools. Units of mortgage insurer PMI Group Inc. allege in a lawsuit that lender WMC Mortgage Corp. breached the "representations and warranties" it made for a pool of subprime loans that were insured by PMI in 2007. The delinquency rate for the pool of loans had climbed to 30 percent within eight months, according to the suit. Rating agency Fitch, which conducted an analysis of subprime defaults in 2007, concluded that lax underwriting and fraud may account for as much as one-quarter of the underperformance of subprime RMBS transactions from 2006.

In addition to the mortgage lenders themselves, owners of mortgage lenders, including investment banks and money center banks, also may be exposed to loss for fraudulent activities of the lender.

#### *Warehouse lenders*

Warehouse lenders provide short-term financing to mortgage lenders. Warehouse lenders are at risk of being dragged into suits by borrowers against mortgage lenders under aiding and abetting theories. In a relevant California case that predates the meltdown of the subprime mortgage market, *In re First Alliance Mortgage Co.*, a lender – Lehman Commercial Paper – was alleged to be liable for the action of a mortgage company – First Alliance Mortgage Company (FAMCO) – to which it provided underwriting services and a credit facility. The plaintiffs claimed FAMCO engaged in deceptive and illegal practices in violation of consumer protection laws, and Lehman Commercial Paper was vicariously liable for the fraudulent lending. In ruling against Lehman's motion to dismiss, the court acknowledged Lehman did not make any false representations itself, and did not do anything to market the scheme to the defrauded creditors. Instead, Lehman was alleged to have had knowledge of the scheme through its due diligence and to have aided the scheme by providing a credit facility to FAMCO from which the fraudulent loans were made. The court further noted Lehman profited from the credit that it extended to FAMCO. Because Lehman's credit facility made the borrower's fraudulent practices possible, the court ruled this satisfied the criteria for an aiding and abetting claim. In 2003, a federal jury held Lehman Brothers liable for \$50.9 million for aiding and abetting FAMCO's fraud on borrowers.

Warehouse lenders also are potentially exposed to suits by mortgage lenders claiming that the warehouse lender improperly imposed a margin call or withdrew a credit line in violation of contractual agreements. Mortgage loans on the books of mortgage lenders serve as collateral for warehouse credit facilities. When loans begin to lose value because of increased defaults, banks typically issue a margin call and demand more collateral be put up or a portion of the credit line be repaid. Many subprime lenders were forced to sell loans cheap – sometimes at a loss – to raise cash to meet margin calls. “These increased margin calls resulted in more distressed sales which, in turn, put further downward pressure on whole loan sale prices, regenerating the cycle with escalating negative results,” according to mortgage lender Accredited Home Lenders Holding Co. in its annual report. “In order to obtain cash to satisfy a margin call or net loss payment obligation, we may be required to liquidate assets at a disadvantageous time, which could cause us to incur further losses.”

### *Investment banks*

Investment banks are the brains and the brawn of the modern subprime mortgage machine, touching virtually every step of the origination and securitization process. Most of the large investment banks owned subprime mortgage lenders, and supported others through repurchase agreements and warehouse credit facilities. Investment banks also were largely responsible for pooling mortgages and structuring and selling securities based on the performance of those pools of mortgages. Ten investment banks served as underwriters for 70 percent of the \$486 billion in subprime mortgage securitizations in 2006. In many cases, investment banks also were purchasers of securities, providing necessary liquidity to certain segments of the market, and were counterparties to various derivatives and swaps.

As a result of their diverse activities, investment banks have been, or likely will be, targeted in lawsuits by players in virtually every step of the origination and securitization process, from subprime borrowers to some of the most sophisticated investors in the world who purchased subprime mortgage-backed securities, and now are claiming to have been misled about the nature of and amount of risk in the investments.

In one closely followed case which was filed prior to the subprime meltdown, Bankers Life Insurance filed a suit against Credit Suisse, the Bank of New York and other defendants that served as trustees for bondholders of several investment-grade mortgage-backed securities originally packaged by Credit Suisse in 2001, as well as companies that insured the bonds and serviced the underlying loans. The securities suffered multiple credit downgrades as the result of increasing delinquencies and default, and Bankers Life ultimately lost most of its investment. The complaint alleges that Credit Suisse misrepresented the quality of the underlying loans and even took actions to disguise the increasing delinquencies in the pool.

Investment banks also have been victims of the subprime meltdown and of the ensuing global credit crisis. In March, Bear Stearns was forced to sell itself to JPMorgan Chase for \$1 billion, supported by a \$30 billion line of credit from the Federal Reserve. The collapse of Bear Stearns was triggered by the failure of two highly leveraged hedge funds under its management that were heavily invested in collateralized debt obligations. Subprime-related losses also forced Lehman Brothers to file for bankruptcy in September. Barclays acquired its North American capital markets businesses for \$1.75 billion, and its Asian operations were acquired by Japan's No. 1 broker, Nomura Holdings, for \$225 million. Nomura also purchased Lehman's European and Middle East operations. Also in September, Goldman Sachs and Morgan Stanley, the remaining independent large investment banks, applied to the Federal Reserve to act as a

commercial banking holding company. This represents a tide shift away from the risks of pure investment banking, and a move toward the safety of deposit-oriented liabilities and a comprehensive regulatory structure.

#### *Commercial banks and diversified financial services firms*

Many of the largest banking groups such as Citigroup and Wells Fargo own large wholesale mortgage operations, and are actual and potential targets for lawsuits in that role. Bank of America has been in the center of a litigation maelstrom after purchasing subprime mortgage lender Countrywide Financial in June. Facing a lawsuit over deceptive mortgage practices, Countrywide and Bank of America recently agreed to a settlement negotiated by Attorneys General of Illinois and California that could cost the company \$8.7 billion in relief to 400,000 borrowers nation wide.

Commercial banks also can function as warehouse lenders and have exposure to loss from that activity. Some commercial banks also are in the business of packaging mortgage loans into securities.

Some of the largest banking groups such as UBS and Citigroup – sometimes known as “universal banks” – have been targets in lawsuits concerning auction rate securities. These securities – for which the interest rate is set by regular auctions – were sometimes marketed as highly liquid alternatives to money market funds. When credit markets froze, auctions failed, leaving many investors holding illiquid securities.

#### *Credit rating agencies*

Thus far, credit rating agencies have been successful in fending off lawsuits from disgruntled investors claiming to have lost money by relying on credit ratings. The agencies have successfully argued that the First Amendment protects their rating activities as opinions of creditworthiness – “the world’s shortest editorial,” according to the general counsel of Fitch in testimony to the Senate committee investigating the fall of Enron. The extraordinary circumstances surrounding the meltdown of the subprime mortgage market, and the key role played by rating agencies, have prompted a new round of lawsuits against the agencies that may challenge, or circumvent entirely, the First Amendment defense. In addition to shareholder suits alleging violations of federal securities laws, plaintiffs have, or are expected to, assert claims under state statutes, common law fraud and common law negligent representation. Credit rating agencies also have been target for investigations by Congress, the SEC and various state attorneys general in the US, and by regulatory bodies throughout the world.

Credit rating agencies are facing allegations that the way they are compensated – they are paid by the entities issuing the rated securities – results in unacceptable conflicts of interest. An investigation by the SEC found that conflict of interest issues were exacerbated in the rating of RMBSs and related CDOs. “The arranger is often the primary designer of the deal and as such, has more flexibility to adjust the deal structure to obtain a desired credit rating as compared to arrangers of non-structured asset classes”, according to the SEC’s report of the investigation. “As well, arrangers that underwrite RMBS and CDO offerings have substantial influence over the choice of rating agencies hired to rate the deals.” A suit filed by Abu Dhabi Commercial Bank over the collapse of a structured investment vehicle claims that Moody’s and Standard & Poor’s were paid three times the fees they would get from typical corporate bond ratings, and that they were paid only if they provided an investment grade rating and the deal closed with that rating.

### *Bond insurers*

Bond insurance companies – so-called “monolines” – have been battered by the subprime meltdown, with almost all losing their coveted triple-A ratings. Monoline insurers guaranty the payment of interest and principal by bond issuers. Through the insurance mechanism, monolines essentially lease their ratings to bonds that otherwise would have been lesser rated. Originally, monolines focused principally on municipal bonds, but in recent years they expanded their scope to asset-backed bonds and CDOs, including bonds whose value is determined by the performance of pools of subprime mortgages. When a monoline is downgraded, bonds insured by that company must be re-rated and, in most cases, downgraded as well.

Downgrades will not be the only cause of lawsuits against monolines arising from the subprime crisis. The suit by Bankers Life against Credit Suisse and others noted above also lists insurer Triad Guarantee Insurance as a defendant, and is illustrative of the type of suit monolines may face. Triad Guaranty, which functioned both as a primary mortgage insurer and as an insurer of the mortgage-backed securities purchased by Bankers Life, declined to pay claims for loans that defaulted because it said they were fraudulent. Bankers Life alleged it had relied upon the "credit enhancement" supplied by Triad's insurance coverage in choosing to invest, but that the insurance coverage was illusory.

### *Other litigation targets*

Other actual and potential targets of subprime-related lawsuits that may trigger coverage under E&O policies include:

- Real estate appraisers that allegedly conspired with mortgage lenders to fraudulently inflate the appraised values of properties;
- Real estate developers and brokers that steered potential buyers into subprime mortgages;
- Lawyers who represented buyers in subprime mortgage origination transactions or who drafted documents for securitization transactions;
- Auditors involved in setting appropriate valuations for subprime-backed assets;
- Securities brokers that allegedly misrepresented the amount of risk in auction rate securities;
- Fund managers that made allegedly inappropriate investments in subprime mortgage-backed securities; and
- Investment advisers that steered investors into funds or other investments that were adversely impacted by the subprime crisis.

### *Investigations by regulatory and law enforcement agencies*

In addition to the lawsuits filed to date, dozens of investigations launched by regulatory agencies and law enforcement officials around the world could result in more lawsuits and could complicate the defense of many suits already filed. Among those investigations that could impact either or both D&O and E&O policies are:

- More than 48 investigations by the US Securities and Exchange Commission;
- Investigations by attorneys general of New York, California, Illinois, Massachusetts, Connecticut, Ohio and other states;

- The FBI's Subprime Mortgage Industry Fraud Initiative, which has resulted in investigations into 21 firms involved in the subprime mortgage industry;
- Examinations of nearly 40 brokerages by the Financial Industry Regulatory Authority to determine whether the firms were aware of the problems in the auction rate securities market and adequately warned customers about the risks;
- European Commission investigation into rating agencies;
- An investigation by the UK Financial Services Authority into the UK subprime market, which referred five firms for enforcement actions; and
- Investigations by authorities in Germany, Switzerland, France, Japan, South Korea and Singapore.

## Subprime exposures and the E&O insurance market

E&O insurance is available to every type of entity involved in the mortgage origination and securitization process. However, exposures and coverage issues vary widely by class of insured and type of policy. Additionally, buying practices differ substantially: penetration is high in some classes of insureds, but in others insurance coverage is uncommon. Coverage issues also vary by class of insured and type of policy.

### *Mortgage brokers*

Mortgage brokers placed about two-thirds of subprime mortgages, and it is likely that most brokers placed mortgages for at least some subprime borrowers.

According to a study by Wholesale Access Mortgage Research & Consulting, Inc., there are approximately 53,000 mortgage brokerage companies in the US in 2004. According to David Olson, a managing director of Wholesale Access, the number is expected to fall to 38,000 in 2008. The Wholesale Access tabulation does not differentiate between active brokers and those in "hibernation," nor does it differentiate between those doing mortgage origination and those doing only refinancing. For purposes of this analysis, the 25,000 members of the National Association of Mortgage Brokers was used to represent the universe of active mortgage brokers.

According to Advisen's Program Benchmark database of 1.2 million insurance programs, the average mortgage broker carries \$1.275 million in E&O limits. Most banks require that vendors, including mortgage brokers have E&O insurance – typically \$1 million limit. Assuming 85 percent of the 25,000 brokers carry E&O insurance, as much as \$27 billion in limits may be exposed to subprime-related losses.

Undoubtedly, coverage disputes will abound as subprime-related lawsuits against mortgage brokers pour in. While the application of some exclusions is reasonably clear, others such as the Intentional Acts exclusions are far more subjective in their interpretation.

Mortgage broker E&O losses tend to be small, with settlements typically in the tens of thousands of dollars. However, there are conceivably thousands of suits filed, or to be filed, against mortgage brokers, and this segment is expected to be one of the largest contributors to total insured subprime-related E&O losses.

### *Mortgage lenders*

For purposes of this analysis, the 299 mortgage lenders that have "imploded," according to The Mortgage Lender Implode-O-Meter, are assumed to represent the universe of

subprime mortgage lenders at risk for subprime-related E&O claims. According to Advisen's Program Benchmark database, the average policy limit for mortgage lenders is virtually identical to that of the average mortgage broker, \$1.275 million. However, many of the lenders involved in subprime lending were among the largest players in the market, and we have assumed that 20 percent of subprime mortgage lenders carried an average limit of \$22 million, the average for commercial banks. Assuming 100 percent of mortgage lenders carry E&O insurance, more than \$1.5 billion of mortgage lender E&O limits are at risk.

Lenders are under assault from all sides, with borrowers, municipalities, state attorneys general, buyers of mortgages and investors in mortgage-backed securities numbering among the actual and potential plaintiffs. As a result, we have assumed in our "probable" insured loss scenario that 90 percent of the 296 lenders will have a full policy limit loss.

#### *Banks and diversified financial services companies*

Many of the largest diversified financial services firms and commercial banks are self-insured for their professional liability exposures. Of commercial banks in Advisen's Benchmark Database with banker or mortgage banker & broker E&O coverage, the average policy limit is \$22 million. We estimate an "all in" exposure of \$5.5 billion from this sector.

#### *Investment banks*

Investment banks are besieged with lawsuits arising from their myriad roles in the subprime mortgage origination and securitization processes. Of the investment banks in Advisen's Program Benchmark database that buy E&O coverage, the average policy limit is \$100 million. However, most investment banks are self-insured for this exposure. While insured investment banks that have been sued can probably expect full limits losses, the impact on the insurance industry should be limited.

#### *Coverage issues*

Insurance coverage issues will loom prominently in subprime E&O claims. Lawsuits are rife with allegations of fraud, and "conduct exclusions" undoubtedly will be invoked, especially when criminal suits are brought against some of the same individuals involved in civil suits. Other terms and conditions may give rise to coverage disputes include prior acts exclusions (did the "wrongful acts" begin prior to the coverage period?), the known loss exclusion (did any insured know or was able to foresee prior to the policy period that a claim was likely?), and interrelated wrongful acts provisions (all related claims deemed to fall only in the policy period of the first claim). In some cases insurers may move to rescind coverage, alleging material misrepresentations in applications.

## **Expected losses**

#### *Methodology and loss forecast*

Expected losses were forecast using a loss frequency and severity model separately for mortgage brokers, mortgage lenders, investment banks, securities brokers, commercial banks, rating agencies, and "other." Using total exposure units, the number and type of suits filed to date from Advisen's MSCAd database, estimates of unreported losses, dismissal and settlement trends, average policy limits from Advisen's Program Benchmarking database, and estimated loss adjustment expenses for both dismissed and settled claims, a range of estimates were generated.

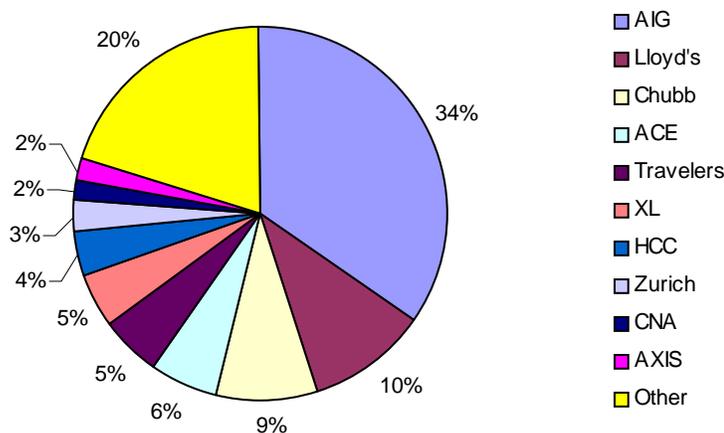
Expected losses are \$3.7 billion, with the range of outcomes extending from \$2.4 billion to \$4.9 billion. Under the “probable” scenario, “mortgage brokers” is the category producing the greatest volume of losses, \$1.5 billion, due to the very high number of lawsuits by borrowers. Although relatively few investment banks carry E&O insurance, the high limits carried by the estimated 35 percent that do buy protection, and the expectation that those high limits will be exhausted, make the category a strong second at \$1.0 billion for insured losses under the “probable” scenario.

*Market share*

Subprime-related E&O losses are likely to be borne largely by a small number of large insurers. Based on \$340 million of financial institution E&O program premium from Advisen’s Program Benchmark Database of 1.2 million insurance programs, the top ten writers account for about 80 percent of the total premium written, and the top three have more than 50 percent market share. (Exhibit 3)

These figures are derived from policy information compiled by Advisen from risk managers and brokers. While the sample is large, and we believe them to be largely unbiased, they are nonetheless samples, and may not be fully representative of the entire market. In addition, market share rankings do not reflect individual company underwriting criteria that may leave them more exposed or less exposed to losses from the subprime meltdown.

**Exhibit 3. Market share of financial Institution E&O writers.**



Source: Advisen Benchmark Database

Many of the large financial institution E&O insurers also have substantial books of financial institution D&O business, a line that also is highly exposed to losses from the meltdown of the subprime mortgage market and the credit crisis. As a result, these companies have a significant aggregation exposure, and as a result may have reinsurance recovery issues. Under some reinsurance program structures, all losses from the same underlying event are aggregated and subject to a single treaty limit. The combined impact

of insured D&O and E&O losses is similar in magnitude to property insurance losses from Hurricane Ike in 2008.

## Impact on pricing

Subprime-related E&O losses will be distributed principally over accident years 2007 and 2008, with some spillover into 2009. Most of the losses – approximately \$2.2 billion of the forecasted \$3.7 billion – will fall in 2008. E&O earned premium for US insurers is approximately \$5.5 billion, meaning that subprime E&O losses will add approximately 40 points to the 2008 industry E&O loss ratio, and approximately 35 loss ratio points to the cumulative 2007-2008 loss ratio. Of the \$5.5 billion in total E&O premium, about \$945 million is derived from financial institutions, based on input from financial institution E&O carriers. Consequently, that segment of the E&O market will see its 2008 loss ratio decimated by 233 points of subprime and credit crisis losses.

The liquidity crisis faced by AIG, the largest writer, by far, of financial institution E&O, is having a short-term impact on E&O pricing. AIG was on the brink of bankruptcy as the result of collateral calls under credit default swaps written by a financial services unit not affiliated with the insurance operations. In September, the company was rescued by an \$85 billion loan from the federal government. Although the balance sheets of AIG's insurance subsidiaries were not affected, some nervous policyholders sought to immediately replace AIG on their programs. According to anecdotal accounts, this panicked "flight to quality" resulted in some insureds paying higher premiums for their programs. However, according to an Advisen survey of risk managers, two thirds of insurance buyers claim to be "very confident" or "somewhat confident" in the financial security of the AIG insurance companies. Although 71 percent say they plan to get quotes from AIG's competitors at the renewal of their AIG policies, it seems likely that many can be persuaded to stay with AIG, though probably at lower premiums. Savvy risk managers should be able to negotiate favorable terms with AIG or its competitors, potentially resulting in a short-term intensification of soft market conditions in some segments of the E&O market.

While painful, subprime-related losses are unlikely to have more than a localized impact on E&O pricing. Driven by a state of overcapacity, which has led to increasingly cutthroat competition, rates have been falling in most lines of commercial insurance, including E&O, since 2004. While companies in the financial services and real estate sectors are seeing sharply higher premiums – if coverage is available at all – competitive conditions in other sectors of the market have prevailed. Broader market forces – most particularly underwriting losses from a combination of depressed rate levels and higher-than-average property catastrophe losses, along with investment losses arising from the global credit crisis and plunging stock markets – are likely to cause the soft phase of the overall pricing cycle to bottom out by the second quarter of 2009, with a period of rising rates beginning by the end of the year.

## Analysis and conclusions

Advisen's analysis of the impact of the subprime mortgage market meltdown on the E&O market assumes that there will be spillover into 2009, but that the majority of E&O losses will be incurred in 2007 and 2008. This assumption is based largely on four factors: (1) the meltdown of the subprime mortgage market, rather than the ensuing credit crunch, will be the principal driver of E&O claims, (2) the bubble in mortgage payment resets falls

across 2007 and 2008, and virtually disappears in 2009; (3) having been through two underwriting renewals since the beginning of the subprime crisis, the most highly exposed companies are unlikely to have E&O coverage for subprime-related claims in 2009; and (4) interrelated wrongful acts policy provisions will allocate 2009 events to 2007 or 2008 policy periods for companies experiencing multiple suits related to the subprime crisis.

Nonetheless, forces at work could prolong the bloodbath. Real estates prices continue to fall in many areas which, combined with rising unemployment, is likely to keep mortgage defaults rates at elevated levels, even on prime mortgages. According to an August, 2008 Standard & Poor's report, since June total delinquencies on prime "jumbo" loans and "Alt-A" loans made in 2007 rose at rates of 7.3 percent and a 9.12 percent, respectively, outpacing the increase in delinquencies on subprime mortgages. These loans require less proof of ability to repay, but were made to borrowers with credit scores above the subprime threshold. This could trigger suits against mortgage brokers and lenders that had thus far avoided the subprime debacle. Additionally, while impact of a deepening credit crunch would likely be felt more by D&O insurers than by E&O insurers, the fallout could spread over segments of the E&O market. Some analysts predict more than 100 banks will fail, which could lead to E&O claims for those banks that had been able to renew coverage in 2009.

The impact of insured subprime-related losses to the commercial insurance market is significant, but until very recently it has been absorbed and offset by favorable experience in other lines of business. The US commercial insurance market posted an underwriting profit in 2007. Analysts predict, excluding monoline insurers, property & casualty insurers will end 2008 with a small underwriting loss. Subprime losses will fall largely on D&O and E&O underwriters, but even within these specialized lines of business, companies in sectors other than financial services and real estate are still largely viewed favorably. Aside from financial services and real estate risks, insurance buyers can anticipate substantial capacity and robust competition for their business through 2008, but deteriorating underwriting results combined with investment losses portend the end of the soft commercial insurance market in 2009.



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