

A man in a dark pinstriped suit, white shirt, and red tie with blue stripes is shown in profile, looking upwards and to the right. He has his right hand to his chin in a thoughtful pose. He is wearing glasses and a gold ring on his left hand. The background is a blue wall with a white ceiling. The overall image has a professional, contemplative feel.

Lessons from the sub-prime crisis

Graham Fulcher reflects on lessons arising from the sub-prime banking crisis which could provide valuable insight for London market insurers.

For many London Market insurers, the main concern with the recent sub-prime crisis is managing their exposure to potential liability claims. However, the errors made by financial institutions which led to the crisis hold valuable lessons for London Market insurers, particularly as they enter into a difficult market environment of softening rates and increasing claims.



This article considers the financial services risk management errors likely to be of most relevance to London Market insurers. We have drawn heavily from the influential March 2008 paper 'Observations on Risk Management Practices during the Recent Market Turbulence'. This paper was produced for the Financial Stability Forum of the Bank for International Settlements by the Senior Supervisors Group (SSG), which comprises the main financial markets supervisory bodies of the US, UK, France, Germany and Switzerland.

Each error is identified in bold (as a direct quotation from the aforementioned report), and then followed by the implications for London Market insurers.

"Firms that experienced material unexpected losses in relevant business lines typically appeared to have been under pressure over the short term either to expand business aggressively or to defend a market leadership position."

In previous soft cycles in the London Market, the most significant losses have been experienced by companies rapidly expanding, often by naively diversifying into new lines of business to compensate as they lose business due to competition in the markets they actually understand.

In this cycle, most London Market operators are now confident that they can monitor rate reductions on renewal business (in contrast to previous cycles). Monitoring rate adequacy on new business however, is a lot more challenging, and even for those companies not entering new classes, writing significant volumes of new business is likely to prove highly risky unless the company has good mechanisms in place for assessing rate adequacy on individual risks.

For those companies not entering new lines of business, following (or even leading) a market down so as to avoid losing market share is risky and is likely to lead to losses.

"Firms also noted that mortgage underwriting standards had deteriorated. An increasing portion of mortgages were being underwritten without verifying the borrower's source of income for repayment; in addition mortgages were often underwritten based upon initial 'teaser' rates rather than a rate consistent with bearing the obligation to maturity. Undeclared and undocumented second loans also served to increase borrower's payments relative to their income and decreased borrower's equity positions in the home."

Despite the considerable strides many London Market insurers have made in rate monitoring, one blind spot for many companies is the ability to monitor the extent and effect of weakening terms and conditions. Given the high level of scrutiny to which management generally subjects pure rate reductions and the setting of 'walk away' rating levels, it seems inevitable that London Market brokers will seek at the bottom of the cycle to secure better terms and conditions for their clients when further rate reductions are not possible.

"Some firms found that they could not syndicate their holdings of leveraged loans because of reduced investor appetite for those assets and they could not cancel their commitments to fund these loans."

A key risk for many financial market companies (and in particular the downfall of Northern Rock) was liquidity risk. This risk arose from the mismatch created by using short-term wholesale assets (in

particular three-month LIBOR lending) to fund longer-term retail liabilities (in particular multi-year residential mortgage lending). The problems materialised when the credit crunch withdrew the sources of short-term funding or made it prohibitively expensive.

An analogous risk for non-life insurers in a soft market is protecting business with Losses Occurring Reinsurance. This risk is increased still further when the original business includes multi-year deals. If the reinsurance market hardens (and typically the reinsurance market hardens before the direct market), the insurer will be left with a number of years of underpriced direct exposure which will either have to be run uninsured, or reinsured at prohibitive terms.

“Firms cited the usefulness of revisiting simple notional limits to highlight potential concentrations of risk. These measures are devoid of assumptions and give management a simpler perspective on the potential scale of the risks.”

In a London Market now dominated by the use of catastrophe models and management of exposure via 1-in-100-year or 1-in-250-year Probable Maximum Loss (PML); London Market insurers should not forget more traditional and less subjective measures such as Maximum Foreseeable Loss (MFL) or, even better, their total aggregate exposures.

“Some firms relied too passively on external views of credit risk from rating agencies and pricing services to determine values of their exposures.”

As the FSA commented in their *Financial Risk Outlook 2006* in the aftermath of Hurricanes Katrina, Rita

and Wilma in Autumn 2005, it became apparent that “some firms may rely too much on the output of their catastrophe models without proper consideration of the inputs”.

Although things have improved since then, some London Market insurers may still be using catastrophe models without sufficient consideration of data quality or sufficient understanding of the assumptions underlying the model.

“Because products had been created during the prior period of more benign market conditions, banks and security firms had not observed how such products would behave during a significant market downturn.”

An important aspect of the sub-prime crisis was that it came after a prolonged period of economic stability with low inflation, low interest rates and rising house prices. Many involved in the market either did not remember the property crash and high interest rates of the 1980s or were convinced that the UK had entered a new era of stability.

The London Market is faced with potentially the worst possible economic conditions for non-life insurance claims: high inflation in fuel and food prices combined with slow economic growth due to a slump in asset pricing – what some would call ‘stagflation’. But many market participants are convinced that the worst excesses of the down-cycle will be avoided.

Many London Market insurers now base their planned loss ratios on prior years’ reserved loss ratios over, say, the last five years, adjusted for a constant rate of claims inflation and for renewal rating changes. But the last five years have seen very benign claims conditions across many classes, while the next two to three

years may see very adverse economic conditions: are London Market Insurers factoring this possible reversal sufficiently into their loss picks?

Conclusion

If London Market insurers want to avoid the problems faced by their banking colleagues they would do well to reflect on the errors made and the potential parallels in the insurance industry. Many players need to be more realistic about the challenges of operating successfully in current economic and financial circumstances.