Special Purpose Captives – Mortgage Reinsurance

2003 Casualty Loss Reserve Seminar

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Special Purpose Captives – Mortgage Reinsurance

- Mortgage Insurance Overview
  - What is it?
  - How does it work?
- Mortgage Reinsurance
  - Who are the reinsurers?
  - Types of reinsurance arrangements
  - Regulatory/Accounting Issues

Mortgage Insurance

Mortgage Insurance

- What is it?
  - PMI – Private Mortgage Insurance
  - Less than 20% down payment
  - Protects mortgage lenders against potential losses in the event of a borrower default
  - Facilitates the sale of low down payment mortgages (<20% down) in the secondary market

Mortgage Insurance

- How does it work?

Example

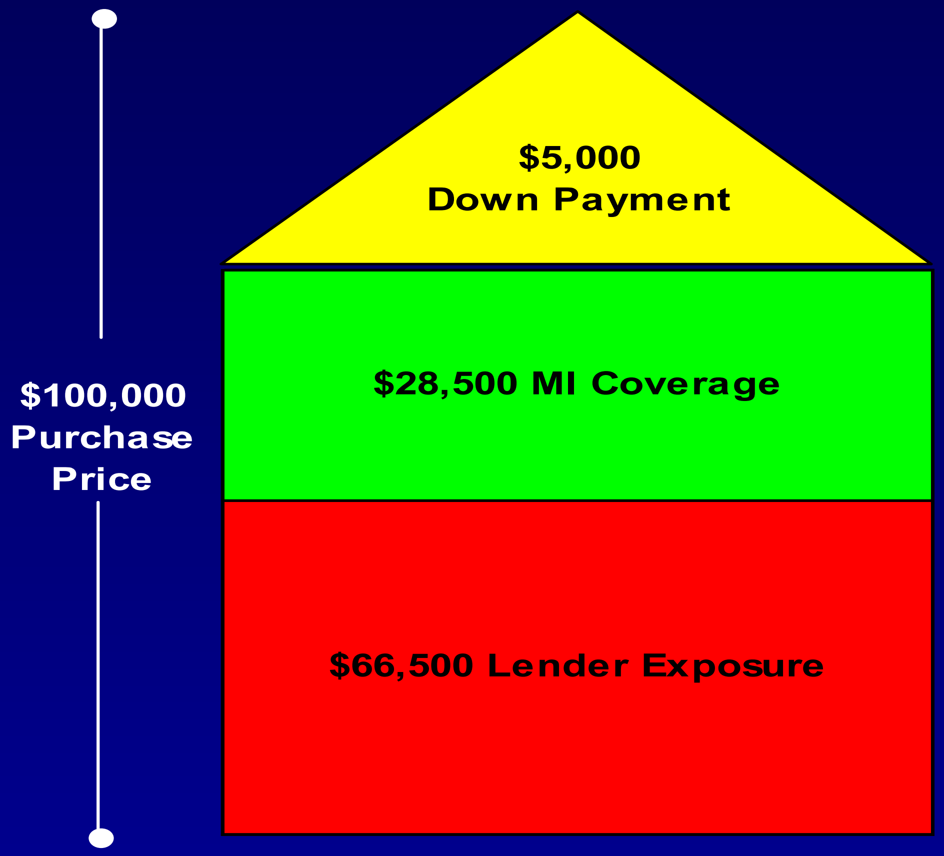
$100,000 Purchase Price

$5,000 (5%) down payment

$95,000 Mortgage

MI coverage = 30% = $28,500

Mortgage Insurance



Mortgage Insurance

- Advantages to Buyer
  - Less $ needed to purchase a home.
  - Tax advantage of ownership versus renting
  - Ability to buy larger house
- Advantage to Lender
  - Increases pool of potential home buyers
  - Lowers credit risk
  - Ability sell loans in secondary market

Mortgage Insurance

- The more you put down, the less coverage you need.
- Borrower pays for PMI coverage, but the lender is the policy beneficiary.
- Premiums typically paid on monthly basis.
  - Annual and single premium plans also available.
- Coverage may be canceled at request of homeowner when equity reaches 20%.
  - Automatically canceled when LTV ratio reaches 78% or original value. (HO Protection Act of 1988)

Mortgage Insurance

- Reserves
  - UPR
  - Loss Reserves
  - Contingency Reserve
    - 50% of calendar year earned premium
    - Held for 10 years
    - May be reduced if calendar year incurred loss ratio exceeds 35%.

Mortgage Reinsurance

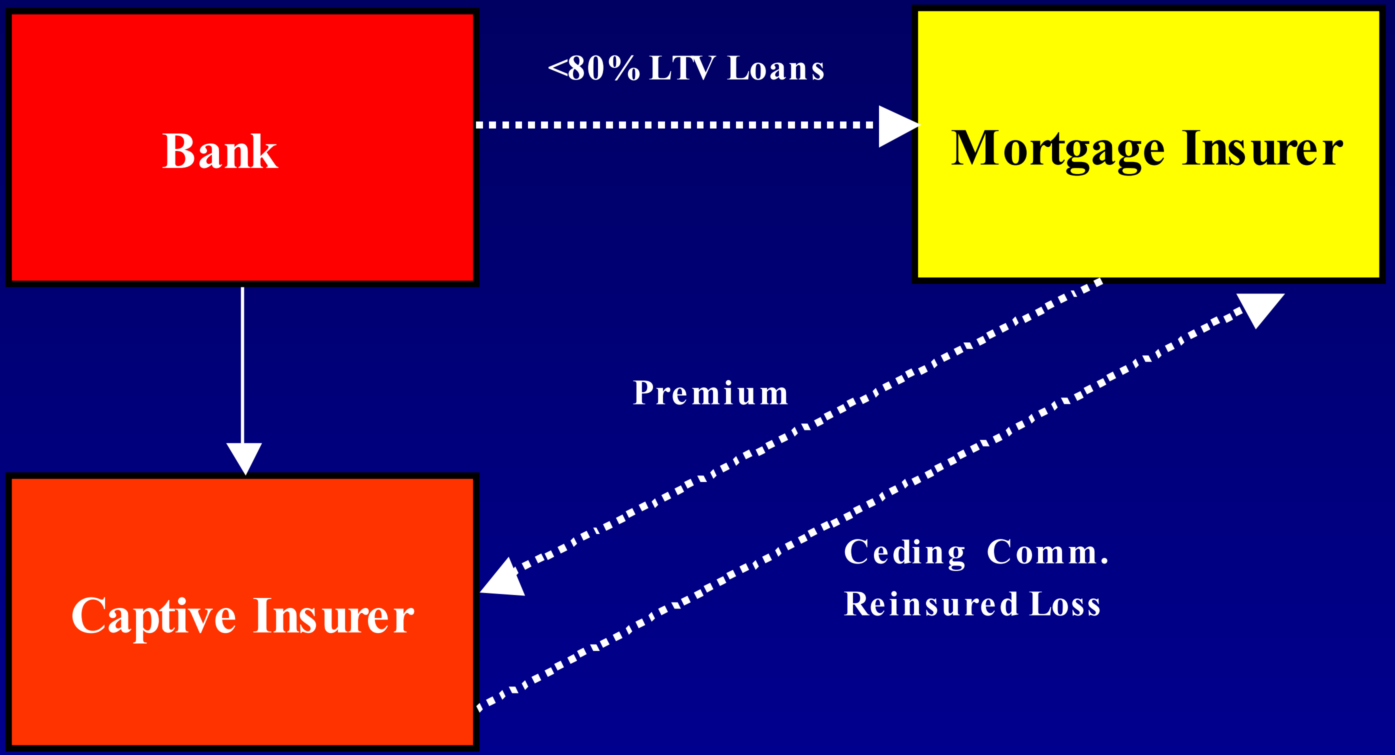
Mortgage Reinsurance

- Captive Reinsurer
  - Typically formed by bank
  - Sole purpose is to participate in the profit/loss experience of the mortgage insurance on loans originated by the bank.
    - Banks originate loans with >80% LTV.
    - Mortgage insurance through one or more mortgage insurers.

Mortgage Reinsurance

- Advantage to Mortgage Insurer
  - Gives banks incentive to underwrite good risks.
    - "Skin in the game"
- Advantage to Banks
  - Capture transaction profits going to third party.

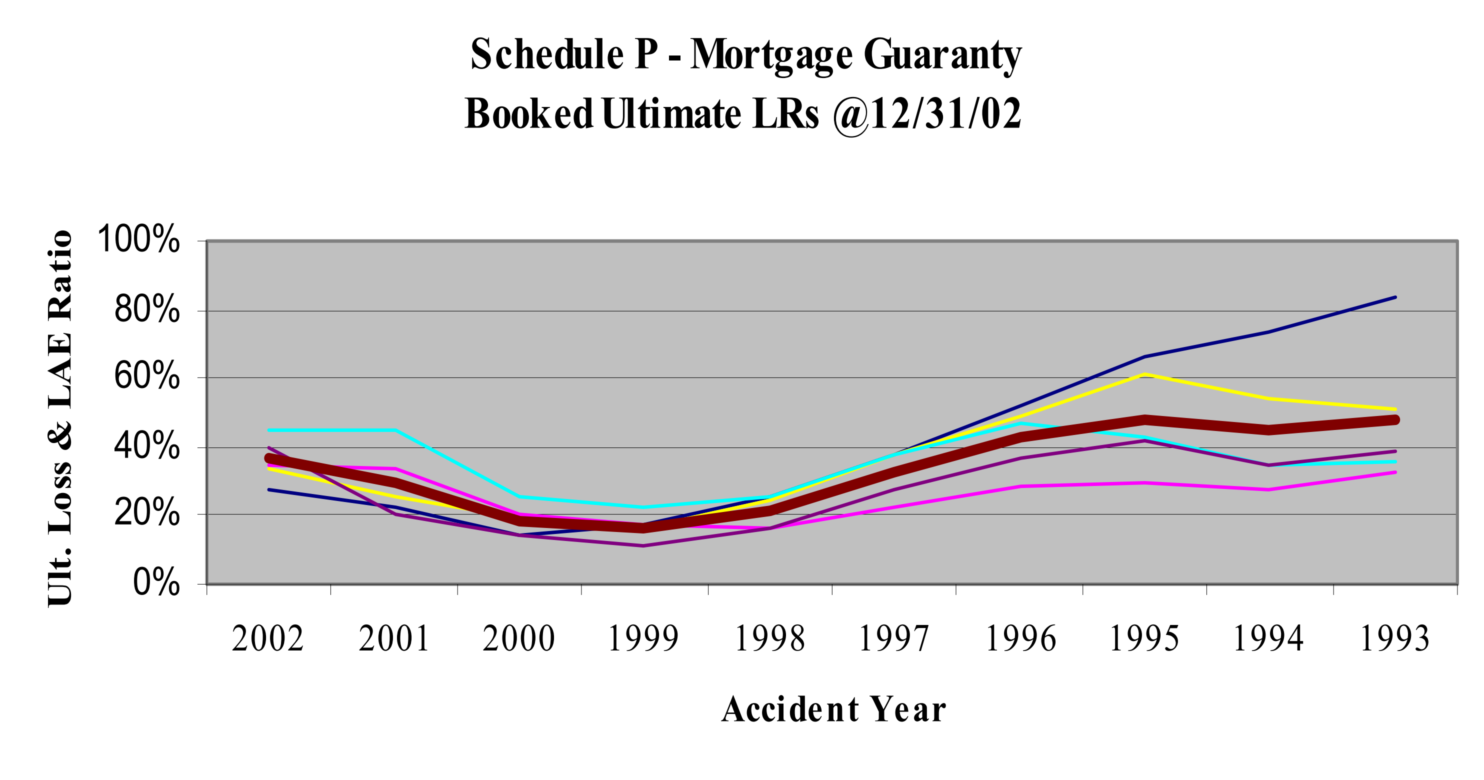
Relationships



Mortgage Reinsurance

Why do banks want to be insurers???

Mortgage Insurance



Mortgage Reinsurance

- Reinsurance Agreements
  - Quota Share
  - Excess of Loss

Mortgage Reinsurance

- Reinsurance Agreements
  - Quota Share
    - Percentage share of premium for equal percentage share of losses.
    - Ceding commission

Mortgage Reinsurance

- Reinsurance Agreements
  - Excess of Loss
    - Attachment point and limit are set in relation to the total original risk insured.
      - 4/10/40
      - 5/10/25
    - Original risk on an individual policy is equal to the loan amount times the coverage ratio.

Previous example:	\$95,000 loan
	30% coverage
	\$28,500 insured risk

Mortgage Reinsurance

- Regulatory/Accounting Issues
  - RESPA (Real Estate Settlement Procedures Act)
  - FAS 113 – Risk Transfer

Mortgage Reinsurance

RESPA

- Section 8
  - No person shall receive any fee, kickback, or thing of value for the referral of business involving a federally related mortgage loan.
  - Prohibits the giving or receipt of any portion of any charge made or received, other than for services actually performed.

Mortgage Reinsurance

RESPA

- Arrangements are permissible if payments to reinsurer:
  - Are for reinsurance services actually furnished or for services performed, and
  - Are bona fide compensation that does not exceed the value of such services.

Mortgage Reinsurance

RESPA

- Lenders typically select mortgage insurer
  - Lender captive must provide actual reinsurance services
  - Premiums assumed must be commensurate with risk assumed
  - Otherwise, ceded premiums regarded as referral fee
    - Violation of RESPA

Mortgage Reinsurance

FAS 113

a. The reinsurer assumes significant insurance risk under the reinsured portions of underlying insurance contracts.

<u>and</u>

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

<u>or</u>

c. All of the insurance risk on the reinsured portions of the underlying policies is assumed by the reinsurer

Mortgage Reinsurance

FAS 113

- Commonly accepted criteria is that there should be at least a 10% chance of a 10% loss in order to have a reasonable possibility of a significant loss.
- Calculations are performed on a net present value basis.
- Only cash flows between the primary insurer and the reinsurer are considered.

Mortgage Reinsurance

- Determining probability of 10% loss
  - Is historical experience a reasonable estimate of potential losses?
    - ~12% "default" rate = 90^{th} percentile?
    - Current prepayment rates
  - Actuarial models
    - Default & prepayment
    - Capital requirements

Mortgage Reinsurance

- Questions
  - When does a transaction fail to meet RESPA criteria that payments do not exceed the value of the risk assumed?
  - Should each individual book year be reviewed separately without consideration of results from other book years?

Mortgage Reinsurance

- More Questions
  - If each book year is treated separately, should each book year have capital allocated to it?
  - If book years are combined for analysis, it implicitly assumes that the addition of a new book year changes the terms of the original policy.
    - FAS 113 needs to be retested.

Mortgage Reinsurance

- Implication of Combined Book Year Analysis
  - Since the trigger for reinsurance is on the cumulative losses by book year (XOL), when multiple book years are reviewed after several years of low losses, it becomes more difficult for combined years to pass risk transfer test.
  - A new book year that may have passed on a stand alone basis may now fail.

Mortgage Reinsurance

- Another view is that the trust fund also acts as an aggregate limit of the contract.
  - Each time a policy year is added, the limit is adjusted.
  - Each contract has thus been amended.
  - FAS 113 re-tested on all years, on a prospective basis.

Mortgage Reinsurance

- AICPA
  - No consensus or guidance yet on “correct” way to analyze a reinsurance contract(s) for risk transfer.