Integration of Insurance & Capital Market Products

Stephen Walker
Integration of Insurance & Capital Market Products

Workshop GIRO Convention 1999
Slides for Discussion

Stephen Walker
Background to Discussion Scenario

- A new mortgage company wishes to begin originating residential mortgages in the UK.
- They are seeking the support of their finance partners to help put together a business strategy, namely:
  - A bank to provide the funding for the creation of new mortgages.
  - An investment bank to provide the refinancing of the banks funding exposure.
  - An insurer to provide support in relation to the credit risk during the origination process.
  - A risk transfer mechanism to help refinance the insurers credit exposure.

The second and fourth steps are a requirement of the bank and the insurer who do not wish to lock in their capital for the 25 year term of the transaction.
Parties to the Origination Project

Customer:
Wants a Loan for
a house.

Insurer:
Help with short term
management of
company's business risks.

ART Agent:
Help transfer risk to wider
capital markets

Risk Investors:
Hold (lower quality) exposures
to capture a return

Origination Company:
Generate profit from
making loans to
customers.
Has only a finite
amount of equity.

Bank:
Short term funding of
company's business needs.

Investment Bank:
Agent to help transfer
funding to capital markets

Bond Investors:
Hold (high quality) assets
to match a liability.
Assets and Risks Created by Origination

- **Mortgage Loan Asset** which may have the following **Funding Risks**:
  A. Right to re-draw principal amounts up-to a schedule.
  B. Early repayment rights and terms (especially if fixed interest mortgage).
  C. Payment holidays.

- **Credit Risk** associated with the inability of a borrower to meet the mortgage repayments in the following time frames:
  D. Short term arrears
  E. Long term to permanent loss of ability

- **Credit Risks** associated with inability to recover the loan value from:
  F. The charged property
  G. Other personal wealth of the borrower

**Questions:**

- How are these risks to be handled in the short and long term?
- What is the major concern(s) of the following:
  - Customer
  - Originator
  - Insurer
  - Risk Investor
  - Bank
  - Bond Investor
Step 1: Origination

Questions:
- How are risks to be handled in the short and long term?
Step 2a: Refinance the Funding Element

Questions:
- What are the issues to be considered when creating this transaction?
- Are there any implications for the design of the products for Step 1?
- How can the insurers participate in this refinance process?
Step 2b: Refinance the Risk Element

Questions: (Consider both the Risk D (MPP) and Risk F (MIG) elements)
- Between which parties should the new cover be placed?
- Should there be a premium?
- What should happen with the old policies and associated reserves?
- Are there any issues in the wording of the new contracts?
- At what price should the insurers purchase the risk bonds?
- What does the operating company get out of all of this?
Step 2c: Structure of the Funding SPV

Waterfall of Cash-flow

Control of Credit

Senior Class

Junior Class

Reserve Fund Sub-Loan

to residual interests

Control of Timing

Senior Tranche 1

Senior Tranche 2

Questions: (Consider the position of Investors and Originators Interest)

- How many classes of note should there be? Is it worth tranching a class of notes?
- How should the classes be repaid?
- What trigger events should affect the payment profile?
- What options (if any) should the SPV have to call the debt?
- What other terms should their be on the notes?
- What should be the size and terms on the reserve fund? What level of initial funding?

Note:
Only consider two classes for simplicity.

Would often be 3-6 in practice
Step 2d: Structure of the Risk Bonds

Questions: (Consider the position of Investors and Originators Interest)
- What advantages are there in structuring the Risk bonds in to Classes and tranches?
- How should the classes be repaid (e.g. sequential / pro-rata / acceleration)?
- What trigger events should effect the class redemption profile?
- What options and terms should be on the notes?
- How should the risk structure behave if the funding structure is refinanced?
- What should be the size and terms on the reserve fund? What level of initial funding?

Note:
In practice very little structuring has historically been done in this area to date.

Such structuring considerations should also be applied to large multi-year reinsurance programs.
Step 2e: Other Support for the Structures

Questions:
(Consider the position of Investors, Third-Party-Support Providers and Originators Interest)

- How can the following products be used to make the transaction more attractive?
- What non-standard contract terms (if any) will be required?