On the brink?

The fall-out from the sub-prime crisis is beginning to emerge. But will it become a crisis for (re)insurers, ask Gavin Coull and Helena Blackwell of Steptoe & Johnson

Although news of the US sub-prime crisis broke last summer, the dust is yet to settle and looks unlikely to do so in the near future. And the collapse of Bear Stearns earlier this year is a grim warning of what may lie ahead.

The sub-prime mortgage market crisis resulted from the disastrous combination of questionable lending practices to high credit risk borrowers and the subsequent decline in the property market. While the epicentre of the crisis was in the US, reverberations have been felt across the globe. There is no doubt that the impact upon financial institutions and their employees has been momentous, but does that necessarily lead to a crisis for the insurance and reinsurance markets?

A significant number of sub-prime related lawsuits have been filed in the US. According to recent statistics from Advisen, 282 actions were filed by the end of May 2008 against a variety of defendants. The claims include borrower class actions, securities actions, commercial contract disputes, employment class actions and bankruptcy cases.

It would seem that few in the financial market are immune to sub-prime related actions. Quite simply, in order to reduce their own exposure, sub-prime lenders pooled their mortgages with other loans and transferred them into trusts or special purpose entities which, in turn, would issue and market various mortgage-backed securities. The securities would then be purchased by investors world-wide who would repackage them along with other assets and sell them on. The result? A wealth of potential defendants at whom the finger could be pointed in the event of a crisis such as the one we are now facing.

Sub-prime related claims will, typically, be brought against banks by lenders who have been asked to buy back loans (and, have consequently had to file for bankruptcy), against lenders who have filed for bankruptcy by their shareholders, and against funds by investors in mortgage-backed securities.

Meanwhile, causes of action range from misrepresentation and misleading statements about financial results to omissions and wrongful acts of companies and their directors and employees in the form of mismanagement of their investment portfolios. Directors and officers will frequently be named as defendants in such actions together with their advisers.

(Re)insurance implications

There has never been any doubt as to whether the collapse of the sub-prime mortgage market would impact on the

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insurance market. Since the collapse was first made public, the question for the insurance industry has not been "if" it will be affected but rather "when" and "to what extent" and, the industry is still searching for the answers. In the meantime, it is preparing itself for the fallout which could involve hundreds of claims from companies and their directors (not to mention the impact on insurers' balance sheets on the investment side).

Product lines which protect executives and board members of companies against allegations of wrongdoing (directors & officers, or D&O) and those which cover companies for claims made for wrongful acts (errors & omissions, or E&O) will be at the forefront of the firing line once the first round of litigation is over. D&O and E&O insurance also covers legal costs incurred as a result of companies having to defend actions and these alone will be significant. "Side A" D&O insurers are likely to be the most exposed, although E&O and other claims have been filed and it is likely that more will be filed as matters unfold.

According to projections in November 2007, insured losses could account for 30 to 35 percent of D&O industry premium, but it is widely thought that the full ramifications of the financial crisis will only be realised by the end of 2008 at the earliest. This is because new actions are constantly being filed and new causes of action uncovered which means that the list of potential defendants continues to grow.

Of course, it may be open to insurers to deny coverage. However, the nature of the crisis could give rise to some difficulties. It is arguable that the fundamental cause of the current crisis lies, not with individual acts or omissions of those in the financial sector, but rather with the decline in the housing market and rising interest rates in circumstances where there was a common misconception that the previous sustained growth of the property market would continue. The scope for insurers to raise defences will be specific to the facts of each particular case, and will depend, for example, upon whether a particular insured was aware at the time of inception of the policy that a sub-prime claim was likely to be made against it.

Three years on from the massive losses sustained by the property catastrophe market as a result of the hurricanes of 2005, many are questioning whether the casualty market is now facing its very own "Katrina". Some say that it is. Estimates of insured casualty losses range from $1bn to $4bn and it is beginning to look like they will hit the upper end of the estimate. The rating agency Fitch has estimated that litigation resulting from sub-prime exposure could lead to D&O liability and E&O claims of up to $4bn and that this would be substantially higher in the event that further exposure arises from credit risk problems resulting from but, not directly related to, sub-prime.

That said, there are others who believe that the long-term impact on the industry may not be as bad as it would first appear. A less than average number of securities class actions in the last few years has, in turn, led to higher than usual profits. This, some say, could mean that sub-prime related losses will barely feature on the radar. However, the picture looks rather different if one considers the possibility of companies not directly involved in sub-prime lending, but which have suffered indirectly as a result of the credit-crunch claiming under their D&O and/or E&O policies for losses suffered as a result of claims made against them by investors. An example of this is the collapse of Northern Rock. Northern Rock was not involved in sub-prime lending but suffered as a result of the general tightening of credit in the US. It is not unfeasible then that banks such as Northern Rock who are heavily reliant on short-term debt to fund their lending will also suffer. The consequence of this is likely to be an increase in claims by investors against banks and their directors. The result? More insurance claims.

While it would appear that more litigation is on the horizon, the reality is that it will be some time until the industry knows the full extent of its potential insured losses. We are still in the early stages of litigation emanating from the credit crisis, but cases filed to date give some insight into what is to come. There is no doubt that this is a significant event for the insurance world as well as for the financial markets, but the picture is far from complete. Even experts are struggling to quantify the extent of potential losses to the insurance and reinsurance markets, but this is inevitable in such an economically uncertain environment where insurance claims are dependant upon any one of the parties involved in the complex chain of securitisation successfully claiming against another.

Prognosis

We are yet to see the full extent of activity on the insurance front, but given the complex nature of the financial products which are central to the troubles currently faced by the US, it is no surprise that the fallout is somewhat delayed.

Whilst most of the litigation likely to lead to insurance claims will be filed in the United States, it is the London and Bermudian insurance and reinsurance markets who will, in all likelihood, pick up the lion's share of the bill. Lloyd's is already taking various precautions and has put triggers in place to alert it to sub-prime related claims. According to Lloyd's chief executive Richard Ward, "about 90 or 100 claims and notifications" have been made from sub-prime banks, insurers and other financial institutions since June 2007. These claims are likely to have been made by financial institutions on behalf of their directors or by financial institutions which have had to pay out as a result of sub-prime related actions. Whilst the market can monitor and model potential sub-prime losses, only time will tell whether the sub-prime crisis will also become a crisis for insurers and reinsurers.

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