Role of the insurance market in development of mortgage securitisation

By Dane Douetil

Securitisation, which has become one of the financial "buzz words" of the late 1980s, is used to describe a range of different financings. People talk about securitising most forms of assets, such as automobile receivables, credit/charge/store card receivables, lease receivables, trade receivables and even debt secured on camping sites! Securitisation of most of these assets has occurred, but rarely outside the United States. However, the securitisation of residential and commercial mortgage assets in the UK has been a major success.

What exactly is securitisation? Briefly, it describes the sale of bonds (the securities) which are collateralised by a pool of financial assets and which are not supported, from a credit point of view, by the originator. It is a technique which enables US$100 billion issued in 1986 alone.

The successful growth of the US market can be directly attributed to the federal guarantees that are provided by such institutions as Freddie Mac, Ginnie Mae and Fannie Mae. With a third-party guarantor it is easier to bundle up residential mortgages into pools and use them as the security to issue various forms of bonds.

In spite of the lack of such government support in other countries, securitisation is spreading, especially in the United Kingdom and to a lesser extent in Australia, New Zealand and, shortly, France. Of particular interest are the very different reasons as to why there has been a success in the securitisation of residential mortgages in different countries, and the factors that allowed it to occur.

In the United States the basic rationale behind securitisation was to assist the movement of the surplus of deposits in one state across the continent, and make the monies available for the funding of shortfalls of residential finance in another state. Borrowers in one state would sell bonds to geographically dispersed investors. This helped avoid local regulation which forbade the transfer of funds through the banking system across state boundaries.

In the United Kingdom mortgage backed securities developed for quite different reasons. In this case, a new type of mortgage lender emerged, the "specialist lender" who was unable to raise funds through deposits and had to rely purely on the wholesale funding market.

By contrast, the forthcoming securitisation of assets in France (titratisation) is predominantly being pushed forward by the French Government to allow the larger French banks to conform with the new capital adequacy regulations (following the Cooke Committee Report). Selling off pools of assets is one way of improving their capital adequacy ratios. It is not yet known exactly what form these securities will take in France: whether they will be traded domestically or internationally, whether they will be secured by way of over-

'Protecting the bond holders'

collateralisation, subordinated debt or by insurance, and even what assets will be used. It may not be mortgages at all. The margins available in mortgage financing are so small that they may not cover the costs of securitisation. Instead pools of, for example, auto loans may be the favoured assets.

In each of these markets insurance either has had, or will have, a role to play in protecting the bond holders against the default risk associated with the assets and thereby enabling them to be transferred off balance sheet. In the US, as mentioned...
above, this protection is by way of government schemes, but in the UK it has been the private insurance market that has undertaken this role. We believe that this will also occur in the French market.

It may be asked why insurers are expected to get involved at all. This question is particularly apposite in the UK, given the outstanding credit performance of UK mortgages. Are not investors in the mortgage-backed securities happy to take the almost non-existent credit risk? It seems not. The security houses involved in the formation of the mortgage backed notes believe it is essential that if investors are to buy these securities then the rating agency's approval, as credible referees to the credit worthiness of a securitised issue, is necessary. They, in turn, will not provide such approval unless the catastrophe credit risk is absorbed by someone other than the investor.

Insurers are particularly suited to taking this risk. Banks can guarantee the issues but there is not a preva-

ence of AAA rated banks in the world let alone in the UK (in fact there are only two). However, UK insurers have been guaranteeing the top slice risk for mortgage lending for years (see article on "Mortgage Guarantee Insurance in the UK" in the November 1988 issue). They were therefore experienced enough in this market to extend their guarantee to protect a pool of mortgages, as opposed to individual mortgages. Also, and very importantly, insurers can write the risk cheaper than can the banks, due to their different capital requirements.

It has, however, not been an easy task to persuade insurers to undertake this business because of the very large numbers involved, their lack of knowledge of the complex financial structures and the past track record of guaranteeing mortgages, for example the EPIC/MAGIC programmes in the United States, which cost European reinsurers dearly. On MAGIC the European insurers have so far paid out nearly US$600 million above the premium received, and the claims are not yet exhausted.

These problems have been overcome by explaining the complex financial structures in insurance terms, demonstrating, by risk stress models, the pure catastrophe nature of the insurance covers being purchased and the development of reinsurance techniques, which spread the risk throughout the world. In 1987 it was difficult to find insurance support for £1 billion of mortgage lending. Due to the constant marketing efforts of Special Risk Services in 1988, over £5 billion of capacity was created. In 1989 we have been able to widen this to well in excess of £12 billion of capacity already pledged to under UK deals alone. The number of insurers entering into the market has increased from six-seven in 1987 to 15-20 in 1988, to well over 30 in 1989.

We believe that this capacity will

### UK MORTGAGE-BACKED SECURITIES

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<tr>
<th>Issue Date</th>
<th>S&amp;P Rating</th>
<th>Credit Enhancement</th>
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grow with the emergence of other markets for mortgage-backed securi-
ties. The reason for this is that insurers will be able to spread their
risk further by taking on similar credit risks from other countries,
thus spreading themselves geographically. The French insurers will
be able to retrocede their accumula-
tive economic risk to the UK insurers
and vice versa.

What exactly does the insurance
cover? There are essentially two dif-
erent sorts of product. The first
guarantees the ultimate bad debt
associated with a pool of, for
example, mortgages, after the dis-
posal of the properties, the realisa-
tion of other securities such as life
policies, creditor protection plans,
and endowment/pension plans, less
the principal and interest, including
interest on interest, outstanding at
the date of disposal of the property.
There is normally some form of first
loss fund that is deposited by the
originator (the mortgagee), thus
allowing the premium to be reduced
by the insurer and the “moral risk”
of the mortgages underwriting
reduced. In the United Kingdom this
is set at around 1% of the issue size.
The sum insured (limit of indemnity)
is established by the rating agencies,
using complex calculations to esti-
mate the worst probable loss to a
pool of mortgages undergoing
severe economic stress. This has
been between 6½% and 10½% on
the UK mortgage pools.

The second product is concerned
with pure “enhancement” of a credit
rather than the remote catastrophe
risk associated with the mortgage
pool. The need for it arises as fol-
lows. The insurance policy described
above pays only once a net loss has
been established. By definition this
can only happen once the asset has
been repossessed and sold. This
may be several months, or even
years, after the original default. In
the meantime, interest payments
need to continue to be made to the
bond holders. Frequently, this short-
fall is offset by a bank line of credit.
Unless the bank providing this
possesses the same rating as that of
the issue, the bank’s credit must be
enhanced up to that standard. An
insurance product known as “the
servicer performance bond” does
just this.

The principles on which these two
insurance products are founded are
capable of being adapted to a wide
range of assets. In France, it is likely
that the insurance policy will be
required to underpin the default rate
on automobile loans, rather than
mortgages. In Australia, one require-
ment is to enhance the credit of an
institution which will commit to buy
back a pool of mortgages after
several years. Here, the security is
being structured with a life shorter
than that of the underlying assets to
increase its appeal to investors.
Without somebody to buy back the
unamortised assets at maturity of
the bond, such a structure would be
impossible. Without insurance to
enhance the commitment of the
“buy back” provider the issue would
never achieve the required rating.

To summarise, insurers basically
have two roles to play in securitisa-
tion. They can accept the catastrophe
default risk on portfolios of assets
and they can “rent” their high quality
balance sheets to enhance this credit
of various parties to the securitised
transaction. This private insurance
technology has developed prin-
cipally in the UK, in the absence of
government schemes such as exist
in the USA.

Now these insurance techniques
are being exported, just as those for
privatisation were several years
earlier. France will be the next large
market in Europe, but in five years’
time we believe securitisation will
have spread much wider than this.
The opportunities for high quality
premium this represents are con-
siderable. It is difficult to think of
another new product in the last
decade that has offered such excel-
lent opportunities to insurers who
are prepared to invest the necessary
time and effort to learn the business,
whilst fulfilling the developing finan-
cial requirements of the housing
market.

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