The Subprime Crisis

The meltdown in the US subprime mortgage marketplace has dramatically impacted individuals and financial institutions around the world. Our Alert examines the moving parts — subprime lending, mortgage-backed securities, the US housing market, the general movement of interest rates and marketplace liquidity — examining implications for individual borrowers, the world of finance and the insurance marketplace. Repercussions continue, and clearly, ongoing events make it premature to speculate how this will end. We will report significant developments and challenges in subsequent Alerts.

We begin our discussion with a review of what is at the root of the crisis — subprime lending and mortgage-backed securities — and how such activities could ultimately affect the worldwide financial markets.

What Is Subprime Lending?

Subprime lending refers to the practice of lending to home buyers with less than stellar credit histories who cannot obtain financing in the usual (prime) market. Individual subprime borrowers generally have a credit score of 620 or lower. This risk has been notched up recently with subprime lending utilizing more hazardous types of loans, including variable interest rate loans, interest-only payment loans and loans with little to no money down. One estimate is that 14 percent of the US residential mortgage market is subprime.

What Is a Mortgage-Backed Security?

A mortgage-backed security is a security which is backed by a share in a pool of mortgages, either residential or commercial. As with a bond, investors receive interest and a part of the principal each month. The cash flow is backed by the property owner’s mortgage payments. This type of security is also referred to as Collateralized Mortgage Obligations (CMOs).

These are similar to Asset Backed Securities, which are securities backed by receivables other than real estate, such as car payments and credit card debt payments. These can also be referred to as Collateralized Debt Obligations (CDOs).

The Securities Industry and Financial Markets Association estimates that the amount of mortgage-related securities issued by Wall Street banks was $773.1 billion in 2006 and $645.3 billion in 2005. Today they are held by financial institutions and institutional investors around the world.
What Went Wrong?
The combination of a slumping US housing market and increasing interest rates has led to the woes in the subprime lending market. Since much of the subprime lending was based upon variable interest rates, many borrowers experienced unexpected increases in their monthly mortgage payments as rates increased. Once the housing market began to cool, but interest rates continued to climb, these loans were put under tremendous pressure.

A major US bank has estimated that in 2007, $500 billion of adjustable mortgage loan rates will be increased by an average of two percent. Compounding the plight of the subprime borrowers is the fact that in many of these cases, the value of the home they are struggling to pay off is simultaneously declining.

Such a confluence of events has proved too much for many subprime borrowers (who by definition are less credit-worthy) leading to skyrocketing loan defaults. An industry tracking source indicated that foreclosure activity in the first half of 2007 was up 55 percent from 2006 and that foreclosures for the month of July rose 93 percent from the prior July, and 115 percent from the prior August. At present, 43 states have reported an increase in foreclosure activity in 2007.

Looking at the Lender / Investor Side
Many of the mortgage-backed security portfolios contain some degree of subprime loans, and the increased foreclosure activity has directly impacted the value of these portfolios. The weakening subprime lending market has led many financial institutions to write down the value of the portfolios containing subprime loans, resulting in billions of dollars of losses.

The initial impact was a direct hit upon the investors in these types of securities, mostly consisting of institutional investors such as banks, hedge funds, pension funds, insurers, sovereign states and other financial institutions.

The fallout continued to spread rapidly as uncertainty regarding subprime losses impacted the financial markets. While many CMO portfolios contain subprime lending, the full extent and exact nature of the subprime risk are often not apparent or available until the managers acknowledge their losses. The uncertainty as to where these losses are has led to the markets’ inability to accurately price these types of securities, which in turn has caused the market for them to dry up.

What Is the Impact?
The impact of the credit crunch has been broad. Banks and lending institutions have seen their stock value plunge over the past few months. Increased credit costs have affected their bottom lines, causing many to revise their earning estimates downward. Several companies have already taken significant losses. Many lenders have closed their subprime operations completely and curtailed their non-conforming or ‘jumbo’ loan
activities (both prime and subprime) because of their inability to sell these larger loans in the secondary market.

Another sector hard hit has been hedge funds, with many reporting double digit to full value losses. Funds have taken steps varying from suspending withdrawals, selling off certain positions, seeking alternative financing sources, restructuring funds and their management teams to completely shuttering their operations. The impact has been broad enough that one major financial institution had to close one of its funds that had little to no subprime exposure, because bad publicity in other funds it managed resulted in a run on the solvent fund.

Not to be left out, the private equity sector has also experienced the credit crunch, which has disrupted financing and resulted in a slow down, causing cancellation, or substantial re-writing of some significant deals.

Many have predicted that the insurance industry will be faced with potentially large management and professional liability losses, and a leading title insurer has reported that the downturn in the real estate market resulted in a 52 percent increase in the amount of claims paid in the second quarter of 2007 as compared to 2006.

The Impact Beyond the World of Finance
The impact is not limited to financial services firms, with industries as diverse as the automotive, manufacturing, food services, media and energy all suffering consequences. In these industries, the credit crisis has either delayed or cancelled bond offerings, spin-offs and acquisitions or simply made these transactions more costly than originally planned.

The fallout continues with new subprime-related problems being reported daily. The extent to which this will spread is unclear; opinions vary from prophesies of financial Armageddon to questions of what the fuss is all about.

How Has the Insurance Market Responded?
As noted in the mid-year edition of Willis’ Marketplace Realities – 2007, the new hot topic for plaintiffs’ law firms has migrated from options backdating to subprime lending. As opposed to the options backdating scandal, however, the subprime lending meltdown involves substantial investor losses, which leads to an increase in claims. Although the subprime mess has not yet generated the frequency of claims that options backdating has, one analyst has estimated that a worst case loss scenario for Directors & Officers (D&O) insurers could be in the realm of $3 billion.¹

Generally, the D&O and Errors & Omissions (E&O) marketplace is still soft. Rates are trending downward, and there is plenty of capacity even for most financial institutions that are in a class by themselves. Terms and conditions have not been affected yet — although subprime lenders can expect a “predatory lending exclusion”. However, we are still early in the game. Dale Ledbetter of Ledbetter & Associates, whose firm has filed at least four lawsuits related to subprime, stated, “We think this is just the tip of a huge iceberg.” The loss potential of the subprime credit crunch has caused the insurance carriers (and reinsurers) to sound the alarm. Management and professional liability underwriters are seeking extensive information about an insured’s potential exposure not just to subprime loans but to the CMO and CDOs in general.

Some carriers have drafted questionnaires on the topic, several containing warranty statements regarding any potential subprime losses with language excluding claims arising from it. Even if a questionnaire is not utilized, insureds can expect queries about their vulnerability to the subprime industry

¹ David Small, Bear Stearns
during underwriting meetings. Fiduciary Liability underwriters are beginning to ask their largest pension clients about the impact of these events on plan funding status. Employment Practices Liability (EPL) insurers are watching the associated lay-offs and are becoming concerned that this could lead to additional claims.

Underwriters are also concerned, perhaps reasonably, with potential bankruptcies and the following blame game that could result in non-indemnifiable claims. There is speculation that the next wave of A-Side claims (non-indemnifiable claims against executives) could stem from the mortgage market meltdown. In the future, profitability for A-Side insurance may no longer be a foregone conclusion.

Willis has assembled a subprime crisis task force comprised of various product and market specialists. The task force will continue to monitor and analyze the situation and issue additional Alerts, keeping you apprised of ongoing developments.

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