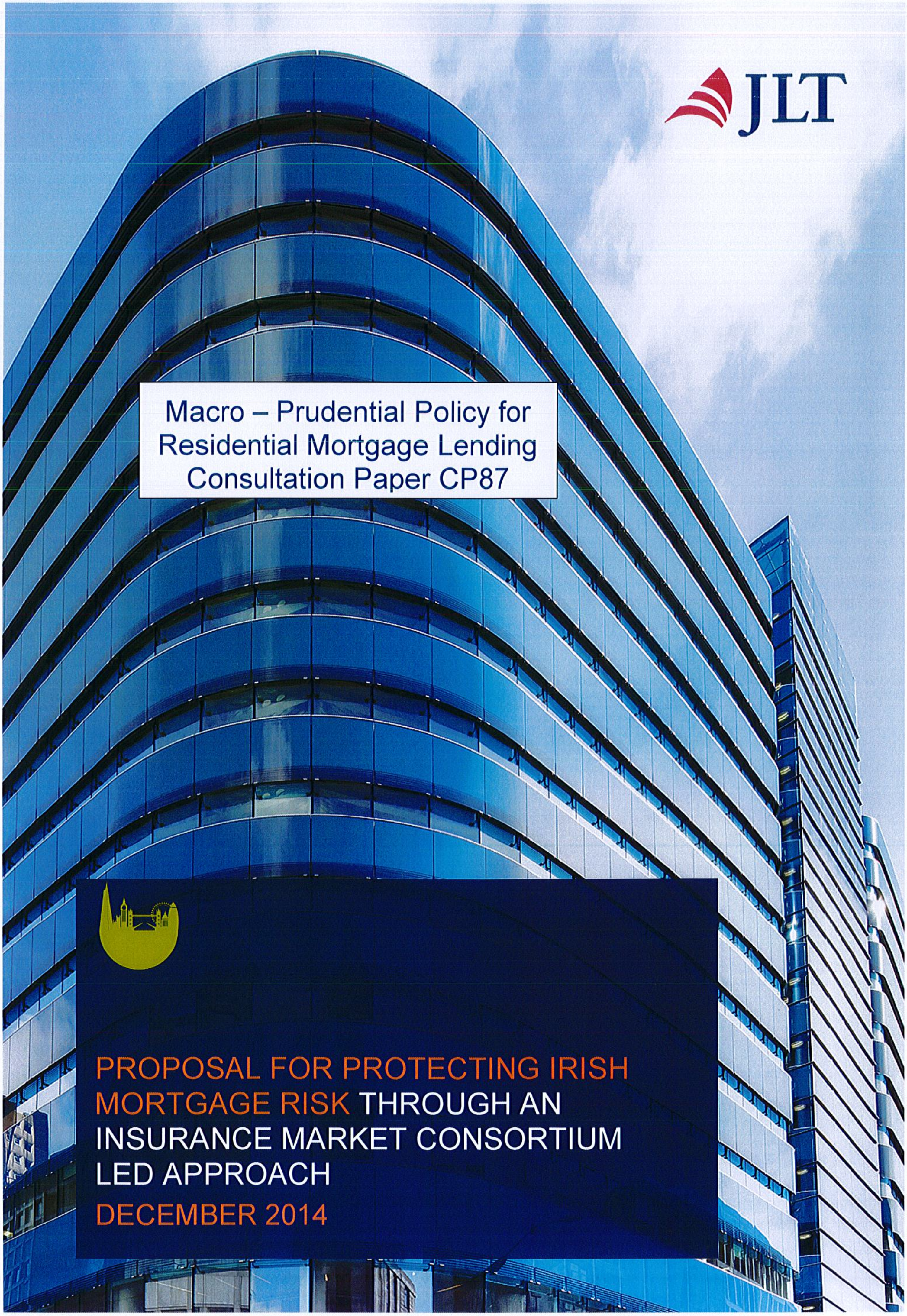

JLT

Macro – Prudential Policy for Residential Mortgage Lending Consultation Paper CP87

PROPOSAL FOR PROTECTING IRISH MORTGAGE RISK THROUGH AN INSURANCE MARKET CONSORTIUM LED APPROACH

DECEMBER 2014

JLT, as one of the world's largest insurance brokers, have been instrumental in providing mortgage risk solutions around the globe for over 20 years.

Most recently we worked with the UK Government and house building industry in developing and delivering the UK's first Government backed mortgage insurance scheme. This initiative also broke new regulatory ground in that it represented the first insurance backed mortgage solution to be recognized as a credit risk mitigant and therefore providing the potential to generate capital relief for lenders.

As one of Ireland's leading brokers JLT have been engaged for some time in discussions with lenders and government entities who have been interested in understanding our international mortgage risk experience. Taking into account these discussions, and the various recent publications, the following document represents JLT's recommendations for a Mortgage Indemnity Guarantee (MIG) scheme. The proposal will provide key stakeholders with;

- A consortium based approach to underpin counterparty risk
- A wholly commercial solution, removing any tax payer burden
- A capital relief generating structure to create both risk and balance sheet protection
- Full regulatory oversight and ownership – providing the regulator with a unique macro-prudential tool to manage the finer points of the housing market

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INTRODUCTION

The Central Bank of Ireland's recent consultation document refers to the possibility of the usage of mortgage indemnity guarantee insurance in protecting mortgages above a certain LTV. In the publication, "Macro-prudential policy for residential mortgage lending", it is stated that, where mortgage insurance is used;

"It can be argued that lenders wishing to make loans at higher LTV ratios than the cap and who have obtained an **adequate form of guarantee from a highly credit-worthy guarantor** for the excess of the loan over the cap should be allowed to treat this guarantee as allowing an exemption from the LTV cap. This would likely need to be **a high-quality guarantee**, for example provided by a highly rated financial intermediary and payable on the first demand … A recent Government strategy document indicated that consideration would be given to the concept of a mortgage insurance scheme"

This document seeks to address the framework for such a scheme including;

- JLT's heritage in developing similar schemes internationally
- Historic lessons learned from the application of mortgage insurance
- The ability to utilise highly rated commercial guarantees rather than unnecessarily exposing the tax payer
- Key regulatory requirements and considerations

ABOUT JLT

JLT GROUP

JLT is one of the world's largest providers of insurance and employee benefits related advice, brokerage and associated services. Our client proposition is built upon our deep specialist knowledge, client advocacy, tailored advice and service excellence. Together, we place our clients first, champion independent thinking and expect to be judged on the results we deliver. The value we create is driven through the personal determination of our highly motivated and skilled people.

JLT has offices in 35 territories with some 8,500 employees supported by the JLT International Network enabling us to offer risk management and employee benefit solutions in over 135 countries.

Our Risk & Insurance group encompasses our global specialty insurance and reinsurance broking operations and wholesale insurance broking business. Our specialist teams focus on those sectors where we have a distinctive level of knowledge and expertise. Working in partnership with clients to manage the key risks they face, we act as their intermediary with insurers and reinsurers as well as providing related risk management, analytical, advisory and other administrative services.

JLT IRELAND

JLT Ireland Limited was established in 1963. It is one of the largest brokers in Ireland and is a rapidly growing operation having doubled in size over the last 3 years. It operates from offices in Warrington House, Dublin 2, Cherrywood Business Park and Cork Airport Business Park, with over 170 employees.

We are strongly placed to provide a complete comprehensive service nationwide for all aspects of General, Life and Personal Lines Insurance. It is the leading broker in the Agri Food sector and has expertise in a wide range of sectors and its success is based on the provision of clients with innovative solutions and quality service.

JLT continues to grow its organisation through organic growth and acquisitions. In the recent past it has acquired Flood Maguire & Robertson Ltd., FBD Brokers Ltd. and has recently obtained approval from the Regulator for the acquisition of Liberty Asset Management Ltd.

JLT's strength is that it listens to clients and develops solutions for their particular needs.

JLT LENDING RISK SOLUTIONS & INTERNATIONAL MORTGAGE RISK EXPERIENCE

JLT have played a pivotal role in UK housing recovery over the past two decades. After the housing crash of the early 1990's JLT were instrumental in developing and executing a captive solution for major UK lenders which led to a revival in lower deposit lending and the eventual market recovery. JLT have also designed and placed mortgage reinsurance protection for lenders in both Australia and Hong Kong, helping to maintain and grow insurer relationships in the mortgage space.

In 2007, at the start of the global financial crisis, JLT again recognised the opportunity for innovative solutions and so invested in strengthening further its mortgage risk expertise. This investment has continued over the past six years and has resulted in a number of UK mortgage transactions including the Perfect 10 mortgage offer between Barclays and Bovis, which led to the NewBuy scheme and MI New Home scheme in Scotland.

For three years JLT has administered both NewBuy and MI New Home and, in the process administers more mortgage risk than any UK insurer. As administrators we also provide a number of complimentary scheme services to Government. Our administrative role will continue over the full seven year term of each loan protected under the schemes.

In addition to our UK experience JLT have and continue to provide mortgage risk advice and solutions to Governments and lenders globally including long-term programmes in Europe, Africa and Australasia.

Having maintained a broad presence in the mortgage space, whilst others have exited, JLT can now boast access to the widest range of mortgage risk insurers and reinsurers, coupled with international mortgage data and modelling techniques.

Some comments from our clients include;

"I thought I should write to you all to convey the Prime Minister's thanks for your assistance in helping to deliver the scheme"

UK Prime Minister's office, No.10 Downing Street

"JLT has developed an innovative solution for the NewBuy scheme that bridges the gap for homebuilders, lenders and consumers in the new-build market."

Barclays Bank

"JLT worked with the HBF, the house building industry, lenders and the Government to finally deliver a truly innovative solution"

Taylor Wimpey

BACKGROUND TO MORTGAGE INDEMNITY GUARANTEES (MIG)

HISTORIC EXPERIENCES UK & IRELAND

MIGs were a common feature of the housing market throughout the 1980s and were predominantly provided by composite insurers as part of an overall housing related insurance package for lenders, including buildings and contents insurance. As a result the MIG cover was not specifically underwritten at inception and claims payment had never been tested.

The arrival of the market downturn in the late 80's generated an unprecedented level of repossessions and at this point many of the MIG insurance policies and claims processes were found wanting. Insurers had never anticipated this level of claims activity and many sought to try and avoid payment of claims. Predictably insurer led MIGs then fell out of favour with lenders and JLT were instrumental in developing self insurance programmes for many of the major lenders through captive insurance programmes.

EMERGENCE OF THE MONO-LINES

As the housing market improved through the 1990s US based mono-line mortgage insurers looked to enter the UK and Irish markets. Mortgage insurance had long been a required feature of the US secondary market, leading to the development of these specialist insurers These insurers focussed often entirely on mortgage related risk, leading to a growth in this specific expertise, but conversely creating uniquely over exposed insurers with no risk diversification. Many sought to address this through geographic diversification and so expanded to the UK, Ireland and other territories.

GLOBAL FINANCIAL CRISIS

After more than a decade of positive mortgage performance the new MIG providers remained untested. However 2008 saw the extreme housing downturn in the US leading to almost all of the mono-line providers suffering huge losses which led to both a collapse in share price and ratings. Many of these insurers immediately exited the European mortgage space and sought to minimise losses through the renegotiation of existing contracts with lenders and negotiating around the full pay out of claims.

More than six years on many of these US based mono-line insurers are still struggling with the aftermath of this experience and their ratings from all major rating agencies reflect this. Similarly lenders remain sceptical of mono-line protection as do many international regulators.

LESSONS LEARNT

For many lenders the historical deficiencies of MIG insurance are stark and any future schemes will need to address these head on. In developing NewBuy and follow on schemes with the UK Government and the regulator JLT have had to address many of these issues of which the main three can be summarised as follows;

1. Claim Payment

Claims can no longer be addressed on the basis that they may be disputed by the insurer at the point of claim. The ability to do this, at best, leads to claim payment delays and cash flow issues for lenders. At worst it can lead to claim denial. From a regulatory point of view this means that the insurance is no longer a true credit risk mitigation as the claim has the ability to be denied and therefore does not offer the lender full protection.

As a direct result JLT has devised policy wording on the basis that all claims are met and can only be denied where a small set of very specific criteria were not met by the lender at the outset. In addition regular insurer audits ensure that originated loans all fall within the agreed criteria and so claims are virtually guaranteed.

2. Capital Relief (Banks) & Costing Relief (Consumer)

Historically MIGs protected loss only. Housing markets tend to perform in extremes of positivity or downturn and, in a benign environment, lenders tended to move away from commercial insurance to self insurance - retaining MIG premiums and risk on their balance sheet. Conversely in a market downturn MIG insurance providers sought to minimise exposure and so reduced activity or withdrew from a market completely.

In an environment where lenders are more challenged on capital, the utilisation of insurance as a credit risk mitigation particularly one with shared risk aspects can lead to an additional layer of benefit for lenders and a reason for all parties to continue MIG activity through the ups and downs of market performance.

Additionally lender regulatory capital requirements on higher loan to value lenders, particularly for those operating on an Internal Ratings Based method, can be markedly higher. This in turn affects mortgage pricing for borrowers with a lower deposit as the lender needs to price for both the increased risk and the increased levels of capital which need to be allocated to these loans. An appropriately structured MIG policy, which fully addresses Basel requirements, can generate capital relief for lenders and so create reasons for lender demand and insurer supply through the various market cycles. JLT have worked with both the UK Government and Regulator in developing such a capital relief generating MIG insurance policy

3. Crystallisation of Loss and Claims Payment Timing

One of the key criteria, under Basel, for a capital relief compliant policy rests on the settlement of claims. Historically MIG insurers only met a claim once the property in question had been repossessed, resold and a loss realised. Under lender forbearance procedures this could take many months and in Ireland many years. Conversely the insurance policy actually encouraged lenders to move to a loss crystallisation as soon as possible to ensure lower arrears, interest and ultimately claim. However this may well not be in the best interest of the lender or the borrower.

Under JLT's policy wording insurers agree to come to an initial claims settlement some 24 months after arrears commencement. If the final crystallisation of loss then occurs some months later the final claim amount is agreed and balanced. This ensures that lender cash flow and capital allocation is addressed whilst providing maximum opportunities for the borrower to cure.

4. Insurer Risk Diversification

As the historic MIG market was dominated by mono-line players, or those with significant exposure to housing related risk, the global financial crisis had predictable results on the MIG providers - capital constriction, rating down grades and reduced ability to meet claims.

JLT are now working with a consortium of international insurers for whom mortgage risk exposure represents a small percentage of their overall risk profile. Indeed, in a recent exercise conducted for another Government we were able to demonstrate that, in an extreme stress scenario greater than the 1991 UK housing crash (which suffered the highest level of repossessions in recent history), a consortium of insurers would experience only a 9% increase in claims incurred across their total book of insurance. This clearly demonstrates that insurer risk diversification is critical in weathering housing down turn. This is amply demonstrated in the US where the 2008 crisis saw three of the seven mono-line mortgage insurers fold.

MIG AS A DRIVER OF LENDER CAPITAL RELIEF

Lender capital requirements on mortgage lending are driven through a series of global directives (Basel I, II & III) and the local interpretation of these directives. These directives allow for credit risk mitigation (CRM) – techniques used to reduce the credit risk associated with an exposure or exposures that a lender holds.

A lender must calculate its credit risk capital requirement using either the standardised or internal ratings based (IRB) approaches. As a lender may have entered into further agreements to mitigate these risks, applying the CRM framework means it can sometimes lower its Basel II Pillar 1 capital requirement on a particular exposure.

CRM can be achieved through either funded or unfunded protection. A lender has funded protection if it can either take rights over assets or reduce its liabilities when the borrower does not pay. An example of funded protection is a bank taking a mortgage over a house. A lender has unfunded protection if it has an agreement that another party will step in when the borrower does not pay. Examples of unfunded protection include a guarantee or an insurance policy.

Unfunded CRM relies on the ability of the party providing the protection to step in when the original borrower is unable to pay. So, the main factors are whether:

- the lender providing protection is reliable; and
- the contractual arrangement provides adequate protection.

There is no set format a protection agreement must take. For example, a parental guarantee or a third-party insurance contract could both be used to reduce capital requirements in the same way. However, the protection agreement must be written in a way that gives certainty to the level of protection that is provided. And there are further specific requirements that must be met before a particular protection agreement can be recognised in the capital calculation.

The normal approach for unfunded protection is known as the 'substitution method'. A lender relying on unfunded protection should take the exposure to the borrower and 'substitute' it with a similar exposure to the protection provider. This is because the lender is now relying on the protection provider for payment. Under the standardised approach there is a simple risk weight substitution, while under foundation IRB the substitution is of the PD - probability of default i.e. the likelihood of a loan defaulting based upon risk factors. Under advanced IRB, the recognition is more complicated and may involve an adjustment of both PD and LGD - loss given default (severity of the loss once the default has occurred.

Key areas for consideration in the provision of MIGs for capital relief are;

1. Timeliness of Payment. The rules state that payment must be made within 24 months of default. Default kicks in at 180 days of arrears, but the full 180 counts so effectively the insurer has 18 months left to make a payment. If the customer partially cures i.e. pays back to the equivalent of say 150 days down, then goes back up to 180, the clock starts ticking again at 180. This represents the FSAs interpretation of BIPRU and is particularly aggressive. Other European jurisdictions are unlikely to enforce this as aggressively.

   For an Irish scheme, JLT recommends that full claim settlement should be made at the 24 month point, as if loss crystallisation had occurred. This loss can then be balanced once the final disposal and resale has happened. However it should be noted that, should the borrower recover the loan at any point prior to the true loss crystallisation, then policy wordings exist to ensure that the home will revert to the original borrower in line with established lender practices.
2. The guarantor i.e. insurer has to be of sufficient quality and this is referenced as minimum single A rating according to Basel II.
3. Option to terminate. The insurer cannot have an option to terminate. This prevents insurers exiting contracts based on performance.
4. The premium needs to be fixed for the term of the cover to avoid insurers increasing premium based on actual performance.
5. Term of cover. For structured transactions the term needs to demonstrate that it covers the significant years of loss
6. There is also a **Significant Risk Transfer Test** which will seek to ensure that the level of premium does not compromise cover i.e. premium level does not exceed risk protection provided.

A CONSORTIUM LED APPROACH TO MIG PROVISION

A Consortium Based Approach for Ireland

Historically MIG policies have been provided by insurers on an individual basis and contracted as such by lenders utilising the coverage. As we have seen over recent housing downturns, such direct one to one exposure can create an unacceptable level of counterparty risk for lenders. This over exposure can be further compounded where the insurer's risk exposure centres in the main around mortgage related risks. Therefore a significant market shift in one region (for example the US) can lead to a draining of international capital and a reduced appetite for other mortgage risks. Where a lender has also concentrated their exposure with one insurer the effect can be significant.

JLT would therefore recommend that Irish lenders adopt a refreshed approach to mortgage risk insurance. As brokers JLT are experts in developing and managing multiple insurer panels to address significant volumes of risk. We would therefore recommend that a panel of insurers would be approached for all lenders within the Irish market. Further we would recommend that the participating insurers operate diversified businesses with the vast majority of their risk exposure being centred on non-correlated risks i.e. outside of the housing and mortgage arena. The effect of this approach would ensure that the diversification of counterparty risk is maximised. In addition, should any insurer fall below the required security level of the panel, they can be replaced without jeopardising the continuance of the MIG programme.

JLT and Insurer Assessment

As a leading insurance broker JLT places business with approximately 1,000 insurance/reinsurance companies spread across the world. The monitoring of insurer security is performed by the Group's Security Committee in London.

All companies are reviewed on a standalone basis, utilising publicly available information. Matters reviewed include profit & loss account and balance sheet; together with a number of key performance ratios, which are industry standard. These ratios include, but are not limited to; solvency, liquidity of reserves, combined ratio, retention levels and return on equity. Attention is also paid to the country in which a company is domiciled, insurance regulation and any political and economic factors which may affect a company's willingness or ability to pay claims.

Whilst the Security Committee considers each company on its own merits, a 'secure' rating from either Standard & Poor's or AM Best is generally one of the criteria required. It is important to note that ratings indicate the varying degrees of probability of failure. For example, a 'AAA' rated company could fail although it is statistically a lesser danger than the failure of an 'A' rated company. Insurers rated below A- generally fall below JLT's accepted level of security and as such are not usually recommended for clients.

JLT have access to appropriately rated (re)insurance partners who would be willing to participate in an established scheme in the Irish market.

Sample Initial Consortium Members

	Insurer A	Insurer B	Insurer C	Insurer D
Standard & Poors	A+	A+	A	AA

REGULATORY OVERSIGHT AND CAPITAL RELIEF

JLT recognise the regulatory desire to ensure that all mortgage lenders are adequately protected against a market downturn, whilst at the same time ensuring consumers have the ability to access and maintain home ownership. However, as with many financial regulators, their ability to directly oversee mortgage lender behaviour remains limited.

We would therefore recommend that the Regulator looks to this commercial consortium approach to MIG's as an opportunity to maintain direct oversight of the scheme and so seek to control the current and future behaviour of lenders through insurance policy conditions and approvals.

It should be stressed that this recommendation does not represent a requirement for review and approval of renewed Regulatory powers, but is simply an extension of the existing oversight with a greater ability to influence and control the minutiae of mortgage lending policy and behaviours.

This proposal considers the following regulatory points to be critical to any successful MIG scheme;

- At the point of inception, full oversight of any MIG scheme should pass fully to the Regulator becoming a critical component in their macro-prudential tool kit.
- We have discussed this "condition" with potential insurers and they all positively support the regulatory establishment of minimum underwriting standards and oversight of the scheme.
- The consortium insurers believe that a permanently established, compulsory mortgage risk tool for first time buyers, with oversight from the regulator, should have the effect of smoothing asset price fluctuations and so provide more favourable conditions for the insurance of mortgage risk.
- In the UK structures have been approved by the regulator for the provision of capital relief – a critical point for lenders. This experience provides both a structure and legal documentation for any future schemes.
- All consortium members offer credit ratings above the minimum required for capital relief approval as laid out in Basel and the Capital Requirement Directive.
- The transference of scheme oversight to the regulator will provide a further degree of certainty in lender risk transfer and counterparty security.

JLT ROLE IN SCHEME STRUCTURE AND CONSORTIUM MANAGEMENT

JLT can provide Central Bank, Government and lenders with a range of services. This will reflect services provided to the UK and Scottish Governments during the development of their specific MIG schemes and will include, but not be limited to;

- Consultative services during scheme analysis, structure and execution - ensuring that all stake holder requirements are reflected in the final structure
- Legal support on structure and policy wording to ensure regulatory compliance whilst delivering maximum protection to lenders and ultimately borrowers
- Potential insurer recruitment and assessment and recommendation; ensuring that lenders and Central Bank benefit from the maximum level of insurer participation and diversification
- Quarterly lender audits assessing loan originations, arrears management and claims
- Data gathering, analysis and reporting to all stakeholders
- Market assessment of supplementary insurance products (and providers) to support all participants and minimise borrower default

BENEFITS OF OUR PROPOSED CONSORTIUM LED APPROACH TO MIG INSURANCE

1. The mortgage market receives a much needed stability boost from the knowledge that a diversified MIG programme, provided by commercial insurers, will be maintained for low deposit lending for as long as is required.
2. The regulator gains oversight of a tool to manage lending criteria and underwriting on an on-going basis – providing a degree of market management not previously available.
3. First time buyer aspirations of home ownership, despite limited access to deposits, can continue to be met and indeed sustained on a long-term basis.
4. This has the additional benefit of saving Ireland from "generation rent" where increasing numbers remain long-term renters, failing to build up underlying assets and creating a greater dependency on the state in old age.
5. Increased housing transactions, over the longer term, create wider economic benefits and employment in associated industries.
6. Government avoids committing to a state backed MIG programme, simply transferring risk from State owned banks directly to the State.
7. Conversely a commercial MIG consortium will relieve the risk weight on state owned lenders and the tax payer.

CONCLUSION

Primarily, JLT's international mortgage experience demonstrates that first time buyers are a mandatory requirement for a fully functioning housing market. Additionally low deposit lending is the key requirement for the majority of credit worthy first time buyers. Therefore a housing market which doesn't provide access to lower deposit lending for first time buyers is not functioning to its full potential.

A stable housing market will often encourage lenders to explore lower deposit lending as they seek higher margins and market share. However a recovering market - one which arguably needs more first time buyer involvement - often suffers from a bias towards lower LTV lending. This is particularly acute where lenders are capital constrained and therefore focus on lower risk / lower capital lending.

After much exploration the UK Government and industry experts recently concluded that insurance had to play a role in the support of first time buyer lending - hence the Government backed MIG schemes.

JLT believe that there is appropriately rated commercial insurance available to support similar developments within the Irish market; however we would suggest that the following factors are of critical importance in the establishment of any successful long-term scheme:

1. A consortium based approach providing a panel of insurers to maximise counterparty risk and scheme flexibility
2. All insurers to be rated A or greater
3. Insurers must demonstrate a level of diversification rather than an over exposure to housing and mortgage related risks only
4. Scheme structure and rules should be compliant with global, European and Irish regulatory requirements, driving capital relief for lenders. Capital relief coupled with risk management will ensure that any MIG scheme has both lender and insurer support through all housing cycles.
5. Deeper risk protection on loans ensuring that all lending from 75% (or lower) loan to value upwards is protected. This will ensure maximum lender balance sheet protection whilst encouraging highly rated lender participation

Critically well structured and appropriately regulated MIG schemes, with Central Bank oversight, will provide the regulator with a subtle and highly effective macro-prudential tool for exercising housing market control. By directly flexing and adapting the minutiae of MIG insurance underwriting policies the Central Bank will be able to directly effect changes to lender practices and so "dial back" specific elements of higher risk lending. This approach will be able to cool any over heating elements of the market without creating a wider damping effect.

Canada cites similar regulatory control, through the Canadian Housing Mortgage Corporation as the main reason for avoiding the worst excesses of lenders at the height of the last market and so avoided the housing crash experienced in the US and other similar markets.

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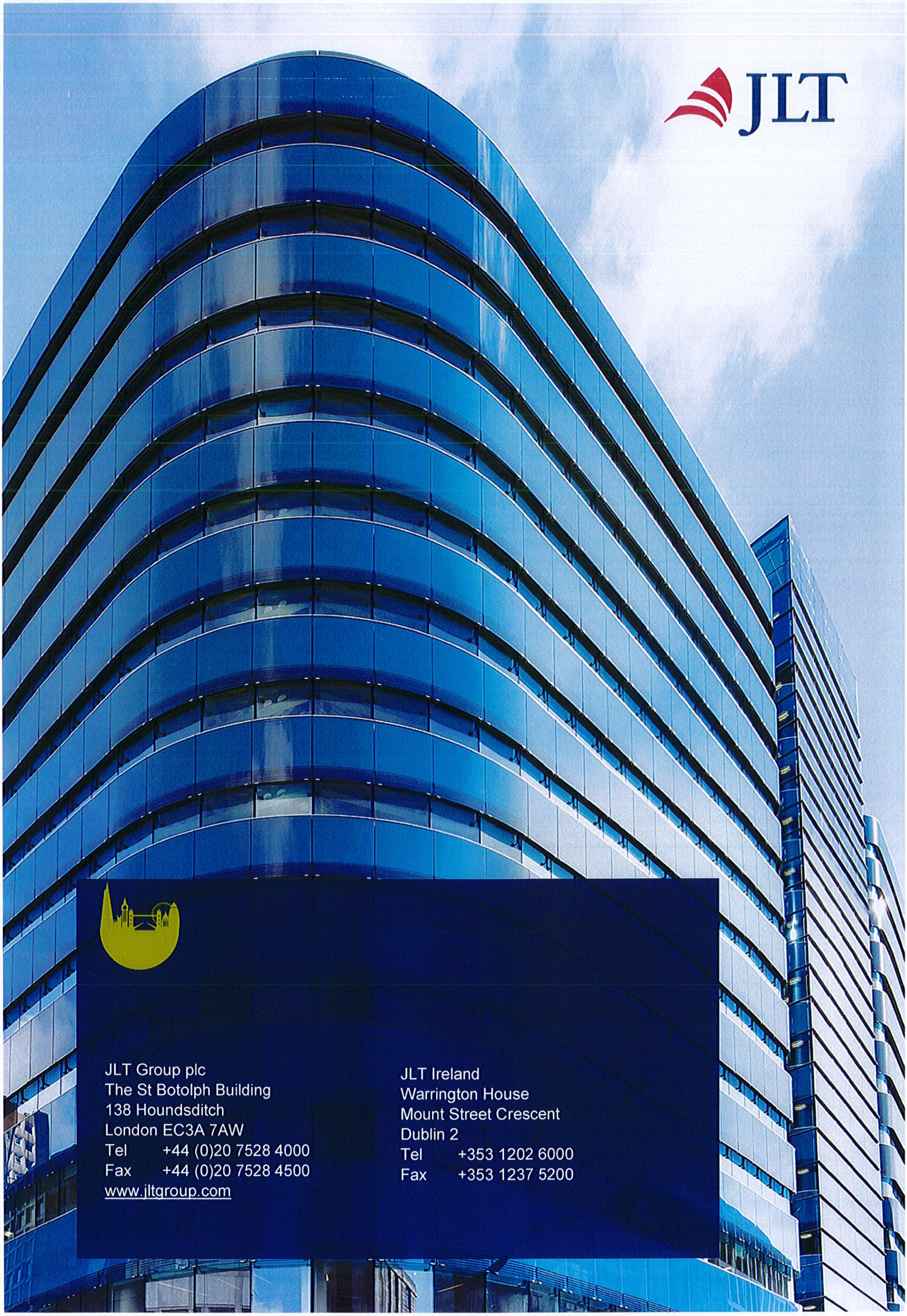

JLT Group plc
The St Botolph Building
138 Houndsditch
London EC3A 7AW
Tel +44 (0)20 7528 4000
Fax +44 (0)20 7528 4500
www.jltgroup.com

JLT Ireland
Warrington House
Mount Street Crescent
Dublin 2
Tel +353 1202 6000
Fax +353 1237 5200