REINSURANCE ARBTRATIONS IN A

SUB-PRIME ERA

By

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I. Introduction

The recent collapse in the housing market as well as the market for mortgage-backed securities has generated, and will continue to generate, a number of insurance and reinsurance disputes. These disputes often arise under traditional mortgage, errors and omissions and directors and officers insurance but may also arise in relation to more esoteric credit enhancement vehicles that are not quite so easy to classify. In light of the significant changes that this business has undergone in recent years, and the recent prominence it has taken on, both outside counsel and reinsurance arbitrators are faced with the need to educate themselves in what may often seem to be a complex and specialized area of the business. The purpose of this article is to explore the knowledge and skill sets necessary to handle disputes in the sub-prime era.[1]

II. Background Information

A. Origins of the Recent Problems

The origins of the problems generating mortgage-related insurance disputes are attributable to more general problems in the economy, particularly related to residential real estate. As real estate values escalated, there was increasing pressure to offer products to a wider range of customers, including those who previously would not have qualified for mortgages under more traditional underwriting. The ability to securitize mortgages in the capital markets drove banks to increase the volume of mortgages underwritten, pressuring mortgage insurers to respond in kind. These conditions led to a relaxation of underwriting standards throughout the industry -- with the assumption that the risk was being transferred to the capital markets, and was not retained on the balance sheets of either the banks or the mortgage insurers.

But when the housing bubble burst, houses could not be sold for their assumed value, defaults began to occur on tranches of mortgage-backed securities that had been highly rated by the rating agencies and the companies that traded in them, all of which caused a ripple effect throughout the housing and related industries. This fueled a downward spiral of job losses, foreclosures and questions about how things could have gone so very wrong.

One consequence of this unprecedented series of events has been an upsurge in claims against mortgage insurers whose products supported banks' ability to write the mortgages in the first place. A natural result of this will be increased disputes between mortgage insurers and their reinsurers. Some mortgage insurers have been downgraded, others are in run-off or have indicated in their SEC filings that they might be placed into run-off, if not insolvency.

B. Evolution of the Mortgage Market and Mortgage Insurance Products

The U.S. mortgage guaranty industry consists of seven companies, six of which are reporting members of the Mortgage Insurance Companies of America (MICA).[2] Mortgage insurance in the U.S. serves to indemnify the holder of a mortgage loan against losses in excess of a predetermined value of the underlying property at the date of origination of the loan. Historically, mortgage insurance is issued for home purchases and refinance transactions where the borrower has equity of less than 20%. If the borrower defaults on the mortgage, mortgage insurance reduces, and in some instances, eliminates any loss to the insured lender. Mortgage insurance also facilitates the sale of mortgage loans in the secondary market, the largest percentage of which are sold to the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Investors and lenders also purchase mortgage insurance to obtain additional default protection or capital relief on loans with equity greater than 20%.[3]

Although subprime mortgages emerged more than two decades ago, they did not begin to expand significantly until the mid-1990s.[4] Since that time, the nature and mix of mortgage insurance products changed rapidly. For example, activity in the subprime sector (see description of terms below) grew from $160 billion (7.2%) in 2001 to $600 billion (20.1%) in 2006; Alt-A loans grew from $55 billion (2.5%) in 2001 to $400 billion (13.3%) in 2006; and adjustable rate mortgages (ARMs) generally grew from $355 billion (16.0%) in 2001 to $1.340 trillion (45%) in 2006.[5]

The manner in which mortgage insurance was underwritten also changed during this period. Initially, it was individually underwritten by the insurer, *i.e.*, loan by loan based on the characteristics of the borrower, the property and the use to which the property would be put. By the end of this period, underwriting authority had largely been delegated to the lenders themselves who underwrite batches of risks using automated systems with little consideration (or even knowledge) of individual risks. This change in the production of the business was made possible by innovations such as the development of credit scoring (making it easier for lenders to assess and price risk) and the growth of the secondary mortgage market, which increased lenders' ability to transfer mortgages off their books to the capital markets.[6] Capital market providers, in turn, pooled large numbers of mortgages and sold the rights to potential cash flows to investors. The resulting change in the mortgage model from originating and holding loans to "originate-to-distribute" gave lenders greater access to the capital markets, lowered transactions costs, spread risks more widely and contributed significantly to the rise in homeownership.[7]

Mortgage insurance products evolved rapidly to meet the needs of these new credit vehicles, with some of the following characteristics and products:

- PNAMs, which are potentially negative amortizing mortgages. PNAMs allowed borrowers to pay potentially less than the interest accrued during the period, meaning that the principle increased rather than decreased over time.
- Interest-Only ARMs, which allowed borrowers to pay only interest on the loan for a specified number of years, after which the payment would increase so that the loan could begin to amortize.
- Payment-option ARMs (POAs) allowed the borrower the option of paying the fully amortizing payment, an interest-only payment, or potentially an amount less than the interest accrued during the period (see PNAMs above).
- Alt-A loans were given to borrowers on the basis of reduced or no documentation – specifically, limited or no income or asset verification concerning the borrower.
- Subprime loans were given to borrowers with weak credit ("FICO")[8] scores.
- Mortgages with high loan-to-value ratios ("LTV ratio") were increasingly issued. The LTV reflects the amount of equity a borrower has in the real estate at the origination of the mortgage loan.
- An increasingly large number of loans were underwritten and insured with higher risk factors, *i.e.*, second homes, investment properties, non-owner occupied properties.
- Significantly greater concentrations of loans were written in "distressed markets" such as California and Florida where residences were considerably overbuilt and, ultimately, overpriced. These markets also reflect a higher concentration of higher priced properties which can increase risk as the number of buyers for these properties is smaller.
- Some mortgages contained a combination of the above factors (referred to as "layering"), which multiplied the risk factors of the loans.

More traditional vehicles, such as home equity loans and cash-out refinancing, were used increasingly to enable greater real estate investment, which, in turn, created increased demand for mortgage insurance.

Mortgage insurers adapted to these changes by dramatically improving their information technology systems to increase their efficiency and assist their customers (lenders) in reducing their processing costs and response time. But, as mortgage defaults increased beyond all expectations, so did losses on mortgage insurance.

III. Examples of Issues in Current Disputes

The very rapid change in the mortgage market and, concomitantly, the mortgage insurance market, raises a number of issues when underwriting results turn profoundly negative. For instance:

- Were markets targeted, products utilized and underwriting performed in accordance with the representations or projections at placement, when the market may have been quite different?
- Could past loss experience realistically be presented as prologue for the future?

- What is “conservative underwriting” in such an over-heated and rapidly changing market?
- Is it a defense to be in the middle of the market when the market is going over a cliff?
- In-house or proprietary models were often calibrated to those of the rating agencies. By using the ratings given by rating agencies, one can argue that these models were blind to the fact that the ratings might have been questionable or at least not of the same quality as for traditional investment vehicles. Can the reinsurer argue that the ceding insurer lacked solid risk management practices with stress testing and contingent planning (including with respect to liquidity) and too often relied on “blind models” ?
- To the extent that risk is transferred within the same financial guaranty/mortgage insurance community, what is the obligation of the cedent to inform the reinsurer of market changes of which the reinsurer should already be aware?

IV. Similarities with More Traditional Disputes

While the residential mortgage market and, therefore, the mortgage insurance market, may have developed some unique products and approaches, the generic disputes arising from these products and practices are similar to those faced by litigators and arbitrators with respect to other classes of insurance.

A. Environmental Factors Impacting Other Arbitrated Disputes

While the specific environmental factors contributing to mortgage-related insurance disputes may be unique, other environmental factors have often provided the backdrop or context for reinsurance arbitrations in past years. For instance, the social and political issues surrounding toxic torts have had a major impact on the resolution of reinsurance disputes concerning asbestos and pollution. Other social and political factors, as well as competitive issues, had a heavy impact on the workers’ compensation market of the 1990s and contributed to carve-out disputes. The Enron debacle provided the backdrop for a number of bond arbitrations. To the extent that such factors are not common knowledge to outside counsel and arbitrators, they can be learned readily and applied to the dispute at hand.

B. New and Different Insurance Products

It is unlikely that many of the current cadre of reinsurance arbitrators became experts in financial guaranty generally, or mortgage insurance particularly, during their professional careers in the industry. However, there are hundreds, if not thousands, of insurance products that have been used in the marketplace in recent decades and no arbitrator can be expert in each. There are similarities in intent and methodologies in many products and arbitrators can be educated as to the relevant detail necessary to perform their function as they are now. Litigators, in particular, excel in the ability to attain deep (if not wide) knowledge of the subject matter of any litigation they pursue so new products should not be a major issue in selecting outside counsel.

C. Underwriting Issues

Reinsurance arbitrations dealing with more traditional products often focus on a variety of underwriting issues. Reinsurers may argue that the cedent introduced or placed much greater emphasis on new and much more risky products without the knowledge or approval of the reinsurer. The reinsurer may argue that the cedent failed to follow its own underwriting guidelines or followed them so negligently as to produce very negative underwriting results, to the detriment of the reinsurer. Finally, reinsurers may argue that broad underwriting authority was improperly or imprudently delegated to third parties.

1. Delegation of Underwriting to Lenders

In order to better penetrate markets and improve efficiencies in the delivery of the product, mortgage insurers delegated underwriting authority to lenders within certain parameters. This, obviously leads to issues of moral hazard and arbitrage as lenders seek to divest themselves from the downside financial consequences of the loans they underwrite. This practice can also raise questions of improper delegation of underwriting authority and negligent supervision of those who are actually putting business on the books of the mortgage insurer.

These questions are only marginally different from those raised with respect to managing general agencies and managing general underwriters in the property and casualty and accident and health industries.

2. *Relaxation of Underwriting Standards*

There is little doubt that with the increasing volume of mortgages written and the expansion of home ownership and real estate speculation, the underwriting standards that previously existed decades before were relaxed. The originate-to-distribute model contributed to this loosening of underwriting standards in 2005 and 2006.[9] As noted above, the delegation of underwriting authority to the banks likely contributed to this scenario, but so did the fact that a loan originator that sells its servicing rights and passes on risk to a loan purchaser has less incentive to undertake careful underwriting than if the lender were to keep those loans on its books.[10] Moreover, in some cases, fees tied to loan volume made loan sales a higher priority than loan quality.[11]

This practice is not unlike that which the property and casualty industry experienced in the 1980s (and periodically thereafter) when insurers delegated their underwriting authority to managing general agents who focused more on volume than on quality of the business being placed on the books.

3. Misrepresentations in Placement

Mortgage-related insurance disputes may involve issues of representations or projections of the mix, volume, geographic distribution of business and/or the expected results. Reinsurers may argue that these representations or projections: (a) were falsely or recklessly made; (b) that the reinsurer would not have underwritten the business but for these false representations or projections; and (c) that the reinsurer was damaged as a result.

Such allegations are very common in reinsurance arbitrations of more traditional lines of business. Outside counsel and reinsurance arbitrators have little difficulty in applying their experience in other lines of business to reinsurance arbitrations involving mortgage-related insurance.

D. Applicability of Fundamental Principles

The arbitration of mortgage-related insurance disputes is not unique in terms of the general principles to be applied. Utmost good faith is the most basic custom and practice of the reinsurance relationship and means that each party to the relationship must hold the interest of the other party as dear as its own.[12] Likewise, follow the fortunes (in its original sense)[13] means that the reinsurer is liable for exposure developing automatically out of an original covered risk without any action on the part of the insurer.[14] However these doctrines are articulated, they are familiar to experienced outside counsel and reinsurance arbitrators and can be applied in a variety of factual contexts.

E. Role of the Rating Agencies

Given the need of financial guaranty insurers to maintain a certain credit rating,[15] mortgage insurers are vulnerable to the opinions of rating agencies. For instance, a rating agency may withhold "credit" under the agency's stress model for reinsurance agreements unless they are of unusually long duration with very few bases for termination.[16] Similarly, a stop loss attachment point might be chosen to match a common risk-to-capital ratio used for regulatory intervention to give further comfort to rating agencies. In such matters, rating agencies may become quasi-regulators. It is possible that a cedent's efforts to secure the approval of rating agencies could conflict with its good faith obligations to insureds or to lender captives reinsuring a portion of the mortgage insurer's risks.

F. Company Results v. The Market

Given the disastrous underwriting results of recent years, questions arise concerning the relevancy and weight that should be given to overall market conditions and the financial results of competitors. A cedent might argue that the fact that their competitors' results are as bad, or worse, are indicative that any mitigating action on their part would have been fruitless. Similarly, the cedent might compare their underwriting with those of their competitors to demonstrate that they maintained higher underwriting standards in an overall market that saw a deterioration of traditional standards.

Given similar underwriting results in such areas as workers' compensation carve-out, these questions are hardly unique to mortgage insurance disputes and may be considered by arbitrators, and argued by outside counsel, in similar fashion.

V. Conclusions

Financial guaranty, generally, and mortgage insurance in particular, involve products and terms which may be unfamiliar to the current cadre of reinsurance arbitrators and counsel. Nonetheless, the terms and products can be learned with an appropriate amount of effort. In addition, many of the issues that arise in reinsurance arbitrations are generic in that they are not limited to specific lines of business. Therefore, prior knowledge and experience in the reinsurance industry can be used to readily translate from more traditional lines of business to the financial guaranty/mortgage insurance arena.

END NOTES

[1] In this article the term "sub-prime" is used generically rather than its technical meaning in the mortgage insurance industry.

[2] These companies include: AIG United Guaranty, Genworth Mortgage insurance Corporation, MGIC Investment Corp., Republic Mortgage Insurance Company, PMI Group Inc., Radian Group Inc., and Triad Guaranty Inc. Radian Group Inc. does not report data to MICA.

[3] Triad Guaranty Inc., Form 10-K, filed April 1, 2008 for the period ended December 31, 2007, *Overview,* p.1.

[4] Testimony of Ben S. Bernanke, Chairman of the Federal Reserve Board, before the Committee on Financial Services, U.S. House of Representatives, September 20, 2007, at 1. (Hereinafter "Bernanke Testimony.")

[5] The 2008 Mortgage Market Statistical Manual, Volume I, citing Inside Mortgage Finance publications.

[6] Bernanke Testimony at 1.

[7] *Id.*

[8] Fair Isaac Corporation's credit scoring model, referred to as a "FICO score," is the most widely used determinant of credit quality. A borrower's FICO score largely determines the class of credit quality to which an individual loan is assigned. For example, "Prime" or "A" loans refer to those with a high FICO score, while "subprime" or "less than A" are assigned to a lower tier of credit quality.

[9] *See,* Bernanke Testimony at 2; "Pressures on lenders to supply more 'paper' collapsed subprime underwriting standards from 2005 forward." Testimony of Dr. Alan Greenspan, Former Chairman of the Federal Reserve Board, before the Committee on Government Oversight and Reform, October 22, 2008 at 3. (Hereinafter "Greenspan Testimon.")

[10] Bernanke Testimony at 2.

[11] *Id.*

[12] Robert M. Hall, *Is the Obligation of Utmost Good Faith Dead in Illinois?* XVI Mealey's Reins. Rpt. No. 3 at 21 (2005).

[13] Some now use the terms "follow the fortunes" and "follow the settlements" interchangeably. In their original sense, however, the former applied to underwriting issues and the latter to claim issues. Robert M. Hall and Matthew T. Wulf, *Allocation to Reinsurers and Follow the Settlements*, XIII Mealey's Reins. Rpt. No. 19 at 26 fn. 1 (2003). Given the elaborate definition of "default" in most mortgage-related documents, the discretionary nature of the "follow the settlements" doctrine is less of a factor in such disputes.

[14] Klaus Gerathewohl, *Reinsurance Principles and Practice* at 464-6 (1980).

[15] Fannie Mae and Freddie Mac require, as a condition of doing business with them, that mortgage insurers retain a AA rating. These GSEs typically account for the largest percentage of a mortgage insurer's risk in force.

[16] Because rating agency stress models project losses over a period of six to eight years, the agency will typically require that the contract be non-cancellable for a period that is at least as long as the stress.