Insurance coverage available for the subprime mortgage collapse: current developments[1]

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When facing a loss, the first rule of insurance recovery is '*think insurance*'. Daily headlines describe the collapse of the subprime mortgage market, the impact on the financial markets and investment community, as well as the hardships suffered by individual borrowers. Investments in mortgage-backed securities, particularly subprime mortgages, have dominated the financial news because of the: (1) stunning losses reported by institutional investors; (2) growing multitude of lawsuits filed by borrowers alleging predatory lending and shareholders alleging securities fraud; (3) government investigations; and (4) collapse of Bear Stearns. In recent months, Merrill Lynch, UBS and Citigroup have each reported losses of more than US$3 billion, while Morgan Stanley and JPMorgan have reported losses of more than US$2 billion.[2] According to Standard & Poor's, the estimated losses and write-downs related to investments in mortgage securities and subprime-related investments amount to US$285 billion.[3] Other analysts estimate that the total losses tied to subprime mortgages are as high as US$400 billion.[4]

Insurance will be part of the solution for some. The claims against investment banks, mortgage companies, and virtually everyone involved in the securitisation chain implicate coverage under a variety of insurance policies. The most obvious coverage will be found in directors and officers (D&O), professional liability (E&O), Fiduciary liability insurance and Financial Institution Bond (FI Bond) insurance coverage. D&O, E&O and Fiduciary liability insurance policies protect the policyholder and its managers, officers or general partners against losses due to an unintentional (negligent) act, error, omission, and/or breach of duty that could give rise to a claim. D&O insurance typically covers directors and officers and the corporate policyholder (where entity coverage is present).

Similarly, standard form E&O insurance policies protect the corporate policyholder and its various directors, officers, employees and affiliates, including securities brokers and dealers working for financial institutions and investment banks, for loss arising from their alleged wrongful acts committed in their capacities as managers, representatives or agents. Finally, the Fiduciary liability policy and the FI Bond coverage fills the void left by D&O and E&O insurance, covering policyholders experiencing loss in an employee retirement or similar fund, or for their employee's fraud and dishonesty, as well as losses caused by forgery, false pretences and the like. All these lines of coverage may respond to subprime litigation against a corporate policyholder and the individuals impacted.

More and more litigation arising out of the subprime crisis has been filed and is gaining speed and momentum. To date, almost 300 lawsuits have been filed relating to investments in subprime loans. This is almost half the total number of lawsuits that were filed during the entire period of the savings and loan crisis. With the losses mounting daily, the number of lawsuits against investment banks, lenders, and others involved in the subprime market is virtually certain to continue to increase.

Investment banks are looking for help

Given the catastrophic losses reported by investment banks, it should be no surprise that even the largest investment banks have turned to investors, including foreign governments, for help.

In November 2007, Charles Prince, the chairman and chief executive of one of the world's biggest banks, Citigroup, resigned shortly after Citigroup reported record losses. Since then, Citigroup has turned to foreign investors, including Dubai International, Abu Dhabi and Kuwait, and raised more than US$30 billion to stabilise its finances.[5]

In early 2008, just months after reporting its first-ever loss, Bear Stearns sought – and received – a federal bailout to help avert a total collapse.[6] However, the bailout was evidently insufficient and, in March 2008, JPMorgan, with the help of the Federal Reserve, made an offer to buy the 85-year-old investment bank for ten per cent of its market value in the prior week, or approximately one-quarter of the value of Bear Stearns' headquarters in New York.[7]

Will regulators step in?

Given the reach of the subprime crisis, regulators in the United States and Europe are evaluating underwriting standards and other risk management practices employed by investment banks.[8] In the United States, regulators have been evaluating deficiencies in

securitisation[9] and are expected to release a report that addresses various deficiencies in securitisation.[10]

Recently, US Treasury Assistant Secretary Anthony Ryan called upon banks and brokerages to address weaknesses in risk-management policies and said regulators are working to ensure financial products are not so complicated. According to Mr Ryan: '[w]e need to see global financial institutions promptly identify and address any weaknesses in risk-management practices that the current turmoil has revealed.'[11] Regulators are reviewing the assumptions and inherent weaknesses in the securitisation process, as well as reviewing lending practices.[12] Additionally, he said that banks should improve their balance sheets to minimise risk and better understand what they're investing in: 'looking ahead, we expect practices will be different... Financial products will be less complex and more transparent, then mechanisms for dealing with complexity will be improved.'[13]

In response to the wave of defaults on subprime mortgages, regulators of mortgage insurance companies are also considering splitting the firms into two parts: one for safe municipal debt and the other for riskier mortgage-related securities.[14] Some insurance companies are eager to restructure. In fact, the Financial Guaranty Insurance Company has reported that it would like to create a company that would inherit insurance policies which it has sold on generally safe municipal bonds totalling about US$224 billion, while its guarantees on US$72 billion in mortgage-related bonds would stay in the existing insurance company.[15]

Mortgage insurance companies, which are supposed to stand behind subprime mortgages and protect investors from default, have also been impacted by the number of claims, and some, like FGIC Corporation, have had their ratings downgraded.

Subprime mortgages in a nutshell

In general, subprime mortgages are loans to high-risk borrowers for amounts greater than they would be able to borrow in a conventional mortgage and at a higher – and sometimes variable – interest rate. The loans are, in general, relatively high-risk loans to individuals with lower credit scores, higher debt to income ratios, at higher interest rates, highly leveraged, and with a higher default rate. Typically, credit scores of borrowers in subprime loans are less than 660, the debt to income ratio exceeds 40 per cent, and the interest rates are more than 200 basis points above the rate for a conventional mortgage. In addition, they are often leveraged of more than 80 per cent and the default rate is more than five times that of a conventional mortgage. According to some, 16 per cent of subprime borrowers default before making the first payment.[16] Borrowers relied on low interest rates and rising housing prices to bolster their ability to make payments on the loans.[17] However, once interest rates increased and housing prices fell, the rate of defaults and foreclosures increased dramatically, and in the case of subprime adjustable rate mortgages, doubled from 2.7 per cent to 5.29 per cent in the past year.[18]

Factors contributing to the meltdown

Numerous factors contributed to the increase in home mortgage defaults and the ensuing meltdown in the subprime sector. At the core, loans have become inherently riskier. Additionally, revolving consumer credit has expanded from 4.5 per cent in 2002 to 8.4 per cent in June 2007, with a 12.2 per cent increase in consumer credit lines.

Defaults on home equity loans have also impacted banks and loan servicers, forcing some, such as American Home Mortgage and New Century, to seek bankruptcy protection. Lenders are impacted because many of the subprime and Alt-A (no documentation-provided loans) were not just new home mortgages, but were refinancings with cash-out loans, or home equity loans or lines of credit. People were borrowing against the value of their homes, using equity that represented the real estate value bubble. Once home values began to fall, borrowers began to face negative value on their largest assets. In the case of a foreclosure, banks and mortgage companies may be left with insufficient equity to protect their loan.

Why have mortgage defaults and foreclosures sent shock waves throughout the financial industry?

The very nature of the capital markets becoming deeply entrenched in the consumer mortgage lending markets through securitisation is the reason the economic fallout has been so broad.

At the outset, lenders extended mortgages to a class of borrowers who did not meet the traditional criteria for taking out home loans. Those lenders then bundled the loans into investment securities, or collateralised loan obligations, and sold them to institutional investors as securitised debt. This sale was effectuated through a bankruptcy-remote trust, established by the lender, which shifted legal rights to receive payment on the loan, otherwise known as a special purpose vehicle or entity (SPE). That SPE underwrote the securitisation of the assets within the trust. The securitisation was essentially treated as a loan sale, insulating investors from the liabilities of the originator/issuer. The SPE controlled the collateral and served as a vehicle for interest and principal to the investors.

Investment banks underwrote the securities from the SPE and resold it to investors and the administration of issuance of the securities to investors. Ratings agencies rated the various levels of debt, or tranches, of the securities. The highest-rated tranches were those that represented the lowest risk to the investor. Those

tranches typically received priority claims on cash flows, or had some other assurance of payment. In theory, there was little to no correlation of risk associated with assets classes in each of the tranches.

Investors rely on rating agencies to calculate the risk of an investment. However, in light of, among other things, the volatility and uncertainty in the market, even the rating agencies were hard-pressed to accurately assess the risks associated with each tranche. Perhaps in response to the new and volatile market, Moody's has recently proposed broad changes to its rating system, its calculations, and reporting.

Credit Enhancement Providers then extended bond/credit insurance in the event of foreclosure and/or subjected the securitisation to the tranche mechanism, or senior-subordinate structure. CDOs are a type of asset-backed security and structured financial credit product. They often are made up of a portfolio of fixed-income assets. These assets are divided into: senior tranches (rated AAA); mezzanine tranches (AA to BB); and equity tranches (unrated). Losses are applied in reverse order of seniority and so junior tranches usually offer higher interest rates to compensate for the added risk. In recent years CDOs served as an important funding vehicle for many types of fixed-income transactions.

Litigation

Three days after Bear Stearns solicited JPMorgan Chase to purchase the company for ten per cent of its market value, a class action lawsuit commenced against Bear Stearns. The plaintiffs' lawyers assert an enormous drop in market capitalisation on account of the subprime liquidity crisis:

> 'The complaint alleges that during the Class Period, defendants issued materially false and misleading statements regarding the Company's business and financial results. As a result of defendants' false statements, Bear Stearns stock traded at artificially inflated prices during the Class Period, reaching a high of $159.36 per share in April 2007. In late June 2007, news about Bear Stearns' risky hedge funds began to enter the market and its stock price began to fall. On March 10, 2008, information leaked into the market about Bear Stearns' liquidity problems, causing the stock to drop to as low as $60.26 per share before closing at $62.30 per share. On March 13, 2008, news that Bear Stearns was forced to seek emergency financing from the Federal Reserve and JP Morgan Chase hit the market and Bear Stearns stock fell to $30 per share. Then, on Sunday, March 16, 2008, it was announced that JP Morgan Chase was purchasing Bear Stearns for $2 per share. By midday on Monday, March 17, 2008, Bear Stearns stock had collapsed another 85% to $4.30 per share on volume of 75 million shares.
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> According to the complaint, the Company's Class Period statements were materially false due to defendants' failure to inform the market of the problems in the Company's hedge funds due to the deteriorating subprime mortgage market, which would cause Bear Stearns to have to rescue the funds, cause the Company and its officers possible criminal liability and hurt the Company's reputation.'[19]

On 12 March 2008, a few months after mortgage insurer, The PMI Group, Inc, requested additional time to file its fourth quarter financial statements after FGIC Corporation, a bond insurer in which PMI owns a 40 per cent interest, was downgraded,[20] a class action was filed against PMI. In that complaint, the plaintiffs alleged that PMI, and others, were liable for:

> '(a) making false statements; or (ii) failing to disclose adverse facts known to them about PMI. Defendants fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of PMI Common Stock was a success, as it: (i) deceived the investing public regarding PMI's prospects and business; (ii) artificially inflated the price of PMI common stock; (iii) allowed certain of the defendants to reap over $7.3 million in insider selling proceeds; and (iv) caused plaintiff and other members of the class to purchase PMI common stock at inflated prices.'[21]

Additionally, the plaintiffs alleged that:

> '(a) the Company's investment in FGIC was materially impaired as FGIC's bond insurance arm, Financial Guaranty, had significant exposure to defaults on bonds it insured due to the plunge in value of mortgage debt; (b) the Company was materially overstating its financial results by failing to properly value its investment in FGIC and by failing to write down that investment in a timely fashion in violation of Generally Accepted Accounting Principles ("GAAP"); (c) the Company was not adequately accounting for its loss reserves in violation of GAAP, causing its financial results to be materially misstated; (d) the Company failed to engage in proper underwriting practices for its book of business related to insurance written in 2005 through most of 2007; (e) the Company had far greater exposure to anticipated losses and defaults related to its book of business related to insurance written in 2005 through most of 2007 than it had previously disclosed; (f) given the deterioration and the increased volatility in the subprime market, the Company would be forced to tighten its standards and stop writing insurance policies to certain categories of borrowers which would have a direct material negative impact on its book of business going forward; and (g) given the increased volatility in the subprime market, the Company had no reasonable basis to make projections about its incurred losses or about its new insurance written.'[22]

PMI has also filed suit against WMC Mortgage Corp

and GE Money Bank in which PMI seeks damages relating to WMC's securitisation of a pool of subprime loans. PMI insured certain classes by agreeing to fund deficiencies in payments of principal and interest. According to the complaint, many of the loans lacked basic documentation regarding the borrowers' employment and income.[23] The complaint alleged that WMC used deficient underwriting methods which failed to employ objective mathematical principles. WMC's alleged 'systemic failure to apply sound underwriting standards' caused 'an excessively high delinquency rate within the pool of mortgage loans'.[24] Given that delinquency rate, PMI alleged that it was 'reasonably certain' that it would have to pay out claims on insurance policies that it sold to cover these loans.[25]

With scores of residents impacted by subprime loans, the cities of Cleveland and Baltimore have also filed lawsuits against investment banks. According to those complaints, the residents of those cities are suffering because of the multitude of high-risk subprime loans.

The claims implicate coverage under various insurance policies

As noted above, participants in the mortgage securitisation process face potential losses and probably have available insurance. The D&O, E&O, Fiduciary liability and FI Bond or Commercial Crime Policy are among the prime policies to check for insurance for this problem. The claims against investment banks, mortgage companies, and virtually everyone involved in the securitisation chain implicate coverage under a variety of insurance policies.

Government investigations

Government investigations are also covered under many of these policies where they encompass 'investigations by any governmental entity into possible violation of law' in the policy's definition of 'claim'. The insurance policies normally cover 'defence costs' incurred from responding to a government or regulatory examination as well. The definition of 'loss' will also include coverage for settlements and judgments arising from the underlying claim. Be careful – insurance companies will argue (and at least one court has upheld) that an informal document request regarding subprime activities, as compared to a formal investigation with the exercise of subpoena power by the Securities and Exchange Commission, might *not* be considered a 'claim' as defined by most D&O and E&O policies.[26]

The subprime crisis is no different than many other insured losses, except perhaps in scope. Keep the first rule of insurance recovery in mind, and '*think insurance*'. The daily headlines and overall enormous magnitude of the subprime loss will require that insurance policies purchased by premium-paying policyholders respond in full. D&O, E&O, Fiduciary liability, FI Bond and Commercial Crime, among other types of potential policies, all should be considered.

Notes

1 This article first appeared in *Coverage*, Volume 18, Number 3, May/June 2008 as 'Insurance Coverage Available for the Subprime Mortgage Collapse: Current Developments'. *Coverage* is a publication of the American Bar Association's Committee on Insurance Coverage Litigation.
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