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 assets to be taken off the originator's balance sheet and transferred to the investor. By taking them off the balance sheet, the capital which is used to support them is released and can be used for further lending.

'Steady increase in volume'

Residential mortgage securitisation first occurred in the United States in the 1970s but did not take off until some 10 years later. Since then there has been a steady increase in volume, with over 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 (titrisation) 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-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.

'Protecting the bond holders'

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

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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 prevalence 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/MGIC programmes in the United States, which cost European reinsurers dearly. On MGIC 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

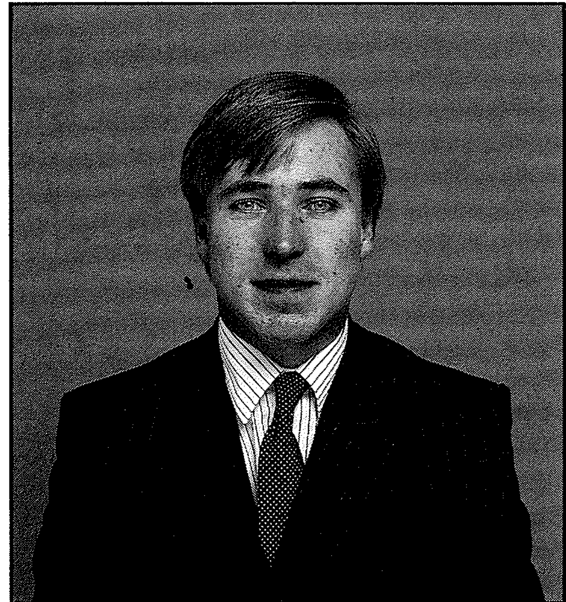
UK MORTGAGE-BACKED SECURITIES

Issue	*Issue Date*	*A-Notes £m*	*S&P Rating*	*Credit Enhancement*	*Broker*
1988					
Household Mortgage Corp. No. 2	14 Jan 88	175	AAA	Junior/Senior	
Mortgage Funding Corp. No. 1	23 Feb 88	175	AA	Eagle Star	Special Risk Services
The Mortgage Corp. No. 5 (Salomon Bros.)	1 Mar 88	125	AAA	Pohjola/Eagle Star	Special Risk Services
The Mortgage Corp. No. 6 (Salomon Bros.)	11 Mar 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
Residential Prop. Sec. No. 1 (Bank of Ireland)	11 Apr 88	200	AAA	Skandia/Pohjola/ES	Special Risk Services
The Mortgage Corp. No. 7 (Salomon Bros.)	25 Apr 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
Household Mortgage Corp. No. 3	16 May 88	150	AAA	Junior/Senior	
The Mortgage Corp. No. 8 (Salomon Bros.)	27 May 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
MAES Funding (Canadian Imperial Bank of Commerce)	6 Jun 88	200	AAA	Hansa/Eagle Star	Special Risk Services
Residential Prop. Sec. No. 2 (Bank of Ireland)	30 Jun 88	200	AAA	Hansa/Eagle Star	Special Risk Services
Exclusive Finance No. 1 (TSB)	27 Jul 88	135	AAA	Hansa/Eagle Star	Special Risk Services
The Mortgage Corp. No. 9 (Salomon Bros.)	1 Aug 88	200	AAA	Pohjola/Eagle Star	Special Risk Services
Mortgage Funding Corp. No. 2	4 Aug 88	115	AAA/AA	Junior/Senior + ES	Special Risk Services
The Mortgage Corp. No. 10 (Salomon Bros.)	1 Sep 88	200	AAA	Pohjola/Eagle Star	Special Risk Services
National Home Loans No. 4	20 Sep 88	100	AAA	Junior/Senior	
First Mortgage Sec. No. 1	1 Oct 88	220	AAA/AA	Junior/Senior + ES	Special Risk Services
Mortgage Funding Corp. No. 3	8 Oct 88	120	AAA/AA	Junior/Senior + ES	Special Risk Services
The Mortgage Corp. No. 11 (Salomon Bros.)	22 Oct 88	500	AAA	Pohjola/Hansa/ES	Special Risk Services
Household Mortgage Corp. 101	24 Oct 88	100	AAA	Junior/Senior/AIG	
		3,215			

grow with the emergence of other markets for mortgage-backed securities. 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 accumulative economic risk to the UK insurers and vice versa.

What exactly does the insurance cover? There are essentially two different sorts of product. The first guarantees the ultimate bad debt associated with a pool of, for example, mortgages, after the disposal of the properties, the realisation 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 mortgagee underwriting reduced. In the United Kingdom this is set at around ½% of the issue size. The sum insured (limit of indemnity) is established by the rating agencies, using complex calculations to estimate 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 follows. 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 shortfall 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.



Dane Douetil: Considerable opportunities for high quality premium.

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 requirement 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 securitisation. 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 principally 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 considerable. It is difficult to think of another new product in the last decade that has offered such excellent opportunities to insurers who are prepared to invest the necessary time and effort to learn the business, whilst fulfilling the developing financial requirements of the housing market. ■

DANE DOUETIL is a director of Special Risk Services Ltd, independent brokers in financial risk insurance.