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Newfound complexities in captive mortgage reinsurance financial reporting

By Kyle Mrotek and Mike Jacobson

As additional stress develops in the housing market and mortgage delinquencies continue to rise, claim liabilities related to insuring low-downpayment loans continue to mount for private mortgage insurers and their captive reinsurance partners.

While the majority of the captive reinsurance contracts mandate that the captive reinsurer follow the fortunes of the primary insurer, idiosyncrasies of the reinsurance agreements, along with ambiguities in statute and accounting, have created questions about reporting liabilities on reinsurers' balance sheets. Among other things, the limitation of the captive reinsurers' liability to the assets in the contractually mandated trust accounts that support the reinsurance agreements has complicated reserving for captive mortgage reinsurers.

Further, nuances in the dynamics of these reserves, contract provisions limiting liability, and the unique nature of mortgage reinsurance as a property-casualty line of business require sophisticated claim, premium, and asset modeling to make the best decision for each captive on a case-by-case basis.

Investors typically require mortgage insurance on loans where the downpayment is typically less than 20%. Many mortgage originators created captive reinsurance subsidiaries, which participate in the mortgage insurance process by reinsuring the private mortgage insurers for a subset of the loans originated by the captives' affiliates.

As typically mandated in the reinsurance contracts, many of these captive reinsurance agreements are collateralized by trust accounts. However, the reinsurance contracts also state that the captives' liabilities are restricted to the assets in the trust accounts. Given this contract provision, it is possible for ceded losses as

indicated by the private mortgage insurers to exceed reinsurers' trust assets. The two main liabilities affected by this trust asset limitation are loss reserves and premium deficiency reserves.

The establishment of booked loss reserves for captives is ultimately a management decision; however, the booked reserves are subject to actuarial review, audit, and ultimately regulation by the insurance regulator from the state of domicile. Because of the current levels of losses seen in the mortgage insurance space, many captives' management teams are currently faced with indicated assumed loss reserves exceeding trust assets.

As the question of what to report is truly an accounting question, the captives' management teams must work with their auditors and regulators to arrive at the appropriate decision. As each reinsurer often has several trusts, one for each cedent, the financial modeling required to support the accounting decisions requires complex programming.

For example, the reinsurance agreements generally are aggregate excess-of-loss contracts and each trust can collateralize several contracts, yielding a net effect of several dozen loss silos that need to be aggregated into a handful of trusts.

Financial modeling complexities aside, there are considerations on both sides of the argument about whether or not reserves should be capped by trust assets. If the reinsurance liability collateralized by the captives' trust accounts is truly limited to the assets in the trust, then it would seem reasonable that the captives would not need to book any liabilities in excess of the assets of those trusts. On the other hand, the captive is entitled to future premium and investment income such that there may be more assets available to pay claims in the future when the claims will need to be paid.

In addition to loss reserves related to unpaid claim liabilities for loans in default, an additional liability has found its way onto captives' balance sheets: the premium deficiency reserve (PDR). According to Statement of Statutory Accounting Principles SSAP No. 58, "When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations."

As mentioned above, the captives' ultimate liability is contractually limited to the assets in the trust accounts that collateralize their reinsurance agreements. On a cash basis, this essentially means that the captives will not have to pay any losses after the funds in their trust accounts have been depleted. This gives rise to a new question: Should reinsurance cutoff be taken into consideration when calculating the future sources and uses of funds in the determination of premium deficiency?

Once again, the booking of a premium deficiency reserve is the ultimate responsibility of a captive's management with oversight from the captive's auditor and state insurance regulator, and the documentation requires robust financial modeling. This question also has an additional layer of complexity, as it requires the answer to whether or not the captive intends to support the reinsurance with additional capital infused into the trust.

In the event that a captive contributed additional capital to the trust supporting one of its reinsurance transactions, it would increase its claims-paying ability. Ironically, if a captive had adopted a limited PDR approach, the contribution of additional capital could potentially have the unintended effect of creating an additional liability immediately upon contribution.

At face value, it would seem that the consideration of reinsurance cutoff in estimating captives' premium deficiency would have the effect of lowering the indication because of a reduction in future paid losses. However, termination provisions in the captives' reinsurance contracts typically state that if the reinsurance is terminated on a cutoff basis, there will be no future premium or loss cessions from the private mortgage insurers to the captives.

Thus, both future paid loss and premium streams would be severed at the point that the trust assets are depleted. Consequently, there is no guarantee that reflecting the contractual provisions of the captives' reinsurance agreements would have the effect of lowering the premium deficiency indication.

As both sides of the premium deficiency calculation are affected by this treatment, a situation could exist where the premium stream subsequent to cutoff would be higher than the loss stream for the same time horizon. In that situation, the reduction of the discounted future cash flows could actually have the effect of raising the indicated premium deficiency. In addition, the ultimate decision on the limitation of the loss reserves can affect the calculation of the premium deficiency reserve, as the loss reserve is a source of funds in the definition of premium deficiency given in SSAP No. 58. In the event that the loss reserve is limited to trust assets, this could have the effect of raising the indicated premium deficiency as well.

At the end of the day, captive management's decision whether to cap loss and premium deficiency reserves requires management judgment along with auditor and regulator approval, supported by sophisticated financial modeling. Issues raising the complexity include ambiguity in accounting and insurance guidance, contractual provisions limiting liability to trust assets, future premium and investment income, multiple trusts per company, multiple reinsurance structures per trust, aggregate excess-of-loss structures, contract cutoff provisions terminating future premium, and the nested nature of loss reserves with respect to premium deficiency reserves. Regardless of the ultimate decision on limiting these liabilities, captive mortgage reinsurance participants should be prepared for a lengthy process to set loss and premium deficiency reserves in today's market.

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