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November 4, 2008

The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market.

An Advisen Special Report Sponsored by ACE

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Executive Summary

In February, Advisen forecast $3.6 billion of insured losses to D&O insurers as a result of the meltdown of the subprime mortgage market and the ensuing credit crisis. Since February, the credit crisis has mushroomed into a global financial calamity that caused the collapse or near-collapse of several leading financial institutions and has required aggressive intervention by central banks around the world. In light of these developments, Advisen has revised its forecast to $5.9 billion of losses to D&O insurers. The losses are spread across 2007, 2008 and 2009, with the largest amount incurred in 2008, resulting in an additional 229 points to the 2008 loss ratio for the financial institution (FI) segment of the D&O market. The revised forecast reflects an increase in securities class action suits, securities fraud suits brought by regulators and law enforcement agencies, losses under Side A policies from bankruptcies, and shareholder derivative suits. It also includes defense costs associated with dismissed suits.

While there has been an increase in securities class action suits as a result of the subprime mortgage meltdown and the ensuing credit crisis, the tsunami of claims predicted by some analysts has not yet materialized: the total number of securities class action suits filed in 2008 is almost certain to be below the 1997-2005 (excl. 2001) annual average. Underwriters of financial institution D&O have been crushed by claims – and premiums for D&O policies of financial services companies are skyrocketing – but other segments of the D&O market are largely unscathed, and competition and capacity remain robust.

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

Findings:

- **More than $750 billion in writedowns**
- **124 subprime-related securities class action lawsuits**
- **$5.9 billion in expected D&O losses over accident years 2007, 2008 and 2009**
- **Approximately $1.25 billion 2008 FI D&O gross written premium**
- **Subprime/credit crisis losses to contribute 179 points to the 2007 FI D&O loss ratio, 229 points to the 2008 loss ratio, and 79 points to the 2009 loss ratio**
- **Losses borne largely by a few financial institution D&O insurers**
- **D&O price hikes for financial institution and real estate insureds**

About the author: Dave Bradford is a co-founder of Advisen and leads the Research and Editorial team. He is Advisen's senior insurance industry analyst and editor-in-chief of Advisen's various publications. Prior to founding Advisen in 2000, Dave spent twenty years in underwriting, marketing and strategy development roles in the reinsurance industry. Most recently he was a senior vice president with Swiss Re and led the Global & National Division of Swiss Re America. Prior to Swiss Re, Dave was a senior vice president with Reliance Reinsurance Corp. He began his career as an actuarial analyst with Allstate's Assumed Reinsurance Division.

About the report: Primary research for this report was conducted using the Advisen.com information and analysis platform and its underlying databases, including the MSCAd large loss database. MSCAd is organized by underlying causes of loss, and presently contains 418 cases associated with the meltdown of the subprime mortgage market and the ensuing credit crisis. Advisen is currently in use by nearly 500 firms including the leading underwriters and brokers of commercial insurance. For more information about Advisen, please contact in New York info@advisen.com or +1.212.897.4800, in London London@advisen.com or +44 (0)20 7929 6929 or see http://Corner.Advisen.Com.

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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 more than 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.

In October 2007, Advisen estimated global exposure between $450 billion and $1.2 trillion; as of November 1, 2008 writedowns had exceeded $750 billion. In February 2008, Advisen released an analysis of the impact of the subprime meltdown on the D&O market. That report forecast $3.6 billion of losses to D&O insurers. Since February, the credit crisis has grown much deeper, spawning new rounds of securities class action and related suits. Taking into account these subsequent developments, Advisen now forecasts $5.9 billion of losses to the D&O market.

The revised forecast reflects an increase in securities class action suits as well as several factors not addressed in the earlier analysis:

- The original forecast accounted only for securities class action suits. While securities class actions are the principal source of public company D&O claims, shareholder derivative suits and securities fraud suits brought by regulators and law enforcement agencies also will result in significant D&O losses. The revised analysis includes estimates of those losses.
- The original forecast did not differentiate between traditional ABC D&O coverage and Side A-only coverage, which provides coverage directly to directors and officers when the company cannot indemnify claims. As the number of bankruptcies grows, Side A-only policies are increasingly exposed. In many cases, especially within the financial institution sector, the Side A limit is several multiples of the ABC policy limit, or entirely replaces the ABC program.
- An estimate of defense costs associated with dismissed claims has been added.
- The forecast methodology has been refined to more accurately account for average D&O retentions and policy limits by market cap and industry sector.
- Expected losses from more than one lawsuit against a company are now aggregated during a policy period, and the combined loss is subject to one policy limit.

A wave of bankruptcies triggered by the credit crunch could be followed by a surge in securities suits against private companies with registered debt. This analysis is limited to public company D&O losses, and potential losses to private companies have not been factored into the forecast. Also excluded from the forecast are losses to non-US companies for lawsuits filed outside the US.

While securities class action suits filed as a result of the subprime meltdown and subsequent credit crisis continue to mount, the total number of securities class action suits filed in 2008 will almost certainly be less than the 1997-2006 (excl. 2001) annual average of 234 suits. The number of securities class action suits dropped sharply in

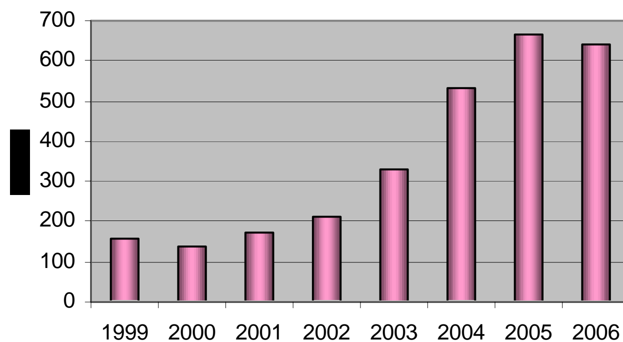
2005 and again in 2006. Even with a steep increase in suits triggered by the present crisis, the total still falls short of the long-term average.

In the February report, we noted that D&O premiums were rising for financial institutions and others affected by the meltdown of the subprime market. We also observed that rate increases had not spread to other segments of the D&O market, and we forecast that, because of chronic overcapacity throughout the property and casualty industry, those other segments would remain highly competitive. Since February, the combined impact of underwriting losses due to plummeting rate levels, subprime-related losses and higher-than-average natural catastrophe losses, as well as 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 D&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. Typically they are adjustable rate mortgages with low initial “teaser” rates that ratchet up to much higher monthly payments after, in most cases, two years. Many were originated in 2005 and 2006 when lenders significantly relaxed underwriting standards. (Exhibit 1) The expectation was that homeowners would refinance before monthly payments were reset, but falling real estate prices made it impossible for many subprime borrowers – who had little or no equity in their homes – to refinance. Unable to pay the higher monthly payments, many borrowers defaulted.

Exhibit 1. Subprime mortgage originations



Source: Hammond Associates

Defaults in U.S. mortgages reached record levels in the second quarter of 2007, and the fallout spread quickly throughout the financial markets. Securities valued according to 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 have reported more than $800 billion in writedowns, and the total continues to grow. In addition to losses 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. Collatoral 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 governement stepped in with an $85 billion loan. Although subprime mortgage defaults are 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, 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 financial services firms are now defunct or have been acquired, while others sit on the brink of collapse, relying on 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, and approved by Congress.
- 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 will require 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.

The mortgage origination and securitization processes and the sources of D&O claims

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

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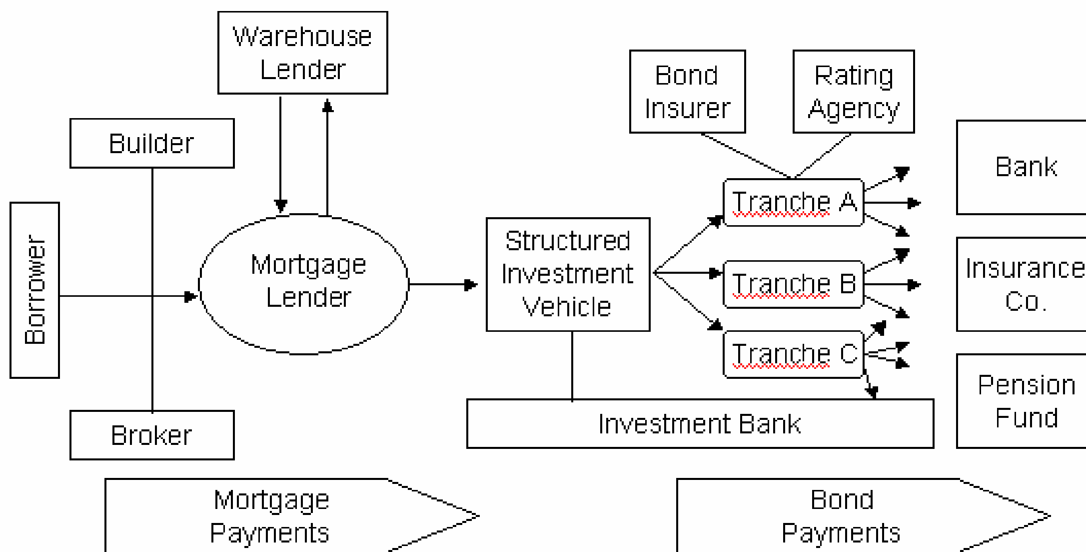
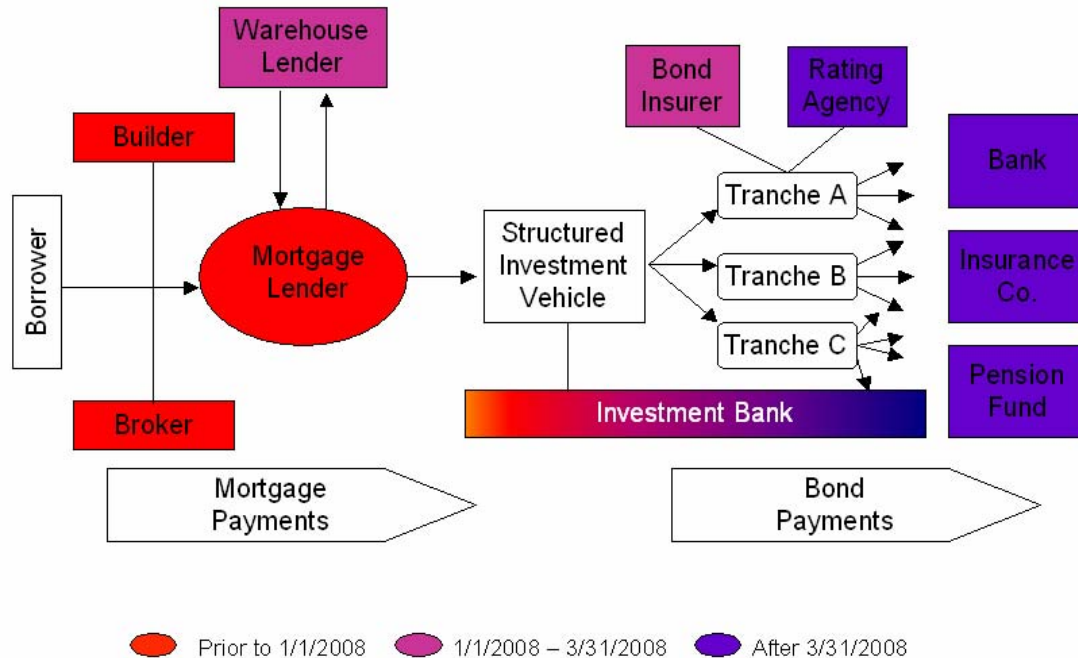
Exhibit 2. The mortgage origination and securitization process



In the past, mortgage lenders were likely to be community banks or savings & loan associations that not only originated the 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 guarantee their AAA rating. Buyers of these securities include commercial banks, pension funds, mutual funds, insurance companies and hedge funds. In many transactions investment banks kept the equity tranches to make the vehicles work.

Almost every party involved in the loan origination and securitization machine is a target for lawsuits. Subprime lenders – of which 296 have "imploded" since late 2006 – are obvious targets for subprime-related securities class action suits. To date, according to Advisen's MSCAd large loss database, 20 mortgage lenders and their directors and officers have been named in such suits. Among the most common allegations are: (1) lenders lacked requisite internal controls, and, as a result, projections and reported results were based upon defective assumptions or manipulated facts; and (2) financial statements were materially misstated due to failure to properly write down impaired assets. Other defendants in securities class action suits arising from subprime mortgage origination and securitization include commercial banks, investment banks, fund managers, bond insurers, REITS, rating agencies, and homebuilders. Many of the same defendants also have been named in shareholder derivative suits.

Exhibit 3 **Timing of Securities Class Action Filings**



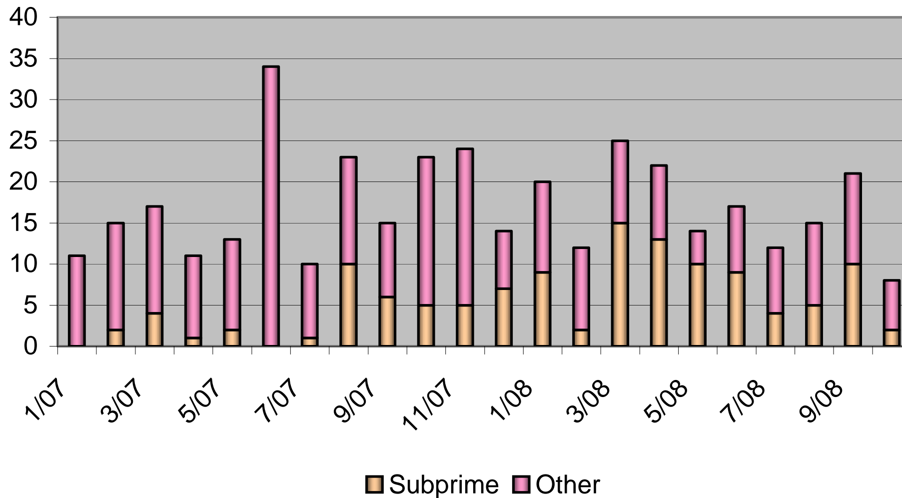
Source: Advisen MSCAd

Subprime related lawsuits have over time moved from left to right across Exhibit 2. The earliest to be slapped with lawsuits – those colored red in Exhibit 3 – were principally companies most directly involved in the subprime loan origination process, especially mortgage lenders. Twenty of 124 securities class action suits have been filed against mortgage lenders and their directors and officers. Many of the more recent subprime-related suits involve companies involved in the securitization process, as well as investors in those securities, which are colored purple on Exhibit 3. Investment banks are involved at virtually every stage of the origination and securitization process, and have been the target of lawsuits repeatedly throughout the history of the subprime meltdown and subsequent credit crisis.

Many of the more recent suits have been triggered by events related to the global credit crisis rather than directly by activities in the subprime mortgage market. Investment banks and "universal banks" such as Citigroup and UBS are defendants in a large number of those suits. One particularly active category – accounting for 20 securities class action suits and 10 securities fraud suits – involves firms that structured or sold auction rate securities. Auction rate securities are investments whose interest rates are periodically reset through an auction process, and which were marketed in some cases as highly liquid alternatives to money market funds. The market for auction rate securities evaporated with the freezing of credit markets, leaving investors stuck with illiquid securities. Other securities class action suits triggered by the credit crisis allege that defendant companies and their directors and officers failed to disclose the impact of adverse credit market conditions on financial performance.

Exhibit 4 shows subprime and credit crisis-related securities class action suits, as compared to all other securities class action suits, filed by month during 2007 and 2008.

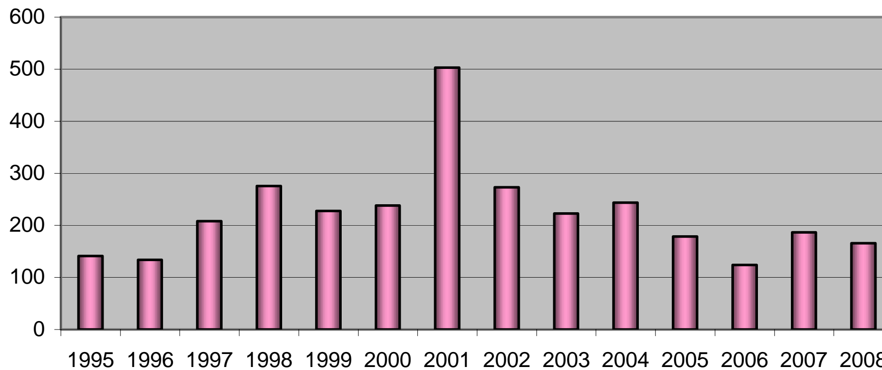
Exhibit 4 **SCAS Filed by Month**



Source: Advisen MSCAd

The meltdown of the subprime mortgage market and the subsequent credit crisis was expected to result in an avalanche of litigation. As Exhibit 4 shows, subprime related cases have contributed significantly to the number of securities class action suits filed, especially during 2008. Nonetheless, the total number of securities class action suits filed in 2007 was far below the 1997-2006 (excl. 2001) annual average of 234 suits, and 2008 probably will fall short as well. (Exhibit 5) The number of securities class action suits filed dropped sharply in 2005 and again in 2006. Securities class action suits spawned by the subprime crisis and its aftermath have not yet pushed the annual number of suits filed to pre-2005 levels.

Exhibit 5 **SCAS Filed by Year**



Source: Advisen MDCAd

One reason why the number of subprime-related cases has not been higher may be that plaintiffs' attorneys are concerned that market cap losses are more likely to be charged

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to a global and systemic stock drop instead of an individual company's malfeasance. Also, following the *Tellabs* decision by the United States Supreme Court, the bar has been raised on proving *scienter* (an intent to defraud). One securities class action suit, *Waymon Tripp v. Indymac Financial Inc. et al*, which was dismissed, may be a harbinger of the obstacles plaintiffs will encounter in pursuing these suits. Plaintiffs contended that statements made by Indymac officials about the mortgage lender's financial health and its positioning in the subprime market were misleading. Citing *Tellabs*, the defendants moved to have the case dismissed. Judge George Wu of the federal court in Los Angeles agreed not only that the plaintiffs had "failed to allege sufficient facts giving rise to a 'strong inference' of *scienter*" and therefore had failed to meet the pleading standards of *Tellabs*, but also noted "that Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic changes in the housing and mortgage markets."

Less-than-expected litigation has led some law firms to downsize. International business law specialist Clifford Chance, for example, recently let go 20 US litigation associates. Mark Kirsch, Clifford Chance's global litigation chair, said the layoffs were necessary because the expected surge in litigation associated with the economic crisis had not materialized. "People were predicting a tsunami of litigation, but so far it hasn't come," he was quoted as saying in a *New York Law Journal* article.[1]

Historically, about one third of securities class action suits filed are dismissed. Because of the various obstacles plaintiffs will encounter in pursuing subprime and credit crisis suits, it is likely a higher percentage of these suits will be dismissed.

Investigations by regulatory and law enforcement agencies

In addition to securities class action and shareholder derivative lawsuits, regulatory agencies and law enforcement officials around the world have launched dozens of investigations, some of which have resulted in lawsuits. Even if investigations do not lead to civil suits, they can complicate the defense of other suits, especially if there are allegations of criminal conduct. Among those investigations 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.

Depending on the nature of the allegations and the structure of the settlements, monetary damages under suits brought by regulators and law enforcement agencies may not be covered by D&O policies. Fines and penalties are typically excluded from the definition of "loss," and settlements characterized as disgorgement or restitution

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[1] "Clifford Chance Lays Off 20 Litigation Associates," *New York Law Journal*, October 15, 2008

probably will not be covered, though the D&O insurer may incur considerable defense costs. Settlements in auction rate securities cases have typically required banks to buy back securities from investors, an expense which usually is not covered under D&O policies.

D&O loss forecast

D&O losses related to the meltdown of the subprime mortgage market and the ensuing credit crisis – specifically losses from securities class action suits, securities fraud suits by regulators and law enforcement agencies, and shareholder derivative suits filed in the United States, including defense costs – are forecast to be $5.9 billion, spread across years 2007, 2008 and 2009. This is the expected value within a range of $4.4 billion to $7.4 billion. Securities suits against private companies with registered debt and suits against non-US companies filed outside the US are not included in the forecast.

Of the $5.9 billion, $5.5 billion is attributable to settlements and defense costs from securities class action suits, and represents the insured portion of an expected $27 billion in securities class action settlements. This compares to $3.6 billion in insured securities class action losses forecast by Advisen in February. The additional $1.9 billion is largely attributable to an increase in the number of suits filed as a result of the global credit crisis. Also contributing to the increase are expected losses under often-massive Side A policies purchased by some financial institutions. Many large banks had reduced or eliminated corporate reimbursement and entity coverage (so-called Side B&C coverages), and instead bought coverage for derivative suits and other non-indemnifiable situations as well as suits with the entity in bankruptcy (Side A coverage). An increase in bankruptcies will put more Side A policies into play. The present analysis also differs from the earlier analysis in that the forecast methodology has been refined to more accurately account for average D&O retentions and policy limits by market cap and industry sector, and multiple suits against the same company during a twelve month period are assumed to be subject to a single policy limit.

We arrived at $5.9 billion in D&O losses through the following process:

- Determine the historical average ratio of securities class action settlements to the drop in market cap following the end of the class period by market cap group. It is necessary to calculate the averages by market cap groups since large companies tend to settle for a lower percentage of market cap loss than do smaller companies.
- Apply those percentages to the actual loss of market cap experienced by companies with securities class action suits to estimate the settlement value of those suits.
- Add estimated defense costs.
- Estimate the insured portion of those suits by applying median retentions and median program limits for D&O polices, by industry group and market cap band, calculated from Advisen's Program Benchmark database.
- From the above, calculate the average insured D&O loss.
- Run scenarios varying the number of expected subprime securities class action suits, and the number of claims expected to be dismissed.
- Add defense costs for dismissed claims under each scenario.
- Estimate losses from shareholder derivative suits based on expected number of suits filed and average expected settlement value, including defense expenses, and add to the total.

- Estimate losses (largely defense costs) from regulator suits and add to total.
- Calculate expected losses based on probabilities assigned to each loss scenario.

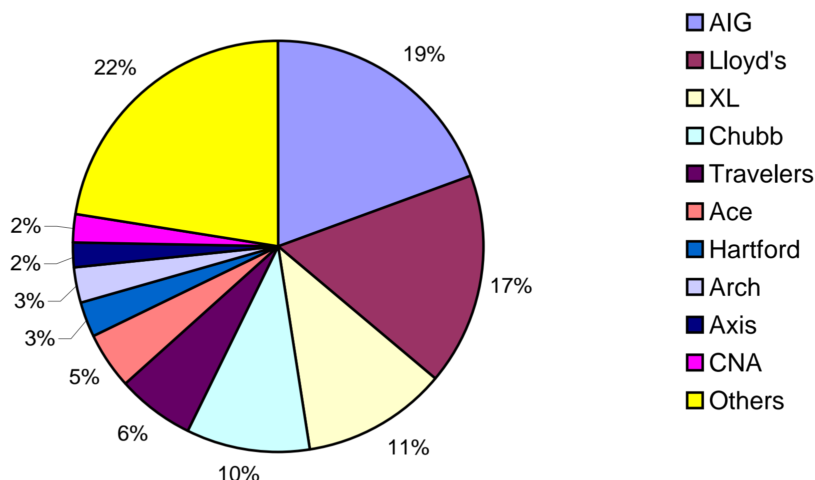
Coverage issues

Insurance coverage issues will factor prominently in subprime D&O claims. Lawsuits are rife with allegations of fraud, and “conduct exclusions” undoubtedly will be invoked. Other terms and conditions that 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. While it is likely that insurers will decline some suits, we have not reduced our forecast to account for this factor.

Market share

Subprime-related D&O losses will not be evenly distributed across D&O writers. More than 90 percent of subprime-related securities class action suits have been filed against companies in the financial services industry. From Advisen’s Program Benchmark database contains policy information for nearly $420 million worth of financial institution D&O premium written in 2006 – 2008, it was determined the top ten writers of financial institution D&O account for 78 percent of the total market, while the top three write nearly 50 percent of the total premium volume. (Exhibit 6)

Exhibit 6 **Financial Institution D&O Market Share**



These figures are derived from policy information compiled by Advisen from risk managers and brokers, which we believe to be largely unbiased. They are nonetheless derived from a sample of the market, 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. Chubb, to choose only one example, in an earnings conference call claimed to have only moderate exposure to subprime losses as the result of decisions taken in 2004 and 2005 to avoid subprime-exposed risks. Where a company typically plays in a program – primary versus excess – will have a bearing on results, as will whether the

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company writes a significant amount of Side A coverage. Net losses sustained by an insurer also will vary considerably according to the terms of its reinsurance programs.

The wide-ranging nature of the subprime meltdown, the large number of entities named in lawsuits, instances of numerous lawsuits filed against the same company, and the array of insurance coverages that may be triggered by these suits make the subprime crisis the new poster child for management liability clash. Clash events are those where more than one policy written by an insurer is triggered by the same underlying cause of loss. Clash events are significant to insurers because of reinsurance terms that may limit recoveries. Depending on the structure of a company's reinsurance program and the specific terms of the treaties, it is possible that the accumulation of subprime-related losses may blow through a company's reinsurance coverage, leaving a far larger net loss than had been planned for.

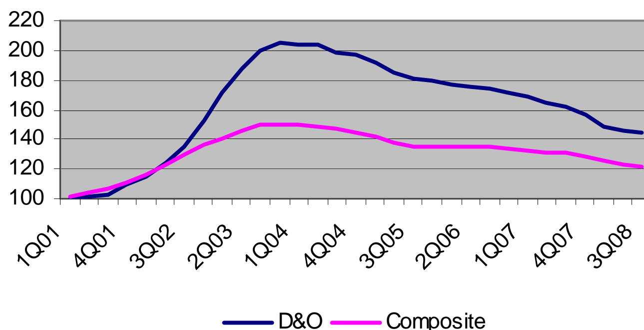
Using a rough estimate of $1.25 billion in annual financial institution D&O premium – an estimate based on input from major financial institution D&O writers – the cumulative financial institution loss ratio for accident years 2007-2009 for subprime-related claims is about 157 percent. However, a large portion of the losses fall in accident year 2008, and will add 229 points to the 2008 FI D&O loss ratio.

Impact on D&O pricing

Advisen monitors and reports on premium trends in North America, both on behalf of the Risk and Insurance Management Society as the administrator of the RIMS Benchmark Survey™, and for Advisen.com's ADVx™ premium index. (Exhibit 7) While D&O premiums for financial institutions and for some real estate risks have increased – in some cases by triple digits – the overall D&O market continues to soften.

ADVx™ index values represent average policy pricing by quarter relative to prices at the fourth quarter of 2000 (=100). At the fourth quarter of 2003, the average D&O policy had doubled in price (=205) as compared to the average policy in the fourth quarter of 2000. As of the third quarter of 2008, pricing for D&O has given up more than half the gains of the 2001-2003 period, falling to 2002 levels.

Exhibit 7 ADVx D&O and Composite



Source: Advisen

The liquidity crisis faced by AIG, the largest writer of D&O by premium volume, is having a short-term impact on D&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. Though 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 D&O market.

Although the AIG liquidity crisis may contribute to a softer market in the short term, the combined impact of underwriting losses and investment losses portend a turn in the market cycle in 2009. Plummeting rate levels, subprime-related losses and higher-than-average natural catastrophe losses led many insurers to post underwriting losses in the third quarter. Under more normal circumstances, underwriting losses would be offset by investment gains, but a large number of insurers are also reporting investment losses due to plunging stock markets, frozen credit markets, and investments in bankrupt or severely compromised companies. Soft market conditions have been driven by overcapacity in the property and casualty insurance industry, but underwriting and investment losses are likely to squeeze out much of the excess capacity by the end of 2008. The soft phase of the cycle is likely to bottom out by the second quarter of 2009 for all commercial lines, including D&O segments not impacted by the subprime meltdown, with a period of rising premiums beginning before the end of the year.

Analysis and conclusions

Advisen's analysis of the impact of the subprime mortgage market meltdown on the D&O market assumes that losses will continue to mount in 2009, but a majority of D&O losses will be incurred in 2007 and, especially, 2008. Governments around the world – especially in the United States and a number of European countries – have taken actions to prop up the global economy and to jog frozen credit markets into motion. Recovery will be slow, but D&O insurers may be spared further seismic shocks that could spark a new round of lawsuits. A significant concern at this point is the possibility of a steady stream of claims prompted by a growing number of bankruptcies, especially since these claims may trigger recoveries under what now seem to be deeply under-priced Side A policies.

D&O insurers may be heartened by the fact that plaintiffs' attorneys have not been more aggressive in filing securities class actions and other D&O-related lawsuits. While financial institution D&O underwriting results have been decimated, the total number of securities class action suits filed still is below historical averages. Law firms apparently recognize that these suits will be difficult to win, and many seem reluctant to commit to expensive litigation at a time when fee income from other practices is falling.

Losses from the subprime meltdown and the ensuing credit crisis are, in themselves, inadequate to halt overall D&O soft market conditions, much less soft market conditions throughout the entire property and casualty market. However, subprime-related D&O and E&O losses, combined with natural catastrophe losses and rate levels depleted by nearly five years of falling premiums, are contributing to underwriting losses for many insurers. Together with investment losses resulting from the global economic crisis, much of the surplus capacity that has been driving rates down has been destroyed, with the likely outcome being an improved pricing environment for all commercial lines of insurance in 2009.

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