Special Comment

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Monoline Insurers Push Back on Mortgage Claims

Large Benefits Recorded from Put-backs and Rescissions

Table of Contents:

Analyst Contacts:

New York **1.212.553.1653**

James Eck
Vice President-Senior Analyst

Ranjini Venkatesan
Assistant Vice President-Analyst

Helen Remeza
Vice President-Senior Analyst

Arlene Isaacs-Lowe
Senior Vice President

Stanislas Rouyer
Senior Vice President

Brian Harris
Senior Vice President

Amita Shrivastava
Vice President--Senior Analyst

Overview

- Recent disclosures suggest that monoline financial guarantors and mortgage insurers are increasingly confident in their ability to reduce losses from mortgage-related risks through loan put-backs to mortgage originators and through claims rescissions and denials.
- Financial guarantors have established more than $4 billion of credits for put-backs to mortgage originators as of 3Q2009, primarily related to 2004-2007 vintage second lien RMBS securitizations.
- Mortgage insurance rescission rates have shot upward – to around 20% to 25% during recent quarters (relative to historical averages of approximately 7%). Industry-wide, Moody's estimates that the mortgage insurers have rescinded approximately $6 billion of claims since January 2008 and could potentially rescind an additional $2 to $4 billion of claims over the next few years.
- To the extent these claim mitigation strategies are successful, ultimate losses for the monoline insurers could be meaningfully lower than expected claims from defaulted mortgages, with positive effects on insurers' credit profiles. Ultimate recoveries, however, remain highly uncertain, and could be materially different than companies' current estimates.
- The implications for insurance policyholders vary significantly based on whether they are facing a guarantor (whose policies generally require them to pay first and dispute later) or a mortgage insurer (who regularly rescind coverage for underwriting irregularities).
- For mortgage originators and other impacted mortgage insurance beneficiaries, put-backs and rescissions could represent significant contingent exposures to mortgage-related losses, with potential negative implications for their creditors. However, most originators routinely set aside provisions for such exposures, although the amounts are not publicly disclosed. Additionally, we expect that protracted negotiations over the amounts could mitigate the potential impact, as we would expect many to opt for settlements rather than litigation.

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Unprecedented Mortgage Defaults Motivate Recovery Efforts

As the residential mortgage market has collapsed, most financial guarantors have undertaken increasingly detailed reviews of underlying loan files on troubled RMBS transactions to identify irregularities in mortgage underwriting practices that would be deemed breaches of contractual representations and warranties. Such irregularities include lapses in standard due diligence procedures, such as the judicious underwriting of stated income loans and home valuation appraisals. When such irregularities are found, the guarantor would continue to pay claims under its financial guaranty insurance policy but seek to compel the mortgage originator to buy back such loans for the principal amount owed, thereby reducing losses in insured mortgage pools. The process is similar for mortgage insurers when reviewing individual claim files, except that the outcome could be to rescind the underlying insurance policy (for contractual breach) and deny the associated claim (for lack of coverage).

Financial Guarantors Expect Significant Recoveries

We estimate that the financial guarantors, in aggregate, have established more than $4 billion of estimated remediation recoveries for breaches of contractual representations and warranties on insured RMBS transactions, primarily 2004-2007 vintage second-lien securitizations (including Ambac ($1.9 billion); Assured Guaranty ($1.1 billion) and MBIA ($1.2 billion)). These estimated recoveries can be a significant percentage of lifetime RMBS losses (consisting of claims paid to date plus carried reserves before put-back credit). Based on public disclosures at 3Q2009, put-back credits approximate 30% of expected lifetime RMBS losses for the largest guarantors.

Mortgage Insurer Rescission Rates Spike

For mortgage insurers, rescissions are part of the ordinary course of business, historically running at a rate of about 7% of submitted claims. With the collapse of the mortgage market, however, amid widespread allegations, and growing evidence, of shoddy loan underwriting practices, rescission rates have shot up, and have hovered in the 20% to 25% range during recent quarters. Moody's estimates that the mortgage insurers have rescinded policies representing approximately $6 billion of claims since January 2008. Based on these recent rescission rate trends and Moody's expectations regarding future defaults, we estimate that perhaps an additional $2 to $4 billion of mortgage insurance claims could be rescinded industry-wide over the next few years.

Implications for Policyholders Vary

The implications of successful claims remediation actions by the monoline insurers can vary significantly for insurance policyholders depending on whether they are facing a financial guarantor, whose insurance policies typically require them to pay investors first and dispute claims later, or a mortgage insurer, who regularly rescind coverage for underwriting irregularities in accordance with their master insurance policies with originating lenders.

Investors in RMBS with financial guaranty wraps would benefit from the improved insurer credit profiles resulting from meaningful remediation recoveries. We would also note that investors in uninsured RMBS tranches in pools where at least one tranche was wrapped by a guarantor could possibly benefit as well, as recovered funds would flow to the RMBS trust account and through the deal's waterfall.

For impacted mortgage insurance beneficiaries, on the other hand (including mortgage banks and RMBS utilizing pool mortgage insurance policies or where underlying loans carry mortgage insurance), put-backs and rescissions could represent significant contingent exposure to mortgage-related losses, with potential negative implications for their creditors/investors. Mitigating these concerns to some extent, however, is the fact that most originators routinely set aside provisions for such exposures, although the amounts are not publicly disclosed. Additionally, we expect that protracted negotiations over the amounts could lessen the potential impact, as we would expect many will prefer to opt for settlements rather than litigation.

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GSEs Pursuing Similar Claims

Fannie Mae and Freddie Mac are also pursuing similar remedies against mortgage originators and servicers to mitigate their credit-related losses on mortgages. The GSEs require mortgage servicers to repurchase loans (or provide reimbursement for losses if a foreclosed property has been sold) that are determined not to meet loan purchase requirements (breach of contractual representations and warranties) or if mortgage insurers rescind coverage. During 2009, Fannie Mae's and Freddie Mac's servicer repurchases and repurchase requests increased materially. For example, the aggregate unpaid principal balance of single-family mortgages repurchased by Freddie Mac's servicers increased to $2.7 billion for the nine months ended September 30, 2009, compared to $1.2 billion for the comparable period in 2008.

However, we believe the GSEs could experience some difficulties in effecting loan repurchase requests, as many mortgage originators have already declared bankruptcy or lack sufficient financial resources to repurchase large volumes of loans. In fact, both Fannie Mae and Freddie Mac disclose that the payment they received in the resolution of IndyMac was "significantly less than" the potential exposure to losses related to repurchase obligations.

Success of Remediation Efforts Remains Uncertain

The timing and degree to which claim mitigation strategies succeed remain uncertain, as these will be subject to potentially lengthy negotiations, and in some cases litigation, with mortgage originators and bank lenders – meaning actual settlements could be materially different from the companies' current estimated put-back benefits. For mortgage insurers, customer relationships may be damaged and the perceived value of the insurance reduced. Nonetheless, recent trends in claims rescission data among mortgage insurers and the increase in repurchase estimates by the financial guarantors suggest that these strategies could ultimately mitigate their mortgage-related losses by a material amount.

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Author	Senior Production Associate
James Eck	Shubhra Bhatnagar

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