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The Emerging Sub-Prime Scandal and Strategic Approaches to Claims for Coverage

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Today's mortgage market has separated into two segments: the prime market and the sub-prime market.

The prime market extends loans to the majority of households with average to excellent credit, while the sub-prime market extends more costly loans to households with less financial security and lower credit scores. Ideally, the sub-prime market presents an opportunity to lenders to extend credit to a class of people that normally would not qualify for home loans and expands the opportunity to own a home to a larger segment of the population.

The U.S. housing market of the past few years has led to a staggering number of sub-prime loans. But, this market expansion has come at a significant cost. To justify the heightened risk, lenders often attach significant fees and balloon payments to loans. Although contested by some market analysts, many attribute increasing defaults on home mortgages and a virtual meltdown of the sub-prime industry to these expensive high risk loans. Although certain sub-prime lenders are experiencing significant financial difficulties, including bankruptcy, the sub-prime meltdown is affecting more than just the originators of the loans. Investors, including large banks, hedge funds and insurance companies, are feeling the financial pressure resulting from the failure of the sub-prime market. In the wake of the crisis, Congress is seeking to strengthen laws to combat the often predatory nature of sub-prime loans to prevent increased default rates in the future.

Over the last several months, lawsuits and investigations of many varieties have been filed or threatened, as investors, trustees and homeowners scramble to recoup losses predicated on the decline of the sub-prime market. It is only a matter of time before litigants embroiled in what may prove to be a long and expensive journey turn to the insurance industry in an effort to defray costs. This paper examines the genesis of the sub-prime market problems and provides an overview of the regulation and litigation reaction that is developing, and the potential effect on insurers.

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