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Specialty Practice Briefing

An update from Professional Liability Specialty

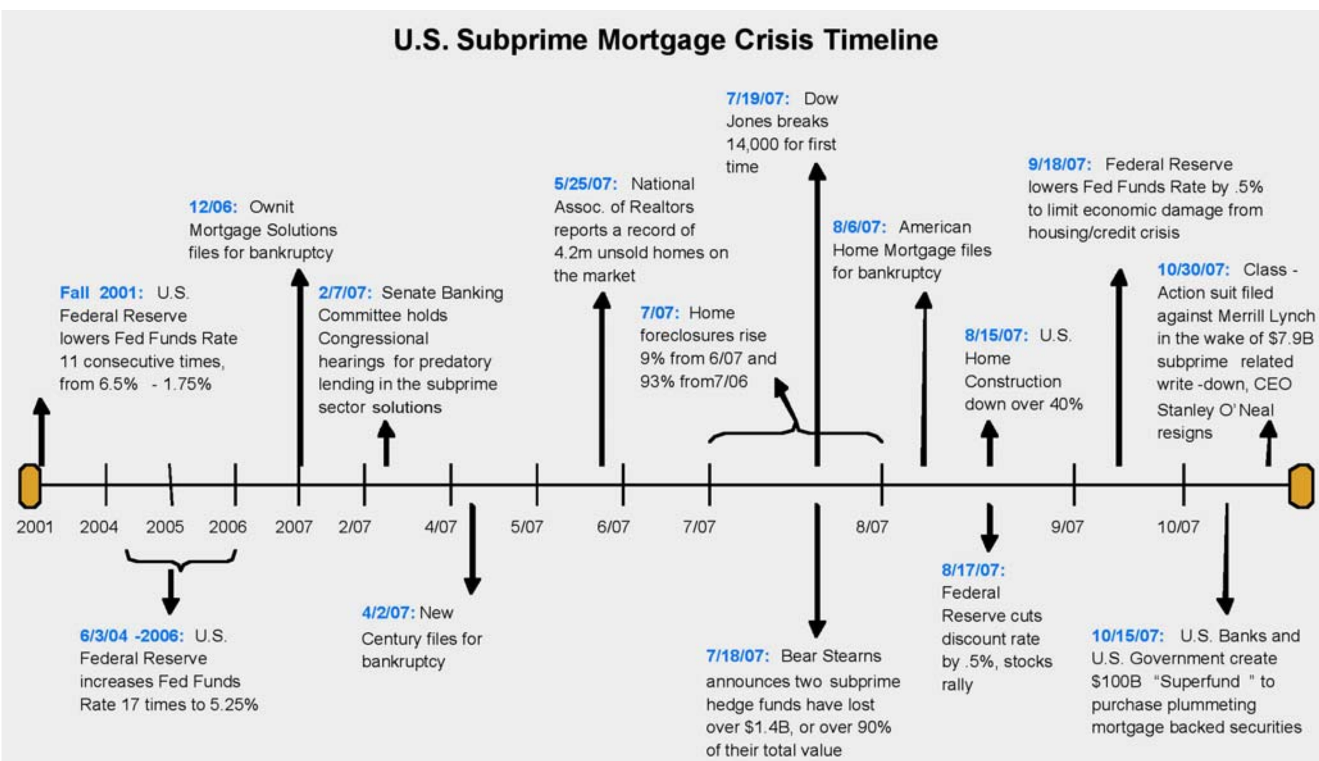
November 2007

Credit Market Aftershock Threatens Professional Liability Profits

There was never any doubt that the subprime mortgage market collapse would have an insurance impact. The question was one of extent. While estimates vary from $1 billion to $3 billion, it looks like the reality may settle at the upper end of the scale. The final answer will not come until 2008 or maybe even 2009, but history, litigation tendencies and capital markets point toward the worst case scenario.

Background

In February 2007, New Century Financial shocked Wall Street. The nation's second largest subprime lender revealed that, because of loan portfolio losses, it would have to restate its financials. New Century's disclosure led to a bankruptcy filing a mere two months later and initiated a flood of reports from financial institutions and real estate industry service providers in which loan portfolios were impaired, earnings were decimated or solvency was threatened. This credit contagion has spread from the real estate sector, short-circuiting the boom in leveraged buyouts (which was fueled by inexpensive debt) and calling into question the way companies value investments that they thought were liquid.



Source: Guy Carpenter & Company, LLC

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As expected, securities litigation has been filed by investors in the companies affected by the credit market's implosion. (Re)insurers of Directors and Officers (D&O), Professional Liability and Errors and Omissions (E&O) lines in the United States and overseas are unsure of the impact that this litigation ultimately will have on profitability. Because investors are still filing, new causes of action continue to be discovered, and the list of potentially affected companies is likely to keep growing. Early reports from insurance equities analysts have focused primarily on asset valuation, indicating that insurers' balance sheets would be unaffected while ignoring the underwriting implications. The analyst community is not unanimous in this rosy assessment. Some have suggested that the underwriting impact could range from $1 billion to $3 billion, though the damage would be contained by an otherwise benign loss environment.

Current claim activity

The crisis could have been worse for insurers. Fortunately, the subprime market collapsed when there were fewer securities class action suits than usual. When the dust settles, total insured losses are likely to be at the top end of analyst estimates (i.e. $3 billion), because most reports have understated the D&O limits at risk and assume there will not be many claims beyond what has been filed already. Insured losses could account for 30% to 35% of D&O industry premium which is unlikely to reduce available reinsurance capacity or substantially impair (re)insurers' results or balance sheets. A hardening of reinsurance pricing in 2008 seems unlikely, except for insurers who are overweight in the affected sectors (e.g. homebuilders, subprime lenders).

Claim activity has occurred across all industries with most resulting from allegations of issuing materially false and misleading statements (based on securities class actions filed through mid-October). Most of the credit crunch's impact will affect the D&O product line, although E&O suits, ERISA actions and other suits have been filed and could lead to further substantial insurance losses.

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One reason why the impact is likely to be greater than it appears is that investors may begin to file against companies not involved in subprime lending but which felt the disruption caused by the subprime mortgage market. For example, Northern Rock–a United Kingdom mortgage lender not involved in subprime markets–relied heavily on short-term debt to fund its mortgage lending activities. But, the collapse of the subprime market led to a general tightening of credit that forced Northern Rock to seek emergency funding from the Bank of England. This move led to the first run on a UK bank in more than a century, and Northern Rock lost 90% of its market value. The net result, of course, was litigation, with various institutional shareholders filing lawsuits against Northern Rock's directors.

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Class Action Allegations

Company	Class Period	Issued Materially False & Misleading Statements	Misrepresented / Failure to Disclose Key Information	Misstated Financial Statements	2/07 to 10/07 Market Cap Change (Millions)	Class Action Period Market Cap Damage (Millions)
Mortgage Banking						
Accredited Home Lenders Holding Company	11/1/05 - 3/12/07	☑			-$400	-$700
IndyMac Financial, Inc.	5/10/06 - 8/15/07	☑			-$1,200	-$1,200
New Century Financial Corporation	5/4/06 - 2/7/07	☑			-$1,700	-$1.0M
NetBank, Inc.	5/1/06 - 9/17/07	☑			n/a	n/a
Mortgage Investment						
Countrywide Financial Corp.	10/24/06 - 8/9/07	☑			-$13,900	-$5,000
Impac Mortgage Holdings, Inc.	5/10/06 - 8/15/07	☑			-$600	-$700
Luminent Mortgage Capital, Inc.	7/24/07 - 8/6/07	☑			-$400	-$200
NovaStar Financial, Inc.	5/4/06 - 2/20/07			☑	-$800	-$800
Thornburg Mortgage, Inc.	10/6/05 - 8/17/07	☑			-$1,700	-$1,000
REIT						
American Home Mortgage Investment Corp.	7/26/06 - 7/27/07	☑			n/a	n/a
RAIT Financial Trust	1/10/07 - 7/31/07	☑			-$1,800	-$1,400
Opteum, Inc.	11/3/05 - 5/10/07	☑			n/a	n/a
Coast Financial Holdings, Inc.	10/5/05 - 1/25/07		☑		-$40	-$30
Fremont General Corp.	5/9/06 - 2/27/07	☑			-$800	-$900
Residential Home Builder						
Toll Brothers	12/9/04 - 11/8/05	☑			-$2,200	$500
Beazer Homes USA	7/27/06 - 3/27/07		☑		-$1,400	-$400
Tarragon Corporation	1/5/05 - 8/9/07	☑			-$300	-$400
Hovnanian Enterprises, Inc.	12/8/05 - 8/13/07	☑			-$1,500	-$2,200
All Other Industries						
E Trade Financial	12/14/06 - 9/25/07	☑			-$4,700	-$4,600
Radian Group, Inc.	1/23/07 - 7/31/07	☑			-$2,900	-$1,900
Moody's Corp.	10/25/06 - 7/10/07		☑		-$5,400	-$1,300
The McGraw-Hill Companies, Inc.	7/25/06 - 8/15/07		☑		-$5,400	-$1,300

Notes:
1. No class has yet been certified in Care Investment Trust Inc. Class action has been commenced.
2. All numbers are rounded up to the nearest $100 except for Coast Financial, which is rounded up to the nearest $10.
3. All allegations set forth above are still pending judicial determination.

Source: Guy Carpenter & Company, LLC

Impact on professional liability insurers

According to an internal analysis by Guy Carpenter & Company, LLC ("Guy Carpenter"), insured D&O losses could exceed $2 billion, based on an analysis of 701 companies in the industries most heavily affected by the market for subprime credit. The market capitalization damage resulting from the 19 subprime shareholder class action filings ranges from 30% to 100%, with the average above 65%.

Guy Carpenter's internal analysis considers a number of variables that will contribute to the ultimate insured loss amount, including available limits and underlying claim allegations (e.g. securities law violations, financial restatements). Securities class actions have historically been drivers of insured loss in similar cases, which is why the estimates are focused on the D&O exposure.

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Co's Mkt Cap Dmg >X% of Beginning Mkt Cap	Total Market Cap Damage	Number of Companies	Potential D&O Insured Loss
20%	$140.7B	219	$8.41B
30%	$70.8B	101	$3.58B
40%	$55.4B	64	$2.46B
50%	$46.9B	41	$1.89B
60%	$11.2B	27	$1.34B
70%	$7.5B	22	$1.22B
80%	$5.1B	20	$1.20B

Source: Guy Carpenter & Company, LLC

The range of potential insured D&O losses for this event is based on claim and stock activity in 2007. Because of the direct correlation between market cap damages (i.e. stock drops) and eventual settlements, we looked at how many firms might experience litigation at varying levels of market cap loss. Then, to estimate severity, we used the market cap damage for non-insiders adjusted for loss expenses on an individual company basis along with information on D&O insurance programs – with the outcome capped at the insurance limit. Where actual insurance limits were not known, we used sources including Marsh's 2007 Financial Institutions Risk Benchmark Report. Furthermore, in our calculation we assume 25% of cases filed will be dismissed.

Industry	Number of Co's	Mkt Cap @ 01/07	Mkt Cap Damage	Potential D&O Insured Losses (% of Mkt Cap Damage) 40%	50%	60%	70%
Credit Services	29	$210B	$22B	$460M	$410M	$410M	$380M
General Building Materials	25	$46B	$2B	$30M	$0M	$0M	$0M
General Contractors	8	$8B	$0B	$0M	$0M	$0M	$0M
Home Improvement Stores	5	$128B	$20B	$20M	$20M	$0M	$0M
Investment Brokerage - National	19	$384B	$47B	$60M	$60M	$60M	$60M
Lumber & Wood Production	14	$39B	$3B	$20M	$0M	$0M	$0M
Mortgage Investment	22	$138B	$19B	$410M	$300M	$100M	$100M
Real Estate Development	12	$7B	$2B	$70M	$30M	$20M	$20M
Regional Banks	512	$452B	$51B	$480M	$260M	$150M	$150M
REIT - Residential	18	$59B	$10B	$120M	$120M	$120M	$100M
Residential Construction	22	$60B	$21B	$560M	$480M	$310M	$280M
Surety & Title Insurance	12	$45B	$11B	$120M	$100M	$60M	$40M
All Others	0	$3B	$2B	$110M	$110M	$110M	$110M
Total	701	$1,577B	$211B	$2.46B	$1.89B	$1.34B	$1.22B

Source: Guy Carpenter & Company, LLC

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Minimum of Insurance limit

or

{Market Cap Damage x (100% - % held by insiders) x (100% + Loss Adjustment Expense %)}

Estimated insured losses by industry are below with mortgage investment, regional banks and residential construction companies likely to sustain the most damage.

D&O loss outlook for 2008

According to former Federal Reserve Chairman Alan Greenspan, “We aren’t through with this yet”. Regarding the subprime financial crisis, Greenspan believes that there still could be an "Act II, in which falling house prices feed into slower consumer spending.” As a result, 2007 may have been an incubation period, with the full ramifications for the D&O market to be realized fully in 2008.

To understand the uncertainty heading into 2008, one can take a look at the ratio of the trading volume of put options to call options (i.e. the “put/call” ratio). Typically used to gauge investor sentiment, a high put/call ratio (i.e. high volume of puts compared to calls) signals bearish attitudes across Wall Street.

From 2004 – 2006 the put/call average for the Chicago Board Options Exchange (CBOE) had an average of approximately 150%. Through 2007, it grew by 13% to 170%. Companies directly involved in litigation over subprime securities have even higher put/call ratios, particularly in the months leading to a securities class action filing. Radian Group (below), for example, saw its put/call ratio reach 461% in June 2007. A securities class action suit was filed the next month.

			Put/Call Ratios								
	Ticker	Company Name	2007 01	2007 02	2007 03	2007 04	2007 05	2007 06	2007 07	2007 08	2007 09
Subprime Related SCA Filings	NFI	NovaStar Financial, Inc.	218%	215%	203%	197%	206%	155%	230%	264%	326%
	LUM	Luminent Mortgage Capital, Inc.	N/A	N/A	N/A	53%	62%	31%	65%	87%	5%
	IMH	Impac Mortgage Holdings, Inc.	31%	191%	118%	36%	62%	116%	116%	110%	84%
	LEND	Accredited Home Lenders Holding Co.	317%	386%	129%	85%	38%	81%	156%	124%	98%
	RAS	RAIT Financial Trust	N/A	N/A	N/A	N/A	N/A	170%	205%	109%	54%
	FMT	Fremont General Corporation	626%	401%	139%	126%	69%	104%	241%	105%	133%
	AHM	American Home Mtg Inv Corp	60%	194%	223%	135%	158%	167%	331%	81%	1239%
	IMB	IndyMac Financial	N/A	N/A	N/A	N/A	138%	185%	226%	195%	136%
	BZH	Beazer Homes USA, Inc.	198%	149%	249%	179%	273%	220%	294%	254%	162%
	HOV	Hovnanian Enterprises, Inc.	75%	47%	258%	281%	204%	227%	154%	169%	139%
	TMA	Thornburg Mortgage, Inc.	190%	144%	182%	73%	61%	50%	231%	150%	113%
	RDN	Radian Group Inc.	225%	452%	366%	269%	173%	461%	138%	190%	73%
	TOL	Toll Brothers, Inc.	66%	47%	44%	115%	72%	122%	135%	161%	148%
	ETFC	E*Trade Financial	35%	63%	196%	60%	28%	36%	99%	161%	81%
	MCO	Moody's Corporation	68%	325%	257%	75%	279%	580%	351%	128%	442%
	CFC	Countrywide Financial Corporation	154%	322%	246%	150%	103%	209%	282%	239%	176%

Source: Chicago Board Options Exchange

The CBOE put/call ratios for the entire market have been ramping up, and more importantly, for the companies in affected industries. Based on put/call increases and stock market volatility (among other indicators), more shareholder class action filings appear likely for 2008, with at least 40 companies showing elevated put/call ratios. Looking forward, the companies with the highest put/call ratio increases (in particular the top 10, below) could be in for a tough year.

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Top 10 Increase in Ratios

			Recent Put/Call Ratios		
Industry	Ticker	Company Name	2007 07	2007 08	2007 09
Credit Services	CSH	Cash America International, Inc.	55%	162%	118%
General Building Materials	FAST	Fastenal Company	76%	173%	131%
Investment Brokerage - National	NMR	Nomura Holdings, Inc.	144%	180%	273%
Lumber & Wood Production	LPX	Louisiana-Pacific Corporation	166%	179%	271%
Regional Banks	FHN	First Horizon National Corporation	167%	1099%	254%
Regional Banks	ZION	Zions Bancorporation	92%	131%	496%
REIT - Residential	EQR	Equity Residential	70%	47%	336%
Residential Construction	RYL	The Ryland Group, Inc.	113%	188%	142%
Surety & Title Insurance	LFG	LandAmerica Financial Group, Inc.	98%	141%	246%
Surety & Title Insurance	MTG	MGIC Investment Corporation	307%	177%	515%

Source: Guy Carpenter & Company, LLC

Loss potential from other professional liability products

More litigation is on the horizon for 2008. As E&O and other professional liability markets are fragmented, it is difficult to estimate potential insured losses. The classes that appear to have the most exposure are alternative investment funds (e.g. hedge funds, private equity funds), real estate agents and mortgage brokers. While hedge funds historically have not been large purchasers of insurance (10% to 15% of 8,000+ funds), their increased interest in buying D&O and/or E&O, as well as the significant rate hardening on existing funds, seems to indicate that attitudes are changing.

According to a 2004 study by Wholesale Access Mortgage Research & Consulting, Inc., there are approximately 53,000 mortgage brokerage companies that employ an estimated 418,700 employees and originate more than 50% of all US residential loans. Assuming an average insurance limit of $300,000 for each company (the minimum required by Fannie Mae/Freddie Mac), there would be almost $16 billion of insurance at stake.

The nature of the parties initiating litigation will impact the outcomes, particularly for real estate-related classes like agents and mortgage brokers. Actions by individuals would represent higher claim frequency, but lower ultimate insured losses, while class actions, in which plaintiff attorneys generally try to structure a party of multiple claimants with similar grievances, represent a much larger potential insured loss, despite a lower claim frequency. Class actions are most likely to be limited to the largest companies who represent deep pockets to potential plaintiffs.

In the event that the credit issues persist and disputes increase, particularly in the residential real estate market, insured losses to real estate agents and mortgage brokers could reach into the hundreds of millions of dollars.

Effects on professional liability underwriting

Outside the companies with claims or those in the industries (e.g. homebuilders) most affected by the credit crunch, insurance rates have not increased, and coverage has not decreased. Nonetheless, most insurers have approached the crisis with a conservative posture, as some industries are exposed to significant risk.

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	D&O Exposure	E&O Exposure	Regulatory/ Governmental
Subprime lenders	High	Medium	High
Money center banks	High	Medium	High
Regional banks	Medium	Medium	Medium
Home appraisers	Low	Medium	Low
Real estate agents	Low	Medium	Low
Mortgage brokers	Medium	High	High
Title insurers	Low	Medium	Low
REITs (non-mortgage)	Low	Low	Low
Home builders	High	Low	Low
Retail	Medium	Low	Low
Home inspectors	Low	Medium	Low
Rating agencies	High	High	High
Bond Insurers	High	Medium	Low
Hedge funds	High	Medium	Medium
Private equity	High	Medium	Low
Building materials	Medium	Low	Low

Source: Guy Carpenter & Company, LLC

(Re)insurers are viewing Side A D&O coverage as increasingly vulnerable to claims from the credit crunch, despite the fact that traditionally it has been more profitable than other professional liability products. The large investment banks, for instance, may have a "failure to supervise" exposure arising from trading losses or debt-structuring (e.g. CDOs, CLOs). This exposure could lead to derivative litigation that would impact their Side A policy forms, traditionally perceived as having less loss exposure. A substantial portion of the insured limits exposed to this credit event are Side A in nature. The plaintiffs' ability to access these insurance policies could mushroom the insured loss.

Impact on reinsurance market, terms and conditions

Since 2004, the largest professional liability insurers have lowered their reinsurance purchasing dramatically. As a group, the top ten buyers reinsure 60% less than they did just three years ago.

Total Gross Capacity, Top 10 Insurers	**250,000,000**
2004 Reinsurance Capacity for Top 10 Insurers	**128,750,000**
Current Reinsurance Capacity for Top 10 Insurers	**50,565,000**
Change	**-61%**

Source: Guy Carpenter & Company, LLC

Middle market insurers are more heavily reinsured than their larger competitors. However, their exposure is reduced by a lack of coverage concentration in financial institutions and Fortune 1000 companies. It seems that most losses will be sustained by the ten largest insurers–and that most reinsurers will see no material adverse effect to their professional liability earnings. Ironically, this event may prove to be positive for reinsurers if the potential for loss activity stems the tide of rate decreases and reinforces the value of reinsurance to all ceding companies.