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Bracing For The Next Crash: Mortgage Reinsurance Emerges

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Law360, New York (January 24, 2017, 5:21 PM EST) --
As many mortgage lenders became painfully aware in the aftermath of the Great Recession of 2008, one potential casualty of a financial crisis is the housing market. In such a strained economy, changed circumstances, such as loss of a job, divorce or death, materially impact a borrower's ability to make his monthly mortgage payments. Mortgage insurers protect mortgage lenders — or the government sponsored entities (GSEs) and investors who purchase the loans originated by those lenders — against the risk of borrower default. Most often, mortgage insurance is purchased when a borrower is not able to make a down payment of 20 percent or more, reducing the risk of these more highly leveraged loans.

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Monoline mortgage insurers were on the front lines of the recession of 2008. The crisis left most mortgage insurers undercapitalized and still others out of business altogether. As the economy has recovered, mortgage insurers are looking for ways to avoid the recurrence of those dark days by figuring out how to better spread their risk. Private third-party reinsurance has emerged as a key component of that strategy.

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Before the Crash, Mortgage Insurers Generally Managed Risk Internally

For decades before the economic crisis, mortgage insurers for the most part managed their risk internally through captive reinsurance and portfolio management, and were generally successful in doing so. Mortgage insurers showed little interest in purchasing reinsurance, and reinsurers themselves had little experience with the risk. As a result, third-party mortgage reinsurance was not widely available.

Mortgage Reinsurance Emerges with a Nod from the GSEs

In 2012, certain entrepreneurial brokers and reinsurers saw an opportunity to assist mortgage insurers in managing their risk. Reinsurers, particularly those experienced with financially focused products such as surety, began exploring the potential for reinsuring mortgage risk. The market opened up further when, in the wake of the crisis, Fannie Mae and Freddie Mac — the GSEs which make up the vast majority of the mortgage market — sought to enhance the security of their insurers in the next economic downturn. In December 2015, Fannie Mae updated its private mortgage insurer eligibility requirements (PMIERs) to increase the capital requirements for mortgage insurers seeking to provide

insurance to the GSEs. The increased capital requirements allow relatively little capital credit for future premiums. Specifically, credit toward satisfying the PMIERs assets requirements can only be taken for 210 percent of annual premiums for loans originated prior to 2009.[1] Future premium can still be used to cover dividend payments and operating expenses.[2]

With the increased capital demands of the PMIERs, mortgage insurers have looked increasingly to third-party sources to provide balance sheet relief. Pursuant to the PMIERS, before entering into any third-party reinsurance transaction, the mortgage insurer must obtain written approval from Fannie Mae, who will review every reinsurance contract. The reinsurer must be "[a] strongly capitalized entity, as determined by Fannie Mae" or "[a] reinsurer that maintains an Insurer Financial Rating of at least 'A-' from S&P or 'A-' from A.M. Best Company."[3] The PMIERs also require that the risk ceded to the reinsurer be collateralized.[4]

A Heavily Monitored Risk

Mortgage insurance differs from many other risks because mortgage insurers are highly regulated and subject to extensive monitoring from the GSEs.

A mortgage insurer seeking to retain its approval to insure GSE loans must comply with stringent quality control standards. These quality control standards are set forth in the PMIERs and require the mortgage insurer to, among other things, maintain a quality control program to assess the effectiveness of its underwriters and those insureds to whom it might delegate its underwriting.[5]

To date, mortgage reinsurance has principally been available for prospective business only. The quality control standards imposed by the GSEs likely will provide added comfort to those reinsurers entering the market — someone else is already constantly looking over the mortgage insurer's shoulders in an effort to ensure that the mortgage insurer is underwriting to acceptable standards.

Mortgage insurance policies, too, are carefully reviewed by the GSEs, and are largely standardized in the industry as a result. This likely will provide further predictability for reinsurers. The policy is typically attached to the reinsurance contract itself.

Like traditional reinsurance contracts, most reinsurance contracts will contain audit and inspection rights. Reinsurers may take advantage of these rights less frequently, however, given the supervision of the mortgage insurers by the GSEs.

The difference in the risk posed by one mortgage insurer compared with the risk posed by another will largely come down to differences in the underwriting quality and/or the credit quality of the loans insured. To manage these risks, most reinsurance contracts are likely to include some type of credit requirements for the loans to qualify for reinsurance, such as minimum FICO scores and minimum loan to value ratios. There is extensive publicly available data about mortgage loans, which can help inform a prospective reinsurer. The mortgage insurer itself is, of course, the best source of information about the risk. The reinsurer and the mortgage insurer can discuss whether any conclusions can be drawn from the past data, and, if so, what those conclusions may be. For example, it has been widely reported that the loans originated during the mid-to-late 2000's were tainted by misrepresentations, making it more difficult to draw any conclusions about the potential risk posed by those loans. In contrast, the loans being written today are reported to be some of the highest quality loans ever originated. Standard & Poor's reported that the crisis incentivized the lenders to undertake "initiatives to tighten underwriting, with a further push from the Dodd-Frank Wall Street Reform and Consumer Protection Act's

introduction of guidelines for qualified mortgages and qualified residential mortgages."[6] Residential mortgage loans have shown "much-improved loss performance for post-crisis vintages compared with historical norms."[7]

Conclusion

The development of third party reinsurance is a key tool for the mortgage insurance market. Pricing and risk assessment for this emerging reinsurance product will likely present the biggest challenges. The Great Recession was painful for the mortgage insurance industry, but with the changes in policy, credit standards and increased risk-spreading options like external reinsurance, the industry is poised to emerge healthier and stronger than ever before.

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[1] Fannie Mae, Private Mortgage Insurer Eligibility Requirements, 703 (Dec. 21, 2015).

[2] Fannie Mae, Private Mortgage Insurer Eligibility Requirements, Frequently Asked Questions, Q9 (June 30, 2015)

[3] Fannie Mae, Private Mortgage Insurer Eligibility Requirements, 707 (Dec. 21, 2015).

[4] Id.

[5] Id. at 500.

[6] Hardeep S. Manku, Taoufik Gharib, and Stephen Guijaro, Standard & Poor's Credit Research, Amid Global Reinsurance Pricing Gloom, Is U.S. Mortgage Reinsurance A Bright Spot or A Risky Proposition? at 2 (Aug. 25, 2016)

[7] Id.

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