"Black Swans", the "Sub-prime Crisis" and Systemic Risk: One underwriter's Perspective

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Presentation Overview

- How did we get here?
- Who is to blame?
- What have we learned?

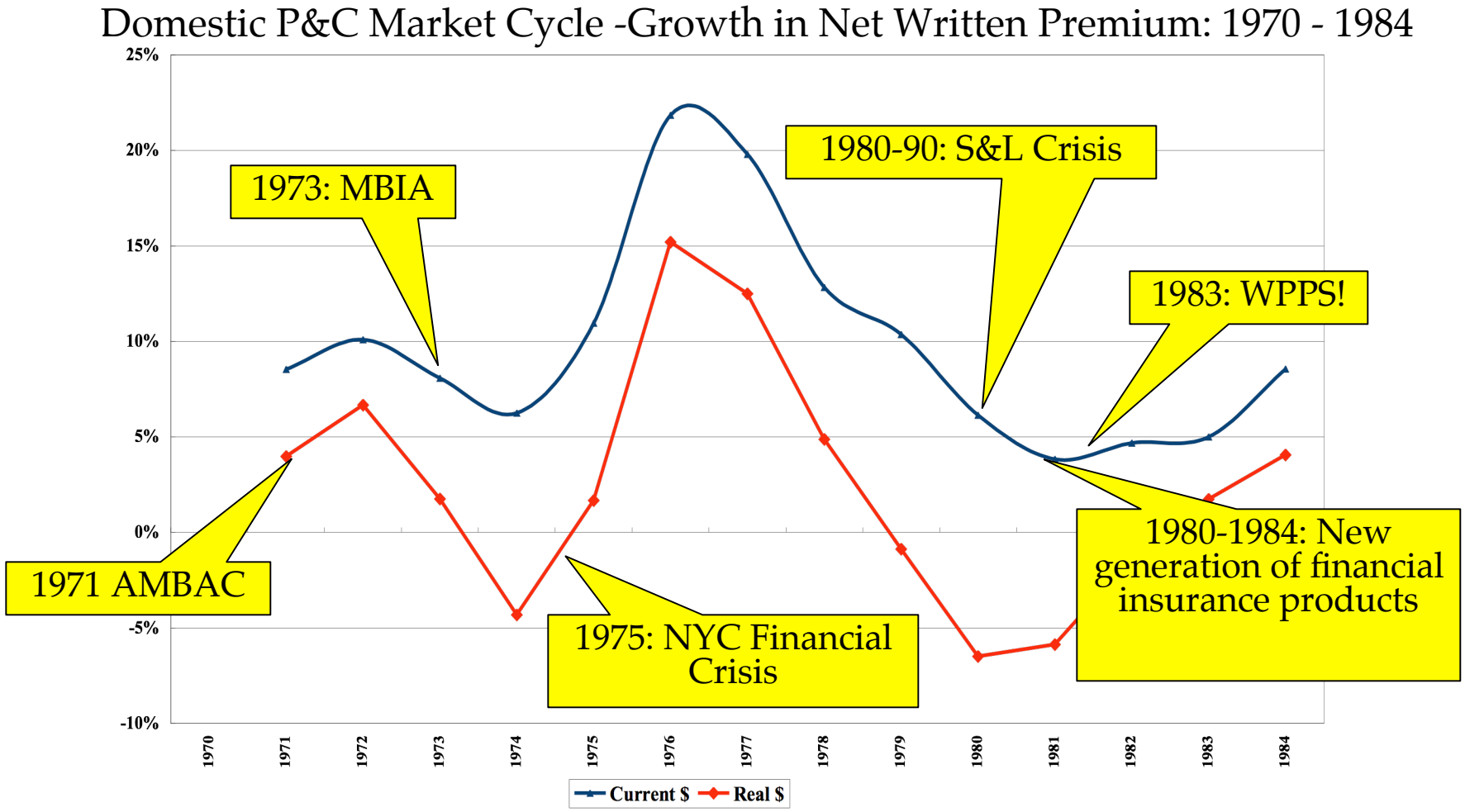
How did we get here?
Financial Risk Policies: Not new to insurance…

- Surety Bonds (predate industrial revolution)
- Municipal Bond Insurance (1971 – Present)
- Credit Insurance
- Title Insurance
- Warranty Insurance
- Other expense related covers (e.g., products recall insurance)

Financial Risk Insurance: Underwriting Challenges

- "Business Risk" – "Insurable Interest"?
- Moral Hazard / Adverse Selection
- "Transaction Value" – Is a Zero Loss Ratio assumption Valid?
- Collateral - Liquid, fungible?
- Recourse - Unlimited?
- Pricing – Credible, equitable?
- Coverage: Non-standardized, complicated - understood?

Financial risk Insurance Products
Accelerated growth in soft markets



Source: Insurance Information Institute

WPPS and S&L Crisis
Resulted in full limits losses to D&O and E&O Insurers

- WPPS Bond Default (1983)
  - $2.25 billion municipal (revenue) bond default
  - Largest municipal default in USA history
  - In litigation almost ten years
  - Losses included D&O of 30 municipalities with "take-or-pay" obligations, A&E, Accountants, Lawyers
- S&L Crisis (1980-1990)
  - Over 2,400 savings and loan association failures
  - Estimated losses of $560 billion - $320 B paid by US Government
  - Major D&O losses sustained by F&D, MGIC and others

Early Eighties Soft Market (1980-1984): New Financial Insurance Products "to the rescue"?

- MGM Grand Fire Retroactive Liability Insurance
- Residual Value Insurance
- Limited Partnership Surety Bonds
- Homeowner's Warranty Insurance Company (first RRG)
- Systems Performance insurance
- "Career Guard" Insurance
- NYIE: Baseball Strike Insurance
- Excess SIPC Insurance

MGM Grand Fire Retroactive Liability Insurance

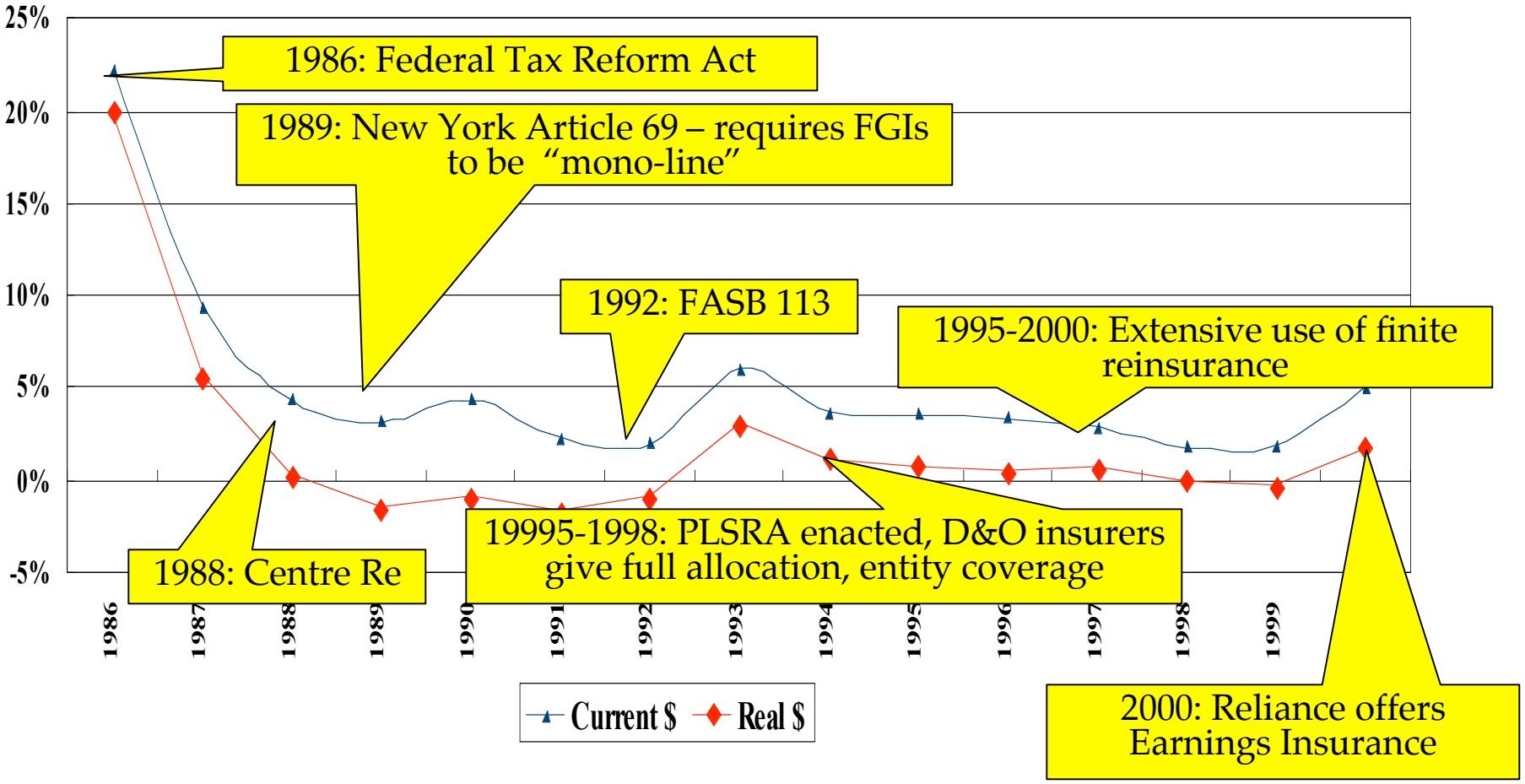
- In early 1981, thirty insurers agreed to multi-layered placement of $120 M limits insured for
- Approximate $40 M premium
- Arguably the first, high profile “finite” deal
- Resulted in detailed industry debate over risk elements to permit “insurability” (including payout timing, and investment income)
- Fronting insurer went into liquidation in March 1995
- Several years later, MGM settled out-of-court for $87.5 million, shortly after jury selection.

Residual Value Insurance

- Typically characterized, like municipal bond insurance, as low-risk credit enhancements to otherwise solid transactions,
- Normally related to asset-based financing, with sale / leasebacks;
- Recourse to insurer / guarantors was normally limited to taking ownership of underlying assets;
- Assets varied widely – included trains, planes, buildings, and even movies.
- Extremely complicated multi-party contracts with numerous possible events of default.

Financial Insurance 1986 -2007:
Key developments…

Domestic P&C Market Cycle -Growth in Net Written Premium: 1986 -2007



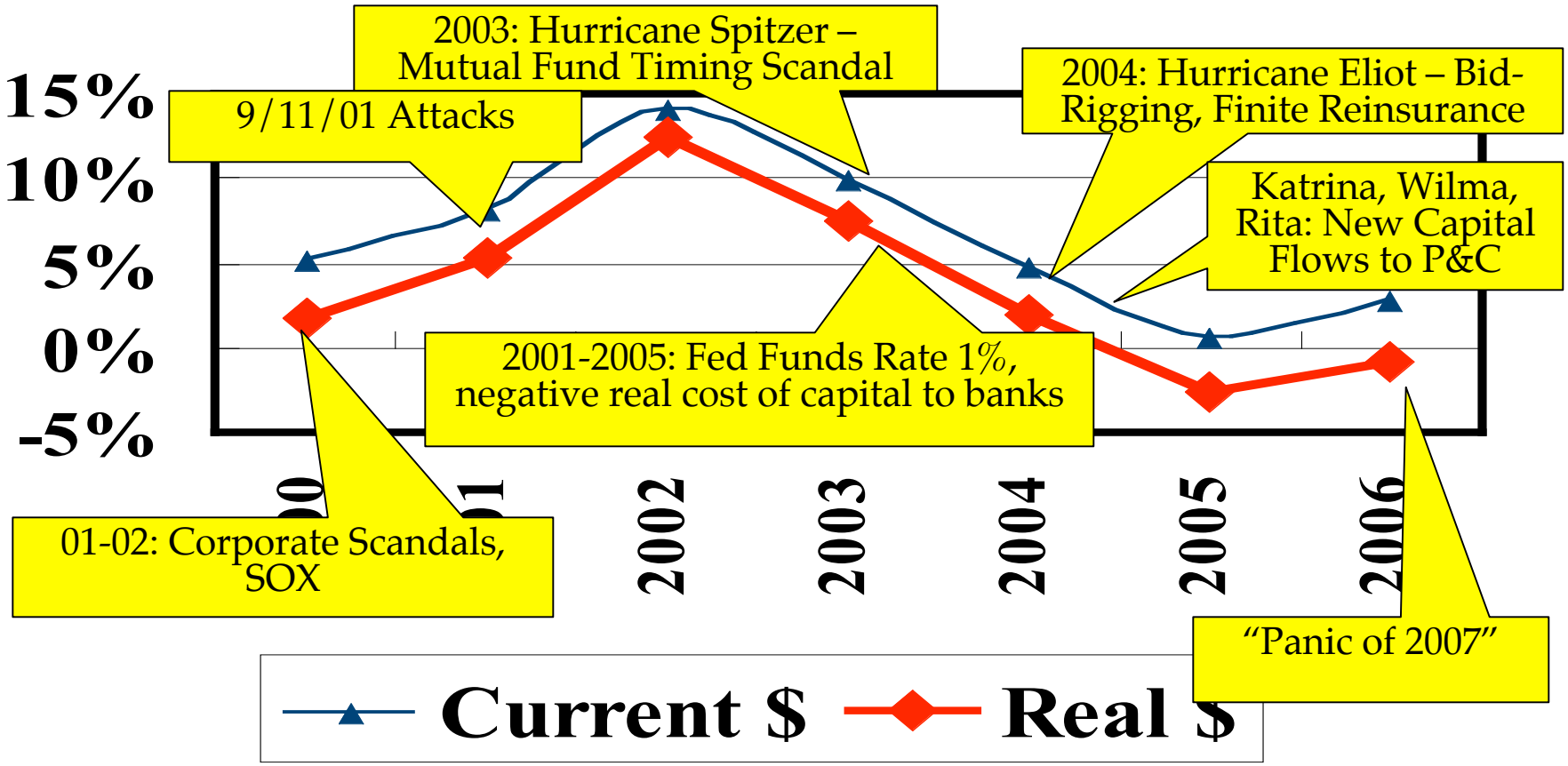
Source: A.M. Best, Insurance Information Institute

Limited Partnership Surety Bonds: Another "Black Swan" event?

- Guaranteed General Partners full payment of scheduled 5 year investments by high net worth individuals. No collateral but full recourse was required;
- Partnerships highly leveraged with gross deductions permitted by early eighties tax code;
- Tax reforms were expected but almost everyone thought the risk to existing deals was zero
- 1986 Tax Reform Act eliminated gross deductibility; no "grandfathering";
- Wealthy investors defied expectations: refused to make future payments;
- Huge initial losses paid by Surety insurers were eventually recouped.

2000-2008
"Black Swans" (Extreme Events), Market Softening, and the "Panic of 2007"

Domestic P&C Market Cycle -Growth in Net Written Premium: 2000 -2007



Sources: Insurance Information Institute, Fortune Magazine (10/08)

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Who is to blame?

"It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."

Joseph J. Cassano, a former A.I.G. executive, August 2007

Who is to blame?

- "Perfect Storm" (Everyone, *ergo*: No One?)
- Greed (i.e., human nature?)
- Late nineties legislative pressure on GSEs?
- "NINJA" and "Alt A"loans – What possible justification?
- Ideological faith in deregulation?
- "Market Conduct" Regulatory Failures (e.g., Is any cost to consumers - be it premiums or mortgages - too cheap?)

Who is to blame?

- Unprecedented Gross Leverage
- No Originator Risk-Taking ("Fronting" / "Pass the Trash")
- Synthetic Financial Instruments?
- Financial rating agencies?
- Flawed mathematical models (i.e., empirical data suggested "all Swans are White")?
- CPA auditor failures
- Fed Funds Rate, 2001-2005, too low, too long.
- Post-Enron, Mark-to-Market Accounting
- GLB, Sarbox: Bring back Glass Steagle?

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What have we learned?

- Financial insurance product growth is pervasive in soft market cycles.
- Regulatory response has been consistently slow, generally ineffective.
- Paradigm shift is occurring: Need alternatives to reliance on private sector self-regulation, e.g., NAIC is currently discussing forming new financial rating agency.

Financial & Insurance Underwriting: Back to the Future?…Many lessons learned

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Financial & Insurance Underwriting: Some positive examples under discussion…

- Real Estate / Recourse: Require the lender to have *full recourse in the event of default*, not just rights to given real property (similar to surety bonds – limits moral hazard).
- Originator: Require some financial risk retention – "skin in the game" – recalls "fronting" and "MGA" legislation in response to insurer insolvencies, e.g. *Failed Promises* – 1990 Dingell report.

Financial & Insurance Underwriting: Some positive examples under discussion…

- Require some underlying "insurable interest" in short selling or CDS transactions – classic difference between "insurance" and "gambling".
- Introduce new modeling approaches such as terrorism risk "deterministic" scenarios to better anticipate tomorrows "Black Swan" events, e.g. Nassim Taleb's "counterfactual reasoning".

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Q&A

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This presentation does not express or imply any opinion on the subject by RAND and offers solely the personal opinions of the author.

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