STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

Circular Letter No. 2 (1999)
February 1, 1999

TO: ALL MORTGAGE GUARANTY INSURANCE COMPANIES

RE: MORTGAGE GUARANTY INSURANCE TRANSACTIONS AND LENDERS

This Circular Letter discusses the position of the New York State Insurance Department concerning various transactions between mortgage guaranty insurance companies licensed in New York and mortgage lenders. Where the mortgage guaranty insurer cedes business originated by a lender to a captive reinsurer established by that lender (lender captive reinsurance), the New York State Insurance Department has reviewed and reconsidered Sections 2324(a) and 6504(c) of the Insurance Law and has determined that under certain circumstances lender captive reinsurance arrangements do not fall within the prohibitions articulated in those statutes.

At this time the Department is in the process of developing guidelines and, if appropriate, a regulation which will articulate the parameters under which these reinsurance arrangements will be permitted. These guidelines will ensure that the transactions constitute a legitimate transfer of risk, are fair and equitable to the parties and whether cession limits are necessary to ensure that these arrangements do not undermine the financial solvency of the insurers. Mortgage guaranty insurers are cautioned that, until otherwise advised, 11 NYCRR 125 (Regulations 17, 20 and 20A) will apply to transactions with lender captive reinsurers.

In addition to the foregoing, the Department has also been concerned with other practices in the mortgage guaranty insurance industry which it has determined are violative of Section 2324(a) or Section 6504 of the New York Insurance Law and may not be entered into by New York licensed mortgage guaranty insurers. These practices specifically include: "supernotes/performance notes", "dollar pool" insurance, and "un-captive captives", as described below:

SUPERNOTES/PERFORMANCE NOTES

Under this program, an affiliate of a private mortgage insurance company ("MI") offers interest bearing notes for purchase by mortgage lenders which refer mortgage insurance business to the MI. In its sole discretion, the lender may invest in all, part, or none of the performance notes offered. In a typical program, the term of the note is seven years following a one year origination period. For approximately the first three years the interest rate on the note is set at a base rate which is approximately the market interest rate for unsecured obligations of established companies. For the rest of the note’s term, the interest rate on the note may be adjusted upward or downward based on the cumulative performance or claims ratio on all the mortgage loans originated by the lender and insured by the MI. The interest rate adjustment may vary from zero to 50% where it becomes capped.

DOLLAR POOL INSURANCE

Mortgage insurers typically sell a majority of loans that they originate to federal agencies such as Fannie Mae and Freddie Mac ("GSE"). The GSE requires a lender to obtain primary mortgage guaranty insurance on all mortgages with a loan-to-value ratio in excess of 80%. However, even with primary mortgage insurance, the GSE is exposed to losses on insured loans which exceed the coverage amount on individual loans as well as on loans for which no primary mortgage guaranty insurance was required. In order to compensate for this risk, the GSE charges the lender a guaranty fee in an amount intended to cover potential losses. Mortgage pool policies developed as a means of stabilizing the risk in the marketplace. The pool policies are paid for by the lender and are issued to the GSE to provide insurance protection to cover a portion of the GSE's exposure. In consideration for issuance of the pool policy, the GSE reduces the guaranty fee it charges the lender. To the extent that the cost of the mortgage insurance is less than the otherwise applicable guaranty fee, the difference is retained by the lender and may represent a significant savings for it. As an encouragement to a lender for its primary mortgage insurance business, a mortgage guaranty insurer may significantly underprice the cost of the pool policy, sometimes charging as little as a dollar a loan. Lenders may buy the lowest priced pool policy to maximize the spread between the guaranty fee to the GSE and the price of the pool policy.

THE UN-CAPTIVE CAPTIVE

In the un-captive captive arrangement the lender directly becomes the reinsurer on a book of mortgage loans insured by a primary mortgage insurer without creating a new corporation, and without the required capitalization for a captive reinsurance structure. In exchange for a transfer of risk to the lender, the lender is paid a fee, as opposed to a ceded insurance premium for its assumption of losses incurred on insurance mortgage loans at a specified entry point up to a maximum aggregate exposure. The agreement is backed by a letter of credit which is purchased by the lender from a rated financial institution. Lenders can influence the quality of the insured loans through quality originations and, if they service the loans, through loss mitigation efforts.

In summary, the New York State Insurance Department will permit legitimate risk sharing relationships between mortgage guaranty insurers and lenders where such relationships are in the form of arms length reinsurance agreements with properly capitalized reinsurers. Other transactions, including those indicated above are violative of the New York Insurance Law.

Correspondence regarding the issues discussed in this Circular Letter should be addressed to:

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