Freddie Mac Single-Family Home Starts Here Podcast Episode Transcript:

A Download on Insurance Risk Sharing with Arch MI

Announcer [00:00:02] Welcome to the Freddie Mac Single-Family CRTcast a series Under the *Home Starts Here* podcast. Now investors have a front row seat to conversations discussing economic and housing markets, portfolio management and analytics, servicing policy and credit risk management from Freddie Mac leaders and other industry experts.

Mike Reynolds [00:00:26] Welcome to the CRTcast, this is the second episode, my name is Mike Reynolds I'm so glad you're with us and I'm very excited to have Jim Bennison from Arch MI with us today. Jim, welcome.

Jim Bennison [00:00:40] Well, thank you for having me, Mike. This is a topic that's simple in concept, but it's proven to be a little esoteric in both execution and understanding. So, I'm looking forward to the conversation.

Mike Reynolds [00:00:52] As am I and hopefully our listeners will too. The general idea with the CRTcast is we're trying to make a difficult subject a little bit easier for a broader audience and I think we had a very successful initial episode with Andrew Davidson. And, you know, you had reached out and offered your availability to join us and I just think it's perfect. So, you know, Jim, why don't you tell us a little bit about yourself and your role at Arch?

Jim Bennison [00:01:23] Sure. I head up the Alternative Markets Group within the mortgage unit at Arch. The mortgage business is is one of three significant businesses at Arch. Arch Capital Group is a large insurance reinsurance conglomerate based out of Bermuda and got into the mortgage insurance space after the financial crisis through a series of acquisitions of legacy mortgage insurance companies. It has since expanded, the company now has mortgage insurance operations in Australia, Europe as well as Hong Kong. My group is responsible for a variety of different business activities, hence the name alternative markets. Principally, we run our own credit risk transfer platform, which includes a capital markets execution, which is called Bellambi, and we also utilize traditional re-insurance as well. We also have what we call our Structured Solutions Business, which provides credit protection to financial institutions who have retained mortgage exposure on their own balance sheet. We have a captive management business where we set up special purpose insurers to help facilitate the transfer of risk for clients. And then most recently, we've set up Arch mortgage funding, which is in the business of acting as a principal. So, it falls outside of our traditional insurance and reinsurance activities, but where we are able to acquire mortgages, certain types of mortgages, and then we'll look to principally the capital markets to manage our long-term exposure in those portfolios.

Mike Reynolds [00:03:04] That's a broad portfolio and maybe we can touch base on some of those. But, you know, I was thinking just a just before we dialed into this call, it's possible folks don't really even understand mortgage insurance. I know when we talked earlier, Jim, we kind of skipped right over that. But you know, I think of mortgage insurance as really the it's the oldest, most used form of credit risk transfer for Freddie Mac. In Freddie Mac's charter, there's a few options for how we can put guarantees and acquire loans. And there's a restriction of if a loan doesn't have at least a 20 percent down payment we either need to get some form of recourse from the originator or we can get mortgage insurance and that's you know a core foundation to our over 80 business, the vast majority of it gets done with mortgage insurance. It really is a pathway to ownership where the consumer does not need to save up that full 20 percent. I just want to kind of share that with our listeners. What would you know, what is mortgage insurance? And I don't know if there's anything else that you would add to that, Jim.

Jim Bennison [00:04:17] No, in the United States the principal use of mortgage insurance is in support of selling loans to Freddie Mac and Fannie Mae that have less than 20 percent down payment. You're absolutely right. And then I mentioned there are other uses for the product, you know, bank balance sheets that are retaining mortgage exposure I mentioned we provide coverage there. And, you know, historically, there's been some use for mortgage insurance and the securitization arena as well. And I think the product has some utility overseas, although it's a little less codified than it is in the US with the charter, one reason we're in Australia is there there are rules around the using of mortgage insurance in that country, and so that's proven to be a good market for the product as well.

Mike Reynolds [00:05:07] In another aspect of mortgage insurance, as I think about it, you know, as the lead for Freddie Mac's Single-Family CRT program is as we're looking to attract capital through our securitization and our reinsurance platforms mortgage insurers such as Arch play a role in checking Freddie Mac, checking the underwriting quality of Freddie Mac. The mortgage insurers have qualified underwriters, skin in the game and I think just in terms of an independent party away from Freddie Mac, at least for the loans that have mortgage insurance, I do think CRT investors should take that extra comfort level, knowing that there's this independent party, you know, watching underwriting, watching underwriting standards and that should be an additional comfort to CRT investors.

Jim Bennison [00:06:08] I agree and you're right to point out that's at the low level. But I would argue that much like mortgage insurers, CRT investors themselves can assess at the portfolio level the mortgage credit risk that they are taking and to a certain extent, the prepayment risks that's inherent in these structures as well. And in so doing, in setting prices for that, they provide valuable feedback both to Arch and our own CRT program, that's a principal reason why we do CRT ourselves and to the GSE and their programs as well. So, you know, we talk about it within Arch as a as an important feedback loop, one that was not in place during our prior to the financial crisis and then arm move into credit risk transfer, Arch's move into credit risk transfer with a significant... with a result of a significant lesson learned from what we what the industry, the mortgage insurance industry experienced during the financial crisis.

Mike Reynolds [00:07:12] I think that's great reason why you're our second guest Jim. In your role at Arch to have another industry participant be utilizing the CRT technology, can can you share for our listeners a little bit of the background of when that started and what you looking at and a little bit of how you're using CRT at Arch today?

Jim Bennison [00:07:37] Sure. So Arch and its predecessor, one of its predecessor companies, United Guarantee initiated the mortgage insurance blank note market back in 2015. And it was, frankly, we plagiarized a lot of your playbook, Mike. We looked at what Fannie and Freddie or Freddie in particular was doing with the STACR Program and recognized that, that it was an important evolution in risk management for entities that concentrated risk. Arch is at its heart, a reinsurance company, and got into the mortgage insurance space post the financial crisis, believing that it could bring fresh thinking to risk management and in the in the industry. And certainly, risk transfer in the form of our Bellambi program was a significant part of that. And so, we look at it as a risk management tool. We look at it as a credit, as a capital management tool. We look at it from a risk management perspective it's not just that you're transferring some risk. What you're really doing is transferring volatility if you want to say that risk is equals volatility and that has earnings implications. So, we believe we are providing a much more stable earnings profile for the investors in Arch for this long tail risk business. And that's a that's a critical part of why we do these transactions. And then, of course, the credit we get from a capital standpoint, from the rating agencies and from Freddie Mac and Fannie Mae through the primary mortgage insurance eligibility requirements, we have tests that are built into those requirements and we do get some credit for these structures and beating those tests.

Mike Reynolds [00:09:30] And since those initial transactions in 2015, several of the other mortgage insurance companies have copied you, Jim, and what your team has established, and they've created CRT programs as well. I think it's fair to say Arch continues to lead that way, you were the first one, the first mortgage insurer back in the space after the markets shut down after the initial covid outbreak in March of last year you all were the first ones back in, from my perspective, from a CRT perspective. So, you've definitely been trailblazing, taking the technology and then applying it to your situation. I think one piece that you touched on there, all of the mortgage insurance companies certainly pay attention to P Meyers, which is a set of counterparty and capital standards that the GSE's use to qualify mortgage insurers. But you also mentioned rating agency, and I think that kind of reflects a little bit on that Arch MI is part of the reinsurer business.

So, I think a lot of our listeners are not really familiar with reinsurance, I certainly was not to the extent that I am over these past few years, can you just talk for a minute on what a reinsurer is and just try to ground folks a little bit on that?

Jim Bennison [00:10:59] Sure. So, the reinsurance industry exists to insure insurers. It's a way for the insurance industry to manage their exposures. So, in our case, where a mortgage insurer, we're looking to reinsurance as a means to manage our exposure in the mortgage space. We do it two ways, we do it through the capital markets by creating these capital markets transactions and then we can also do it through traditional reinsurance. So, there's an industry of hundreds of reinsurance companies across the globe, they have hundreds of billions of dollars of capital to deploy in support of the insurance industries across the globe. Mortgage is a specialized class, so there's a subset of reinsurers that are familiar in underwriting mortgage credit risk, but they they play a significant role alongside the capital markets and taking on portions of the mortgage credit risk that we originate and GSE, you've certainly taken advantage of the reinsurance markets as well as the capital markets. And I think the Covid experience you just mentioned where you're absolutely right, when Covid hit the uncertainty that that created caused a pause in the capital markets for about 90 days before we were able to come back and issue our new Bellambi transaction for 2020. But nevertheless, the reinsurance markets remain largely open. We placed a significant codeshare reinsurance agreement on our mortgage insurance business a month before we did our first Bellambi transaction. So during the period, the capital markets were under some duress the reinsurance market proved to maintain its availability and I think that goes to the importance of having diversified sources of capital and taking advantage of capacity and capabilities in the different markets in order to ensure that you have ready access and sufficient access to continue to manage through the cycle basis.

Mike Reynolds [00:13:14] I agree, Freddie Mac's strategy is to have multiple products to be able to diversify its sources. I think a lot of our listeners are very familiar with the equity markets, you know, stock markets and but certainly securitization debt is widely used and now reinsurance, at least in the mortgage market, is material. And I would say as an example, just just to finish that thought for our listeners, you know, natural disaster risk is also like, say, a very common risk that insurers take on and they then look to get reinsurance for their own books. And you're not only we seeing this evolution of CRT since our initial STACR transaction back in 2013, we've now seen it with inside the mortgage companies, and now we've started to see some banks, both large and midsized banks, are also starting to use CRT and I think just overall, that is that's a very healthy process. That's certainly something that is good net net for Freddie Mac, right? To have a broader CRT market, to have a broader understanding, to have multiple uses. And it's also something for us to study. CRT is relatively new this form of it is less than a decade old and it's still evolving but, you know, other issuers, other participants also gives Freddie Mac an opportunity for us to look at how that CRT is structured, look at how the investor base is there. What in your view Jim are there any key differences of the way Arch goes creating a CRT structure versus what you've seen in our STACR and ACES programs?

Jim Bennison [00:15:03] Well, there are some differences, they're a little bit of form over substance. I mean, we're not a GSE, we don't have the implicit or explicit support of the US federal government. So, our structures necessarily need to be a little bit different to account for that fact. Also, as an insurance company, we've chosen the mortgage insurance like no structure and insurance late note structure, where we set up a special purpose reinsurance to act that the issuer of the securities proceeds of which will back the insurance policy, that special purpose reinsurer issues to the mortgage insurance company. So that also has the added benefit of not falling under risk retention rules, which were rules that were set up after the financial crisis under the Dodd-Frank legislation. because it is all an insurance contract that makes the transaction a little bit more efficient for us and that's just frankly, taking advantage of the fact that we're an insurance company and can enjoy that exclusion. But outside of that and mechanically, the structures are virtually identical, you know, we put the cash into a trust rather than hold it on our own balance sheet. It's invested in short term Treasury securities in order to insure that as loans pay down and our mortgage insurance amortizes down, our credit exposure amortizes down on a monthly basis pay back the bond holders and that the cash is there should losses exceed a certain percentage that that cash would then be used to pay claims that would otherwise be our responsibility. And in that respect, as I mentioned earlier, that that's that's how we ensure that the earnings profile of Arch has a certain degree of stability so losses, we'll accept losses up to a point once that threshold is breached, that investors will take the losses for for a period of time until their coverage is exhausted and in doing that, we're preserving the earnings profile of the business. And the expectation is it should be experience, an unexpected event similar to the financial crisis back in 2008, rather than that of being a solvency concern it becomes more of an earnings concern so that the business has the viability to continue to operate, continue to offer mortgage insurance and continue to stay in business.

Mike Reynolds [00:17:43] And that that has to be very appealing to your equity investors right? That's a component of the description of the business and how you, you know, an earnings event versus a solvency event is materially different.

Jim Bennison [00:18:00] I would agree the equity investors find that comment much more appealing than the alternatives.

Mike Reynolds [00:18:05] Absolutely. So, are there any other topics, Jim, that you would want to cover before we before we wrap up here?

Jim Bennison [00:18:16] Well, you touched on it very briefly, but I do think it's worth some emphasis about is the fact that we're beginning to see banks enter the credit risk transfer space. This is something that JP Morgan Chase has kind of championed over the last several years working with bank regulators to get them comfortable, various structures. And then we saw a very noteworthy transaction a few months ago, Texas Capital, more of a super regional bank, a little more specialized institution did their own credit risk transfer transaction. Again, these are in the capital markets, but they're noteworthy because it looks as though some momentum is starting to build for the bank market to take advantage of this technology again. Also, the same reason is to manage capital, to manage risk and to help insulate the businesses a bit of from earning volatility. And so I do agree, and again, I have to give all the credit to Freddie Mac - they were the leaders in developing Credit Risk Transfer after the financial crisis. But it has been fascinating to watch this industry, this product, this execution evolve and move throughout now different industries really proving its viability and certainly look forward to seeing how this continues to evolve going forward.

Mike Reynolds [00:19:53] Yeah, I'm glad you went back to that and completely agree that, you know, when we first launched credit risk transfer, we were trying our best to create an instrument that could be broadly distributed. And, you know, mortgage credit risk is is sophisticated and, you know, investors really have to be well-educated on it and understand it, but there are ways to try to make it as repeatable as possible. And we did a fair amount of studying of of similar types of transactions that are happening over in continental Europe, but those often are very customized trades, you don't get up to the scale. And although transactions have evolved over time, I do think the those bank transactions look very similar to say, you know, the current STACR transactions, of course there are some adjustments, but overall that helps attract capital, it helps attract dollars into the space. And again, it's another tool that is outside of just the pure equity space or, you know, dividend policy space. before we stop. Jim, you know, we're on the verge here of hopefully, you know, CDC, as recently as at least of this recording, you know, lifted some mask mandates of if you're fully vaccinated and hopefully we're going to kind of get back to whatever the new normal is, as you have any plans once, once you can kind of fully move about? what's kind of like tops on your list of what you want to do once we get once we can?

Jim Bennison [00:21:43] I'm from Texas I've got a brother that lives in Austin and I'm reminded, one thing I'll remember about about Covid is I was flying back with my daughter after having spent a week out in West Texas with my brother. We were flying back to Raleigh and when I landed, when we landed I had a message on my phone that the offices were going to be closed due to Covid and we were all going to be working from home. And I have not been back out to see my brother and my son was a few years younger than my daughter was listening to our stories and he's been desperate to get back out to West Texas, spend some time in Big Bend National Park Marathon, Martha, Ft. Davis area. And so that's what we're planning on doing, is getting out there and spend some quality time with family and a part of the country that, frankly, I just don't get a chance to go see very often. It's pretty unique. So that's my big post Covid travel plan.

Mike Reynolds [00:22:53] And I'm happy for you when you're going to be able to do that. I think a lot of our listeners they can relate to that. Looking forward to seeing family, looking forward to traveling. I'm looking forward too to seeing what the new work space is. You know, I've been I'm doing this podcast out of my basement, but I will say I spent a few weeks working remote at the beach. I was like well if I'm working remote, why don't I work from someplace nice? So, we'll see how that all comes together. But either way, we know we have plenty of work with our CRT and again Jim I want to thank you for taking your time to talk with us today and then just more broadly for the great partnerships that we have with Arch and I wish you the best of success with all of that portfolio that you're managing.

Jim Bennison [00:23:36] Well, you too Mike and look forward to future conversations on this topic. Thank you.

Announcer [00:23:45] Thank you for listening to Freddie Mac's CRT cast a series Under the Home Starts Here podcast. Stay tuned and subscribe to catch additional interviews with key industry leaders and experts. Home starts here is available wherever you listen to your podcasts, we appreciate you rating, reviewing and sharing with your network.