

Reserving for Financial Guaranty Contracts

2009 Casualty Loss Reserve Seminar

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Agenda

- Reserving Background
- Reserving for Residential Mortgage Backed Securities (RMBS)

Forms of Financial Guaranty Protection

- Financial Guaranty Insurance – Written in traditional insurance format.
- Derivative (i.e. Credit Default Swap)

Financial Guaranty Sectors

- U.S. Public Finance – This is where financial guaranty insurance originated
- International Public Finance
- Structured Finance (i.e. mortgage backed securities or CDO's)

Financial Guaranty Reserving Pre FAS 163

- Portfolio Reserve established for performing credits.
- Case Reserve calculated for credits where a default has occurred or is likely to occur.
- Contingency Reserve set up for all credits

Portfolio Reserve

- Practice varied widely by company within industry
 - Portfolio base vs. Watch List based
 - Various approaches:
 - Algorithm (i.e. frequency/severity)
 - Individual credit calculation
 - loss ratio approach
 - Stochastic Model
- Inconsistent practice with regard to discounting
- Company's approach to earning exposure varied

Case Reserve

- Established when a loss was both probable and estimable
- Loss is calculated on a credit by credit basis
- Discount rate represented potential investment return and was fixed.

Case Reserves Calculated Using

- Internally developed model (i.e. stochastic)
- Industry Standard Model (i.e. Intex).
- Frequency/Severity statistics

Contingency Reserves

- Greater of 50% of earned premium or between .5% and 2.5% of principal guaranteed
- Established over 15 – 20 years and taken down over a similar time horizon
- Can petition regulator to take down earlier

Loss Reserves Booked Depend on Purpose and Jurisdiction

- U.S. GAAP: Reserve is only established for credits done in FG format (credits done in derivative format run through mark to market). Pre-FAS 163 portfolio reserve booked.
- U.S. Stat: Reserve is booked for credits that have defaulted or where a default is reasonably probable (no distinction between insurance and derivative format). Pre-FAS 163 portfolio reserve not booked.
- Bermuda Stat: Reserve requirement similar to FAS 163 with an additional reserve required for catastrophe load.

RMBS Loss Reserves

RMBS Sectors

- Prime First Lien - Prime Loans, Alt-A & Option ARM's.
- Prime Second Lien – Home Equity Lines of Credit (HELOC's) & Closed End Second Loans
- Subprime Loans

Considerations when Calculating Projected Losses for RMBS

- Projected Losses
 - Default Rate (stress period vs. normalized rate)
 - Severity Rate
- Prepayment Rate
- Subordination
- Recoveries
- Government Programs (i.e. loan modifications)

Projected Loss Rate

- Stressed Rate – Length and severity of stress period
- Normalized Rate – Long term rate (historical expected rate vs. current expected rate)
- Transition Period – duration between stressed rate and normalized rate

Severity Rate

- Current severities vs. historical severities
 - Home values have decreased at faster rate
 - Length of time until foreclosure (fees and interest continue to accrue)
 - Foreclosure sales vs Non-Foreclosure Sales
- When will home prices increase?

How do I know my reserve is reasonable?

- Review ratios (i.e. pool factors, paid/amortized par)
- Compare actual and projected from prior periods
- External Benchmarks
- Roll Rate Approach
- Relationship between reserve and macroeconomic indices (i.e. Home Price Appreciation index)