Freddie Mac Single-Family Home Starts Here Podcast Episode Transcript:

CRTcast E7: State of the (Re)insurance Market

VO [00:00:01] Welcome to the Freddie Mac Single-Family CRTcast, a series under the Home Starts Here podcast. Now investors have a front row seat to conversations discussing economic and housing markets, portfolio management and analytics, servicing policy and credit risk management from Freddie Mac leaders and other industry experts.

Mike Reynolds [00:00:24] Hi. My name is Mike Reynolds and I'm very happy to have Joe Monaghan join me for today's podcast. Joe, thank you for coming. We really do appreciate it.

Joe Monaghan [00:00:35] Mike It's a pleasure. Great being here.

Mike Reynolds [00:00:38] Joe, before we dive in, you're with AON. Tell our listeners a little bit, what is AON and what's your role at the company.

Joe Monaghan [00:00:47] Sure. Happy to. So, AON is a global professional services firm. It was founded in in Chicago. But we operate in 120 countries worldwide, and we do several different things. We are an insurance broker, so we assist all kinds of different institutions, including corporate institutions and government entities and private institutions with their insurance needs. We have a business focused on, an investment consulting business, that is focused on kind of people who have accumulated wealth assets. Those are typically institutions as well. So large asset managers, pensions, we help them evaluate their pension liabilities, but we also help them determine who their advisors should be. So, we are consultants who help them decide who should invest their assets if they want to do a fixed income or they want to do equities or they want to do alternatives, you know, who are the good investment managers for that business?

We have a business focused on health. We help institutions and corporations thinking about their health plans, but it's also focused on human capital, which is a topic that we're all thinking about in new ways today because of the effects of COVID-19, the pandemic, and working remotely and the flexibility that's coming from that. But it's changed work habits and work styles in ways that were not anticipated. So, we have a human capital business that's helping institutions think about how they need to adapt for their talent moving forward.

And then finally, the business that I'm most involved with is our reinsurance business. Re-insurance is an area of financial services that's not incredibly well known outside of the insurance sector, but our clients are principally insurance companies. And as you can imagine, insurance companies accumulate a significant amount of risk doing what they do every single day. And for now, several hundred years, they've been buying insurance for themselves. And that's called (re)insurance. And that comes from large financial institutions that only take risk from insurance companies. But we don't just serve insurance companies, we serve institutions like Freddie Mac and have been proud to do so for many years. And my role within that group is to lead growth globally for our (re)insurance business, which is really about focusing on segments of risk and helping our colleagues drive more impact for customers who have that type of segmented risk so that when we show up every day, we have something more relevant to say.

Mike Reynolds [00:03:49] And one segment of risk that you and your team had led the charge on was getting into US residential. So going back a little bit of history, you know back in 2012, 2013 timeframe, as Freddie Mac was coming off of the effects of the great financial crisis, a global financial crisis, and Freddie Mac recognizing our concentration in U.S. residential credit risk, we started to look through the CRT program to basically (re)insure, (re)insure a portion of our risk.

And we do some of that through our capital markets execution, which on this podcast we've talked about several times. But we also reached out and engaged with AON and your team, Joe, to say, “Hey, can we develop a (re)insurance execution?” And talk to us a little bit about, I guess, the decision at AON to get engaged in that business and why you thought it would be, why you thought you'd be able to develop the markets. And clearly history has shown that we have. But can you talk to us a little bit about that?

Joe Monaghan [00:04:59] Absolutely. So back in, and as you point out, Mike, and, you know, just after kind of the peak of the crisis in 2011 and 2012, I joined AON in 1998 and a couple of months will be my 25th year. And in fact, one of the very first accounts I was ever assigned to was a mortgage insurer called Triad Guaranty, which was the only mortgage insurer that was buying (re)insurance. They were doing it for capital purposes, augment their capital base. And I worked on that business and thought it was fascinating business, very small in that respect because only one buyer and the other MIs weren't buying. And as you know, the GSEs were holding a lot of the risk net with the exception of the MI protection. Well, you flash forward to the crisis and in the immediate aftermath, you know, there is not like there's a ton of things that are certain in life, but what was apparent to me and some of the people on our team was that any institution that made it through the crisis was going to want to distribute their risk going forward. Because going through a near-death experience where you are concentrated in an asset class, when that asset class blows up, is a harrowing experience. And one of the lessons that, and we've seen it happen in the insurance and (re)insurance business across different types of asset classes, different types of crises over time, and what happens in the aftermath is people say, wow, we should have diversified our risk and not retained as much of that risk net. So, we knew that there was an opportunity.

Now, having said that, the insurance industry and (re)insurers in particular did not have a lot of exposure to US housing risk during the crisis. Their balance sheets from an asset side are fixed income and typically sovereigns. They might have some high quality corporates, but they're a very low vol [sic] asset because they take all of their volatility on the underwriting side, on the liability side, and because there weren't a lot of buyers of mortgage default protection, it wasn't a big part of their portfolio. Coming out of the crisis, they were screaming from the rooftops on every quarterly call, we have no exposure to U.S. housing and we have no exposure to U.S. housing because if you go back in that environment, it was chaotic and there were so many institutions that months before seemed unassailable that were needing to be bailed out or were going bankrupt. And so the insurance industry came through without needing that protection. People talk about AIG. That's a separate story with the financial products and credit default swaps.

But in the core insurance and (re)insurance business, it was not a factor. And so when we started to work with Freddie, and you guys were really the innovator here and driving these changes and thinking about multiple ways to transfer the risk, we had done a transaction for a mortgage insurance company and started to build up a little bit of a market, but we only had two or three reinsurers at the time and we knew anything at GSE scale was going to require billions and billions of dollars of capacity, which meant we had to get 20, 30, 40, 50 (re)insurers participating because it is a syndicated marketplace. And so a small team of us, you know, one of the great things about AON, in my experience here, is it's a very kind of flat organization and the senior leaders are very accessible. And we went right to the top. We went right to Greg Kase and said, “Hey, we think there's a big opportunity here. We're going to need to pull together the senior leaders from across the firm to convince insurance and (re)insurance company CEOs that now's the right time because they've been saying on all their quarterly calls, we don't have mortgage risk and now we're trying to convince them to take a bunch of mortgage risk.” Well, there's a bunch of really good reasons to do that. And now's the time to get in because it's after the events and so much of the underwriting had changed and the quality of the books had improved. But we knew it was going to take a significant amount of effort to get them there and a multi-year process.

So, we committed to it with your great support. And I got to say, one of the things that your team, the Freddie team in particular, I think just did a fantastic job of, was the engagement and the transparency. And that was critically important because you had executives at insurance and (re)insurance companies that you didn’t have the exposure, so they didn’t know a lot about it. Obviously, the industry had just been the mortgage industry was still repairing and changing a lot was to be developed. But the amount of transparency that you provided was critical in building that confidence because it's important to remember the (re)insurers, different from the capital markets, they're not leveraging these positions. So they're operating on their own balance sheet, their rated balance sheets, they're taking this risk and they're warehousing the risk. They're not really redistributing it. So, when they write these transactions, it's a buy and hold. That's and that's not just for this class of business that's across almost all of their classes of business. So that was really the impetus. We thought this could be a big opportunity, but it was going to take kind of a whole of company effort with great support from all of you to get there.

Mike Reynolds [00:10:55] Well, you and Greg and then the management team there at AON, I would argue, made the right call. And I appreciate you bringing up the transparency. We had our former CEO Don Layton on an earlier podcast and we talked quite a bit about that because, Don, you talk about, you know, you have to go to the top of the house for some of these, Don was very instrumental in the decision for us to publish the historical data set, which was a real, that was a huge challenge for us in terms of, you know, what opportunities are we giving up, putting that data out there. But certainly our you know, the transaction teams are arguing the only way we're going to attract the capital at the level, at the scale, that we wanted to attract and it's been billions and billions in the last year was 20 billion approximately, and was to be able to share that data so models could be developed and so on and so on. And I think you touched on a little bit there were some great tailwinds coming out of that period, you know, significant changes to underwriting standards, manufacturing quality, valuations and the way home price paths went in. And, you know, it was a small, it was a small set of (re)insurers in those initial books. And that has certainly grown over time. I've sat in on countless meetings with you and others on your team where I've heard a (re)insurer who's maybe now about to join the market, and there they kind of said, Oh, I missed it, I missed it. Oh, the really great returns were then and then. And you know, and I think we've talked about that. There is an ongoing opportunity, and we can start to move forward a little bit. But I think that period was easy in a way, just that we had such great kind of again, tailwinds, multiple tailwinds, hard for people to kind of get to it and understand it, up until we hit COVID, right?

And so then, COVID came and that was like the first real stress, you know, since, you know, since the global financial crisis. So what kind of calls were you fielding as COVID was hitting? And (re)insurers are now trying to figure out how this impacts their position? Tell us your experience.

Joe Monaghan [00:13:16] Mike Absolutely right, that COVID was the first real test of the programs. And, you know, to your point, because (re)insurers, you know, they're building a portfolio of these and they're adding new risk every year. And they're monitoring that risk. What often occurs in these institutions is anytime there's volatility in the marketplace, senior executives want to understand what that means for the underlying portfolio. That happens in all kinds of different risk-taking institutions and reinsurers are no different. And so, as COVID hit, uh, (re)insurers really wanted to understand what the implications for, you know, much higher delinquencies would mean. Now, uh, what's been really amazing to see coming out of the crisis was all of the lessons that were learned. As you and others try to manage through the crisis with different modification programs and borrower support programs. You learned a great deal about what worked and what didn't work. And what happened very, very quickly during COVID was you pulled that playbook off the shelf and with great positive effect. The thing that (re)insurers take a lot of comfort from, and it goes back, Mike, to the foundation of transparency. And Don was in so many of these initial meetings, and it was terrific to have him in those meetings because the marketplace understood that right from the tippy top of the organization, there was a commitment to risk transfer. And one of the things that new participants were worried about is will they spend all of this time, money and effort to understand this risk? And you'll buy for a year or two, but then you'll stop once the dust settles and it's a clear marketplace. And so that commitment was really important to see. Your ability then during COVID to pull that playbook off the shelf and think about ways to modify the loans, to give borrowers a chance to catch their breath, you know, it's, taking a pause in payments, extending and all the end. The (re)insurance market took a ton of comfort from that because they understood that at the end of the day that's to their benefit. And you were making these decisions because they were driven by the right thing to do for all parties involved, not the least of which was yourselves as the owners of the risk, and then (re)insurers as partners in that risk ownership. It was the right economic decision and you learned it from the crisis. You learned will worked well and what didn't work well and those we knew and there was a series of calls that you all did again, and that spirit of candor really going through it, letting the marketplace ask all of their questions. We understood that we'd see delinquencies stay high for some period of time. But you were able to so effectively communicate the changes you were making and why that wouldn't ultimately turn into defaults and foreclosures, which would drive bigger economic loss. And so, by May of 2020, (re)insurers were back in the marketplace and doing transactions. Not all (re)insurers and not at the price that they were doing pre-COVID, but at a price and with capacity. And again, this is one of the reasons why you have a variety of outlets for your risk and that these outlets have different capital rules, different structures, different ways of thinking about the risk. In the (re)insurance market, we don't have the mark to market volatility because these are buy and hold transactions that are, you know, indemnity covers that aren't traded in a marketplace that would have a mark to market application. So, they're held to maturity, and they're valued on the fundamental risk. (Re)insurers, of course, set a loss reserve on the transactions and they set aside that, but they don't have to mark down a bunch of positions because of volatility in the capital markets. And so, one of the things that we saw during COVID was once they gained comfort in the fundamentals, what was happening in the marketplace, the tools you were utilizing to manage risk, they were able to say, okay, we understand all of that. Let's get back into the marketplace. Let's start to do transactions because we understand the environment are operating and we understand the rules that you're deploying, the toolkits that you're utilizing, why that's good for everybody. Let's get back to business. And by May, we were doing transactions.

Mike Reynolds [00:18:36] Yeah, that that's such a short timeframe from when things really started unfolding in March and April to be right back there in May. And to your point, the (re)insurers are a buy and hold, right? So, there's not that same liquidity options that you have in the capital markets, but you don't have the mark to market, you don't have the liquidity squeeze. A lot of the, you know, the demands for cash, the pressures that were being built up on that side. But here we are, here we are today, March 23, we're in a different set, we're in a different environment, another unanticipated environment, rising rate environment. The (re)insurer profile is global. Maybe you can touch on that a little bit. You know, just geographically where some of these parties are located. But we're seeing rates rise across the board. So how are (re)insurers responding to the current market situation?

Joe Monaghan [00:19:37] Yeah, so you're absolutely right, it is, the (re)insurance marketplace is a global marketplace. And part of that goes back to the history, the founding of (re)insurance, which is it's kind of interesting because, uh, most people have heard of Lloyd's of London, which is an exchange or think of it as a marketplace for insurance in London. It actually originally was a coffee shop. So, Lloyds was the owner of a coffee shop in London, and ship captains and ship owners would meet at the coffee shop. And (re)insurance really started as a way for the maritime industry to spread risk, because if you if you think about it, it was a very risky proposition. We had sailing vessels all over the world and typically people might own a share of one vessel. Well, if that vessel went down in a storm, which happened all the time, you were done, you lost everything. And so owners and captains got together, and they started to neutralize the risk amongst themselves. And then they started to bring in wealthy individuals that weren't in the maritime industry, but maybe had large landholdings and were looking for diversification, right. Like some of these things we talk about today, were talked about 300, 400 years ago, and that's how this marketplace of Lloyd's got started.

And because (re)insurance began with a maritime trading tradition, it was always global because you were dealing with owners and captains and executives of trading firms. And so, you always had a global nature to the risk. So, you have large (re)insurance entities all over the world and they trade as global institutions. So, they all have a holding company and a flagship balance sheet that might be based in a geography. And then they'll have additional subsidiary balance sheets across different geographies, and they'll manage their capital and their risk position on a global basis. So, they'll look at, for example, natural disaster as property catastrophe risk is the biggest source of risk in the reinsurance business. And they'll write a portfolio that has exposure to hurricanes on the East Coast, California earthquakes, Japanese typhoon, European wind, wildfire, and brush fire in Australia and create a diversified portfolio of those risks. As I mentioned, they tend to hold very high-quality fixed income assets because they have volatility on the liability side. And so, what occurs in a rising interest rate environment is they have unrealized losses on those bonds because as interest rates rise, the value of those bonds, which are at lower interest rates, decline. Now they're not selling those bonds. So that's a mark to market and unrealized loss on the asset side, not selling those positions. But as those positions come up, the good news is they are replacing them with bonds at higher coupons. And so, in general, this environment over time on the asset side improves their yields and improves their investment return. Now, having said that, most, if not all of their return happens on the liability side. And what we've seen with inflation is if you just take a step back, and it's getting better in some regions, it's not getting better in others, but if you think about in a property environment where you are as a (re)insurer covering, if you just look at the United States as a microcosm, there is all kinds of insurance companies. They buy (re)insurance. If there's a big hurricane like Hurricane Ian, many of them have recoveries in (re)insurance. Well, if you look at the impact of inflation, it just costs more, to replace a house to rebuild a house now than it did two or three years ago. And that's not just because building products cost more, but it's also homes are worth more. You guys have experienced the home price appreciation. The replacement value has increased as well because of that inflation. So, when you look at it, inflation has been driving increased exposure to that core segment of risk that (re)insurers have. And they've had a lot of frequency of events and those have been happening all over the place. So, I talked about you might do the U.S. and Europe and Asia and you get spread. Well, that's great until you get it popped everywhere. If you get losses in every place because that can happen, that's part of the unknown, you have an accumulation of losses and we've seen that over the last several years.

So in the current environment, we have some things that everyone's experiencing, which is the impact of inflation, the impact of higher interest rates and what that means for, you know, the (re)insurance business. But all of this loss activity has also meant that if you look at the past several years, (re)insurers really have not been earning their cost of capital. They have been, if you look over the last five years, they've been earning about a single digit return. And that's because of these compounding effects of natural disasters and higher losses associated with that. And so, what we saw over the last, call it 18 months, and especially at January 1st, was significant price increases for (re)insurance on property account risk, significant retention adjustments. They want their clients to keep more of the risk. They want to move out of some of the volatility to kind of reset where that return adjustments are. Now, the good news for you is it means that risk like mortgage credit, Freddie's risk, which was attractive to them as a source of diversification and because of the ultimate performance, it's performed extremely well, remains attractive. It remains attractive because it's a source of diversification. Having said that, we are entering uncertain times. We're dealing with issues of bank collapse and the reverberations from that. Chairman Powell, as we're taping this, Chairman Powell, and the Fed just raised by another 25 basis points, and there's a lot of economic uncertainty. And so that is starting to percolate amongst reinsurers in terms of what does that mean for housing risk, this uncertainty that we're facing.

Mike Reynolds [00:26:45] That focus has to be there. There's no guarantees. I mean, that's part of the process of why we're getting (re)insurance. But, you know, probably one of the biggest tailwinds for this year is the volumes, at least, at least from a Freddie perspective, and I think this is across the board, are way down, are way down. You know, we've gone the really large refi books in ‘21 and ‘22, where now with rising rates is very much a purchase book. So, volumes are down. So, the, in terms of you know, putting on new risk, the outlays are just that much smaller, and I would think that makes it a little bit easier to kind of deal with whatever uncertainty. Joe, we got to wrap up, but, you know, since you mentioned natural disasters and climate change, does this go back to that a little bit? You know, that's also you know, you mentioned that in the broad AON. So, what are you hearing? Has that part of the business changed significantly? And where is the focus areas there?

Joe Monaghan [00:27:58] Yeah. So, you know, way back when, when I started at AON, I started as a catastrophe modeler and I, I didn't last long doing it, but I, I can tell you that.

Mike Reynolds [00:28:09] You found something. You found something that you're pretty good at.

Joe Monaghan [00:28:11] I found something different. But those models have come in tremendous ways in terms of their sophistication. And yet they remain inadequate in terms of giving us true confidence in our ability to predict extreme events. And it's very, very hard to do. So, I'm not suggesting that, and we own our own catastrophe model, AON does, we license all of the models. We own our own model, and we say models are useful, you know. But they're always wrong. But they're useful, right? And so, you need to understand their real sense of parameterization around these models.

What's happening now, and we in our industry have been looking at extreme weather, natural disasters and trying to quantify that that risk for decades upon decades. And we are now seeing all kinds of institutions, public, private, and they're being tasked by not just regulators, but by stakeholders to in a much more sophisticated and thoughtful, consistent way, understand, identify, quantify their institution or company or divisions, exposure to extreme weather and how that's going to change because of climate change. And so, we are spending a lot of time, we've worked with you and you're you've got a great team of colleagues on this but work with others. When you think about, for example, in lending, unlike in insurance, insurance policies are typically 12-month policies. And so as the risk changes, you can adjust your pricing, you can adjust the coverage. But when you are making a loan, 30-year mortgage, you have that exposure to that underlying asset for many, many years. And so increasingly, all kinds of institutions want to understand that risk better. That means a multistep process of first understanding the risk today. So where are we today? What does it mean and what does it mean, for example, on a mortgage, just because a property might be damaged from a flood or from wind damage from a hurricane doesn't necessarily mean they're going to default. And even if somebody defaults, your net economic loss will vary based upon the ultimate sale value and the equity present in the home and so forth. So, it becomes a very complex series of questions that you ask just to set the baseline. And then there's a very much developing science, not fully developed, but developing science around, okay, well, what's the frequency of severity for East Coast hurricanes, for flood risk in the Midwest? We've engaged with 15 academic institutions globally to help us think through that on a geography peril basis for our own model. So, everybody is dealing with this, and regulators are dealing with this. Because we've had many conversations with regulators who were trying to wrap their head around it, and they want to know what they can ask today, that's a reasonable question to ask and what the limitations of the ability of their regulated entities to respond with anything more than high level topics or responses because of the limitations of the science at this point.

So, it's something, Mike, that every institution, every sector is dealing with, and we are spending a lot of time really changing our business in a way. Most of, almost all of our analytics around extreme weather has been done in the context of a transaction. So, someone has to buy a big tower for a hurricane or big tower for earthquake or what have you. Our analytics has been done to inform how you structure that transaction and what that risk transfer should cost. But we are getting a number of inquiries from institutions now that just want to understand the risk in the first place. And before they even get to a transaction on it, they don't even know what the risk is today. And so, we're spending a lot of time on really consulting activities, really helping people think through all of this, even beyond or even before we consider anything to transfer the risk.

Mike Reynolds [00:32:51] And that's great insight, Joe. Hey, thank you very much for taking time out of your busy schedule. I know you've got a lot going on and certainly thanks for all the support and business that we've done together through the years. It's been a fantastic partnership and hopefully our listeners learned a little bit about (re)insurance today. So thanks again, Joe.

Joe Monaghan [00:33:12] You bet, Mike. Thank you.

VO [00:33:18] Thank you for listening to Freddie Mac's CRTcast, a series under the Home Starts Here podcast. Stay tuned and subscribe to catch additional interviews with key industry leaders and experts. Home starts Here is available wherever you listen to your podcasts. We appreciate you rating, reviewing, and sharing with your network.