ROUTE TO:

THE RHA REVIEW

Vol. 14, No. 1, Fourth Quarter 2007

A publication of Robert Hughes Associates, Inc., an international litigation support, actuarial, risk management and insurance consulting company

SIX DEGREES OF SEPARATION

by Robert N. Hughes, CPCU, ARM

Item … "Losses from the falling value of subprime mortgage assets may reach $300 billion to $400 billion worldwide, Deutsche Bank AG analysts said." —Copyright 2007 *The Miami Herald*

Item … "As the housing market crumbles, homeowners are worried about mortgage payments and sellers are worried about slumping prices—but the companies that insure their loans are worrying about their very survival in the face of billions of dollars in claims."—Copyright 2007 *The Journal Gazette*

The villain in this little vignette, of course, is something called "subprime lending." Willis North America, in its October 2007 issue of *Financial Institutions* defined subprime lending as follows:

"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."

The villain in this little vignette, of course, is something called "subprime lending."

IN THIS ISSUE:

Now, let's complicate the issue by introducing Mortgage Backed Securities, aka collateralized mortgage obligations (CDOs). This is a security that is secured by a share in a pool of mortgages. The investors get interest and a piece of the principal each month. The cash flow is produced by the property owner's mortgage payments. Financial institutions and investors worldwide now hold about $800 billion in these mortgage-related securities. According to the Willis report, many of these portfolios contain subprime loans. Similar securities backed by receivables other than real estate are known as collateralized debt obligations (CDOs) … same beast in different clothing.

My father was not a financial genius, but often when I asked his opinion about a deal, he would say, "Son, this is a deal that either everyone ought to be doing or no one ought to be doing." I'm sure, if he were alive today, he would impart those same words of wisdom if I said to him, "Dad, here's the deal. I'm thinking about buying some securities, called 'mortgage backed securities,' which are securities backed by a share of a pool of mortgages. The cash flow is created by the borrower's mortgage payments. And, oh, by the way, these mortgages are for people with bad credit who can't get a loan in the regular market. Also, some of them are 'no down payment' loans. So, Dad, what do you think?"

My father's good judgment notwithstanding, the gleam of high interest rates was irresistible to financial institutions, hedge funds and private investors who gobbled up subprime-mortgage-backed securities like hot waffles with syrup. Michael Brush of

(SIX DEGREES, continued inside)

(SIX DEGREES, from cover)

MSN Money, in his article entitled "Who's to blame for the mortgage mess?," dated 11/15/2007, made his own list of those most responsible for the mess. They were:

1. Alan Greenspan … who took Fed funds rates down to 1% for a year and who championed adjustable-rate mortgages.

2. Angelo Mozilo … Countrywide Financials CEO, with a name and a face straight out of *The Godfather*, who made $310 million selling stock options in his company and now claims he could not have foreseen the current problems.

3. Christopher Ricciardi … the Merrill Lynch banker who with abandon flogged CDOs, which eventually led to an almost $8.0 billion write-down.

4. Ralph Cioffi and Jim Kelsoe ... hedge fund gurus whose subprime-fueled dynamos blew up in their faces, costing investors billions of dollars.

5. The ratings agencies, Standard & Poor's, Moody's Investors Service and Fitch Ratings, et al. … who turned impartial and professional rating into big business, ignoring the conflict of interest created by getting paid by the people they were rating.

6. Mortgage brokers … who were zoning out on commission income. Here's just one notable quote from a former mortgage broker: "It was like kids in a candy store. You had to be a complete screw-up not to make money. There were basically no guidelines, no restrictions and no oversight."

> ***"This crisis is expected by most observers to result in financial failures in banks, hedge funds, investment companies and brokerage firms."***

I'm sure, by now, you are wondering where an insurance guy like me is going with all of this. Trust me, we'll get there. But, first, I want you to listen again to these words … "Less than stellar credit histories … Cannot obtain financing in the usual market … The risk has been notched up … no guideline, no restrictions and no oversight." Does that sound like something you would be thirsting to insure? No? Well, guess what? According to *The Journal Gazette*, in a 11/14/2007 copyrighted article, Mortgage Insurance Companies of America, an industry trade group, reported that "… there was $776 billion in private mortgage insurance in force as of September. …" One of the better known of the private mortgage insurers, MGIC, has a portfolio of $196.6 billion in home mortgage insurance policies.

While the exposure to the mortgage insurance companies is obvious and

(SIX DEGREES, cont'd opposite)

FROM NEAR AND FAR

California – According to an article in *Best Week*, Safeco estimates that its pretax catastrophe losses attributed to October's California wildfires will reach $35 million. Farmers Insurance group said that as of November 19, it had received more than 7,300 claims.

California – Fitch Ratings has predicted that total insured losses from the wildfires that swept across Southern California could pass $1 billion.

New York – According to the Associated Press, federal prosecutors are going to call Berkshire Hathaway's chief executive, Warren Buffett, to testify against five former insurance executives who are charged with helping AIG to manipulate its financial statements.

Chicago – Aon Corporation announced that it is starting a new restructuring effort that will cost the brokerage firm $360 million and reduce its workforce by 2,700.

Boston – With the Red Sox World Series victory came a bonus for many furniture buyers. Jordan's Furniture of East Taunton, Massachusetts, is refunding the cost of certain purchases made between March 7 and April 16. The cost to Jordan's will be offset by insurance coverage bought specifically to cover the possibility of a Red Sox win.

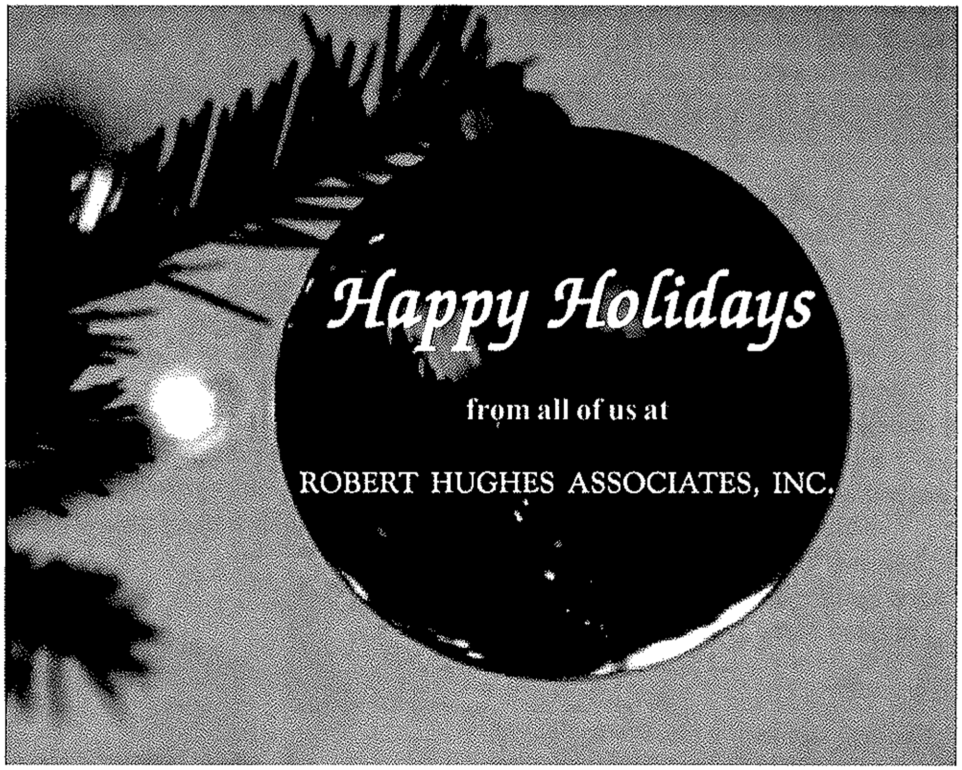
(SIX DEGREES, from opposite)

serious, a more obscure and insidious danger that could affect insurers and, as a result, policyholders lurks in the wings. This crisis is expected by most observers to result in financial failures in banks, hedge funds, investment companies and brokerage firms. The subsequent fallout will likely produce a plethora of litigation. (Wait, what is that scurrying noise I hear in the background? Oh, it's the rush of lawyers dashing from the no-longer-hot stock option backdating scandal to new

"Closer to home for most businesses and individuals, however, will be the possible effects on the cost and availability of Comprehensive General Liability and Umbrella coverage."

lawsuits related to subprime lending.) Willis quotes one such attorney, Dale Ledbetter of Ledbetter & Associates, as stating, "We think this is just the tip of a huge iceberg."

So what insurance products will be most affected? Well, certainly directors & officers liability markets are steeling themselves, as are the errors and omissions liability underwriters (many of whom are one and the same.) While these markets don't directly affect the general public, any shrinkage in the market will stimulate rate increases, which will ultimately be passed on to the consumer. Pension plan managers are likely going to be faced with increased premiums and



tighter underwriting from their fiduciary liability insurance underwriters.

Closer to home for most businesses and individuals, however, will be the possible effects on the cost and availability of comprehensive general liability and umbrella coverage. As layoffs occur, employment practice liability claims (a coverage generally provided under a CGL) could snowball. As insolvencies occur, potential claimants will likely structure their allegations and complaints to target coverage provided by the bankrupt companies' CGL and umbrella carriers.

So the situation could easily be likened to the amusing, but frivolous, recently invented exercise known as "six degrees of separation," which theorizes that any one person is only six contacts away from any other (principally applied to well-known personages). I think, however, that the poet John Donne hit it on the nose when he said over 400 years ago:

No man is an island, entire of itself
every man is a piece of the continent,
a part of the main
if a clod be washed away by the sea,
Europe is the less,
As well as if a promontory were,
As well as if a manor of thy friends or of thine own were,
Any man's death diminishes me, because I am involved in mankind
And therefore never send to know for whom the bell tolls
It tolls for thee.

Let's hope not.

Robert N. Hughes is founder, chairman of the board, and chief executive officer of Robert Hughes Associates, Inc.

ROBERT HUGHES ASSOCIATES INC.
508 TWILIGHT TRAIL, SUITE 200
RICHARDSON, TEXAS 75080
(972) 980-0088 FAX (972) 233-1548

New Associate Joins RHA, Inc.

Please join us in welcoming Joseph R. Peiso, CPA, ARE, to the RHA group of experts and consultants. Joe has a very strong background in the financial, managerial and regulatory aspects of the insurance industry. He has expertise in all areas of the financial operations of an insurance company, including CFO duties, statutory examination preparation, internal audits services and Form A/UCAA 13 filings. He also has experience in performing captive insurance company feasibility studies as well as due diligence reviews. He has served as the chief financial examiner for the North Carolina Department of Insurance and also has expertise with reinsurance accounting for premiums and claims as well as technical audits and examination of records of MGAs, TPAs, ceding companies, reinsurers, reinsurance underwriting managers, intermediaries and insureds.

For Joe's complete CV, please call us at (972) 980-0088 or e-mail us at joakley@roberthughes.com.

THE RHA REVIEW

Publisher .... Robert N. Hughes
Editor .... John R. Oakley
Assistant Editor .... Alice H. Oakley

The RHA Review is published quarterly by Robert Hughes Associates, Inc. — an independent international litigation support, actuarial, risk management and insurance consulting company based near Dallas, Texas, with offices in Houston, Texas, and London, England. The purpose of this publication is to offer insurance-related information and critical comment pertinent to the clients, friends and fellow professionals of Robert Hughes Associates, Inc. This publication is available free to interested parties. The information contained in this publication is intended to be general in nature; readers should obtain professional counsel before taking any action on the basis of this material.