

Structured Finance Reinvents Mortgage Insurance Industry

This is not your father's mortgage insurance. Structured finance, especially captive mortgage reinsurance, has redone the business.

By S. Trezevant Moore Jr.

The mortgage insurance business has undergone a sea change since the mid-1990s. No longer do MIs just provide card-rate insurance, interesting giveaways and contract underwriting. MI companies are now playing an integral role in sophisticated risk-and revenue-sharing programs, cooperative arrangements with the GSEs, private label securitizations, and portfolio and capital-relief transactions.

Some companies seek to partner with their clients through these products, which are generically known as structured transactions. Typically, a structured transaction involves restructuring the premium stream of a number of mortgage insurance policies.

Probably the most dramatic example of how structured transactions are changing the competitive landscape has been the rapid acceptance of captive mortgage reinsurance. The concept is really an innovative twist on a common insurance industry practice of ceding some of the premium to a third party in return for the third party underwriting some of the risk. These captive mortgage reinsur-

ance companies underwrite some of the risk and garner some of the return of the MI company.

Make no mistake about it: captives are insurance companies. Captives must contribute real capital to cover losses. In order to justify the cession of premium to a captive, there must be a real transfer of risk to the captive.

In addition to an initial contribution of capital, operating and investment income must remain in a trust account to provide the captive with sufficient capital to undertake the risk assumed. Once the captive reaches its appropriate capitalization, net income is available for returning dividends to the owner, usually within five years from inception.

Different flavors of captives

Today, lenders have several choices when it comes to captives. The first is whether to set up their own captive reinsurance company or to participate in a "group" captive, al-

ready established by an MI company.

Stand-alone captives require fairly significant investment, management time and expenses. For these reasons, larger lenders tend to prefer stand-alone captives, while small-sized mortgage bankers are more likely to use group captives. Stand-alone captives can be domiciled domestically or offshore. Offshore captives may have some tax benefits that are attractive for certain lenders.

The lender must also choose between a "quota share" or an "excess of loss" reinsurance agreement captive. Quota share agreements are quite simple: the captive gets a pro rata share of both the risk and the return. For example, a 20% quota share provides the lender with 20% of the premiums and the obligation to pay 20% of the losses.

In an excess of loss captive, the



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lender will pay a layer of specified losses in return for a specified portion of the premium, called a cession. The MI will pay the first "X" number of losses in a book of business, the captive will then pay a second layer of losses and, finally, the MI will pay any catastrophic losses.

The point at which the captive starts to pay losses is called the attachment point, and the losses the captive pays is the coverage band. The band width is the number of losses paid by the captive. For example, a 4/6/20 excess of loss captive means that the MI pays the first 4% of losses, the captive pays from 4.01% to 10% and the captive receives net 20% of the premium for that risk.

Pool and its evolving options

The other broad category of structured transactions is known as pool insurance. Over the years, that term has been appended to a number of different products. The earliest pool policies, known as standard pool, were written from the mid-1980s to early 1990s.

These policies called for MIs to pay all credit-related losses up to the dollar amount stop loss. They were very popular forms of credit enhancement for publicly registered, rated MBS. But financially, they were a disaster for MI companies that took on more risk than they were compensated for.

Another problem with standard pool policies is that they sometimes cover non-credit-related losses, such as special hazard or earthquake, fraud and bankruptcy or cramdown. Senior subordinated structures roll all four risks into the subordinated bonds, with losses on the three ancillary risks being subjected to their own rating agency-specified stop losses.

As the subordinated bond market suffers periodic bouts of illiquidity, standard pool transactions continue to be requested by lenders and Wall Street. Also, as banking and thrift regulations finalize risk-based capital regulations, pool policies are becoming popular for private, capital relief-oriented transactions.

Recently, pool insurance has been

written on conforming loans. So-called "GSE pool policies" provide lenders with a reduction in their GSE guarantee fees if they enter into pool policies that provide the mortgage agencies with an additional layer of pool protection.

Today, however, a tiered primary or secondary market execution transaction, which provides a more efficient use of an MI's capital, has largely replaced GSE pool policies. Although each program with a particular MI and GSE is somewhat different with tiered primary, the MI typically agrees to split standard MI coverage into two pieces.

The first 'piece' pays claims down to 80% LTV, which is the minimum the GSEs can accept under their charter. Losses in excess of charter minimum coverage are covered by a modified pool policy, which provides for deeper MI coverage up to a finite amount set by the MI and GSE.

Modified pool policies

Modified pool policies are another option. Modified pool is similar to standard pool, except it normally encompasses deep MI coverage on most or all loans in a pool down to anywhere from 50% to 70% LTV, but subject to an aggregate amount of claims paid, known as a stop loss.

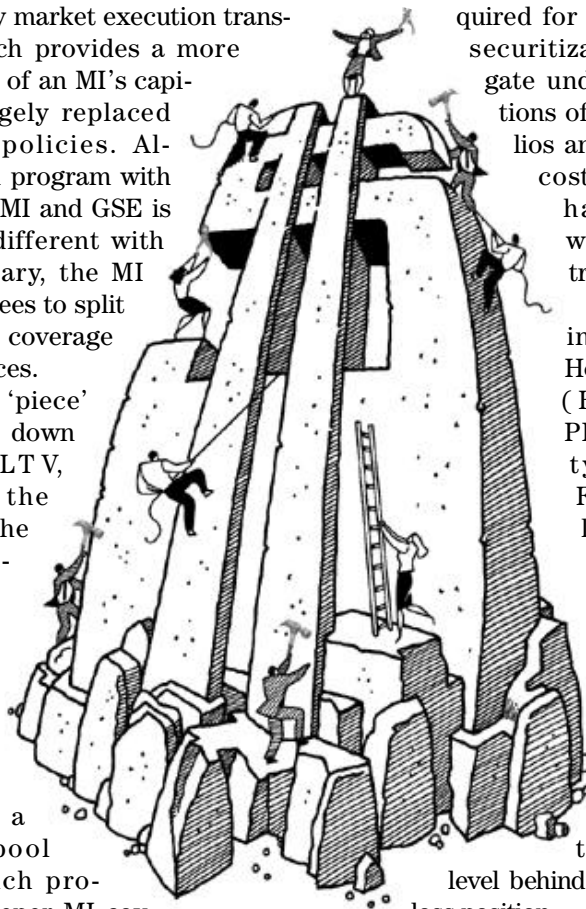
The limit on a claim paid on any individual loan (the incidence cap) reduces the cost of a modified pool compared to that of a standard pool policy. It should be noted that, unlike traditional pool policies, modified pool policies do not pay claims on loans with LTVs below the incidence cap. In other words, there is no insurance on a 55%

LTV loan if the modified pool coverage is down to, say, 65% coverage.

For this reason, modified pool is often used in conjunction with other enhancements in securitized transactions. Modified pool has been used as a way to significantly reduce the

total credit enhancement required for a private label securitization, to mitigate undue concentrations of risk in portfolios and to lower the cost of credit enhancements in whole loan transactions.

For example, in the Federal Home Loan Bank (FHLB) 125 PLUS program, typically the FHLB will cover loss up to a set number of basis points of expected realized losses. The MI will then provide modified pool policy with coverage to a 60% LTV



level behind the FHLB first loss position.

The stop loss of the modified pool policy provides for an implied AA rating. Finally, the lender then retains a small amount of risk. The total package is generally sized to an AA level. The FHLB will take catastrophic risk past the AA risk level.

Structured transactions have proven to be valuable tools for risk management for lenders, GSEs and investors. The efficient reallocation of risk and revenue through structured transactions has transformed the MI industry and provided real economic benefits to its partners and, ultimately, the American consumer.

Although structured transactions are not your father's MI products, they do help many Americans obtain attractive, low downpayment financing. The borrower may even be your father. **SM**