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January 28, 2025

Insurance Company Investments in Mortgage Loans

Today’s Presenters

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Agenda

- Welcome & Introduction
- Overview
- Mortgage Regulatory Updates
- Insurance Regulations and Risk-Based Capital
- Investment Structures
- Conclusion

Welcome & Introduction

Overview

- Insurance companies continue to allocate significant portions of their investment portfolios to mortgage loans, both commercial and residential
  - Residential mortgage loans have been biggest driver of total growth in recent years
- Multifaceted regulatory environment
  - Federal (CFPB, FTC, HUD, DOJ, SEC)
  - State (Licensing regulators, Attorneys General, Anti-Discrimination Regulators)
  - Insurance Regulation (State Regulators, NAIC)
- Other considerations include structuring, financing (including through FHLB) and investment management
- Prior Mayer Brown webinar can be found at https://www.mayerbrown.com/en/insights/events/2023/10/insurance-company-investments-in-mortgage-loans

Mortgage Regulatory Updates

Mortgage Regulatory Risks

- Highly regulated industry
- Risks exist related to purchasing, holding, and servicing residential mortgages in today’s regulatory environment
  - Licensing requirements
  - Significant requirements under federal and state consumer financial laws
- Subject to increasing regulation in wake of financial crisis, with respect to both the breadth of legal requirements and regulatory, enforcement, and litigation scrutiny

What's New for 2025?

- Impact of Trump Administration
  - Likely to see less aggressive federal regulators
    - Focus on clear issues of consumer protection for CFPB
    - Less regulation through enforcement
    - Pause (and possible reversal) of Biden CFPB regulations and guidance
  - Possibility of more aggressive state regulators in certain states
    - State AGs have authority to enforce certain federal laws in addition to state laws

What’s New for 2025? (cont’d)

- Maryland guidance applies licensing requirements to assignees of residential mortgage loans
  - January 10, 2025 guidance issued by the Office of Financial Regulation
  - Assignees of residential mortgage loans—including certain “passive trusts” that acquire or obtain assignments of residential mortgage loans in Maryland—must become licensed in Maryland prior to April 10, 2025, unless the assignee is expressly exempt under Maryland law
- The guidance expands on an April 2024 court ruling that an existing assignee of a home equity line of credit was required to obtain a license as a prerequisite to bring a foreclosure action in Maryland court
  - The court took this position despite the fact that Maryland’s existing licensing laws do not expressly require a license to purchase closed and funded residential mortgage loans

Maryland Licensing Guidance

- Background on Maryland case:
  - Maryland statute requires a license to “make” a loan
  - Because Maryland case law observes “the principle that an assignee ‘succeeds to the same rights and obligations under the loan agreement as its assignor[,]’” the appellate court held that an assignee of a loan made subject to the Credit Grantor provisions is subject to any licensing requirements that applied to the originating lender
  - The assignee in the case (including the statutory trust at issue) was required to obtain both an Installment Loan license and a Mortgage Lender license in Maryland
  - The court did not address whether its conclusion would be different if the national bank that acted as trustee for the trust—and which, as a national bank, is exempt from licensing under Maryland law—was the party that acquired and held the loans in its capacity as trustee for the trust

Maryland Licensing Guidance (cont'd)

- Under the guidance, any assignee of residential mortgage loans, including "mortgage trusts," are required to obtain a license under the Maryland Mortgage Lender Law to "acquire or obtain assignments of any mortgage loans," regardless of lien position
- The Mortgage Lender Law exempts, among other entities, federally chartered banks, Maryland state banks, and insurance companies that are authorized to do business in Maryland
  - State banks that are chartered by a state other than Maryland are only exempt if the bank maintains a branch in Maryland
- An Installment Loan license is also required, unless an express exemption applies and if the mortgage loans are made subject to the Credit Grantor provisions

Maryland Licensing Guidance (cont'd)

- OFR also issued emergency regulations to create a way for "passive trusts" to satisfy net worth and qualified individual requirements and obtain a Maryland Mortgage Lender license.
  - "Passive trust" = a trust that (i) acquires mortgage loans that are serviced by others; (ii) does not make mortgage loans; (iii) does not act as a mortgage broker or mortgage servicer under the Maryland Mortgage Lender Law; (iv) receives all periodic payments through a mortgage servicer; and (v) is not engaged in the day-to-day servicing of mortgage loans.
- Like the court, the guidance does not specifically address:
  - Whether a trust would be required to obtain a license if the trust is structured so that a national bank, which is exempt from licensing under Maryland law, is the party that "acquires" or obtains all residential mortgage loans in its capacity as trustee for a trust
  - Whether existing trusts structured in this manner must obtain a license

Insurance Regulations and Risk-Based Capital

Insurer Investment Regulation—A Three-Legged Stool

1. The types of investments that an insurer is authorized to make are specified in the insurance code of the insurer's state of domicile

2. The NAIC has developed a system of statutory accounting and statutory reporting of investments that is used across all the states

   - Statutory accounting is more conservative than GAAP and focuses on the availability of assets to meet obligations to policyholders

3. The NAIC has also developed a risk-based capital (RBC) system that is used across the states to measure whether an insurer is maintaining a sufficient ratio of capital to cover its business risks, including the risk associated with its investment assets

   - Each asset class has an associated RBC factor that is multiplied by the carrying value of an investment asset to calculate the RBC required for the insurer to hold that asset

The Authority of Insurers to Invest in Mortgage Loans

- The laws governing authorized investments for insurers differ widely across the states, and in some states differentiate between life and non-life insurers
- The NAIC has developed a model act to govern insurer investments, but only nine states have adopted it
- All states permit investments in mortgage loans, but differ on such matters as:
  - What percentage of the insurer's assets may be invested in this asset class
  - What loan-to-value ratios are required
  - Whether junior lien mortgages are eligible investments
  - The extent to which the statute expressly addresses indirect methods of owning mortgage loans (e.g., trusts, LLCs, partnerships, joint ventures)

What Counts as a Mortgage Loan for Statutory Accounting Purposes (*SSAP No. 37*)?

- A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. In addition to mortgage loans directly originated, a mortgage loan also includes mortgage loans acquired or obtained through assignment, syndication or participation
- **Included**: A "bulk purchase" where the insurer's interest in each mortgage loan is legally separate and divisible and the purchase just facilitates the acquisitions of multiple single mortgage loan agreements. <u>Example</u>: a titling trust
- **Not included**: Where an insurer acquires an interest in a "bundle" of mortgage loans with various unrelated borrowers and collateral. <u>Example</u>: a commingled fund

Individual Mortgage Loan Participations Can Qualify for Treatment as Individual Mortgage Loans

- In order for a participation to qualify as a mortgage loan under *SSAP No. 37:*
  - The insurer must have a signed participation agreement with the lender of record named in the mortgage loan
  - The financial rights and obligations of the insurer under the participation agreement must be the same as the lender of record
  - The insurer's participation interest in the single mortgage loan proceeds must be *pari passu* with the lender of record named on the mortgage loan agreement, and
  - The participation agreement must be properly and promptly recorded in the lender of record's books and records

How Are Mortgage Loan Investments Treated for Statutory Reporting and RBC Purposes?

- Mortgage loans (and participations) meeting the *SSAP No. 37* definition are reported, based on the amortized principal, as individual line items on **Schedule B** of an insurer's statutory investment schedules
- Risk-based capital (RBC) factors are determined in part by whether the mortgage loan is residential or commercial (which is not always a clear-cut distinction)
- The next two slides show pre-tax RBC factors for life insurers for **Schedule B**:
  - Residential mortgages (insured or guaranteed)
  - Residential mortgages (not insured or guaranteed)
  - Commercial mortgages (insured or guaranteed)
  - Commercial mortgages (not insured or guaranteed)

RBC for Mortgage Loans for Life Insurers (Pre-Tax) – Residential and (Insured or Guaranteed) Commercial

Loan Status	RBC If Insured or Guaranteed (Residential or Commercial) (%)	RBC If Not Insured or Guaranteed (Residential Only) (%)
In Good Standing	0.14	0.68
90 Days Overdue, But Not in Foreclosure	0.27	1.40
In Process of Foreclosure	0.54	2.70

RBC for Commercial Mortgage (CM) Loans for Life Insurers (Pre-Tax) – Not Insured or Guaranteed

CM Category (determined based on type of commercial property, debt service coverage and loan-to-value ratio)	RBC Factor (%)
CM1	0.90
CM2	1.75
CM3	3.00
CM4	5.00
CM5	7.50
CM6 (90 Days Overdue, But Not in Foreclosure)	11.00
CM7 (In Process of Foreclosure)	13.00

Schedule BA Mortgage Loan Investments

- When an insurer holds an interest in a joint venture, partnership or limited liability company that owns mortgage loans, such investments are reported as “Other Long-Term Assets” on **Schedule BA** and are valued based on their audited GAAP equity
- If the entity that owns the mortgage loans is **unaffiliated** with the insurer, then the Schedule BA RBC factors are based on commercial mortgage factors:
  - Where DSC and LTV covenants exist and are complied with, they determine the CM category
  - Investments defeased with government securities are CM1 (0.90% RBC)
  - Other investments comprised primarily of senior debt are CM2 (1.75% RBC)
  - Other investments (e.g., mezzanine or subordinated debt) are CM3 (3.00% RBC)

Schedule BA Mortgage Loan Investments – New Development in 2024

- If the joint venture, partnership or limited liability company that owns the mortgage loans is **affiliated** with the insurer, then beginning with the 2024 RBC calculation, the Schedule BA RBC factor for residential mortgage loans in good standing is 0.68%—same as for a Schedule B mortgage loan
  - The standard definition of “affiliate” applies: an entity that controls, is controlled by or under common control with the insurer
  - Although control is presumed to exist when an insurer owns 10% or more of the voting securities of an entity, a 10% passive investment in a limited partnership would likely not trigger that presumption, since a limited partnership is controlled by its general partner
  - To qualify for this RBC treatment, the mortgage loans need to be in good standing, so a mechanism is needed to transfer delinquent loans out of the structure

Schedule D Mortgage Loan Investments

- Notes issued in mortgage securitizations (RMBS and CMBS) are treated as "bonds" and reported on Schedule D
- RBC for a Schedule D asset is determined by its NAIC risk designation
  - For MBS, the NAIC designation is assigned through a financial modeling process
  - For senior loans in an MBS structure, the NAIC designation is derived from the NRSRO rating
- Schedule D assets are carried at amortized cost so long as they are above NAIC-6
- Effective 1/1/2025, the NAIC's new principles-based bond definition requires MBS structures to provide substantive credit enhancement (through guarantees, tranches for payment priority and/or overcollateralization) in order to qualify as bonds

Bond RBC Factors for Life Insurers (pre-tax)

NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)	NAIC Designation	NRSRO Equivalents	Life RBC Factor (%)
1.A	Aaa/AAA	0.158	3.A	Ba1/BB+	3.151
1.B	Aa1/AA+	0.271	3.B	Ba2/BB	4.537
1.C	Aa2/AA	0.419	3.C	Ba3/BB-	6.017
1.D	Aa3/AA-	0.523	4.A	B1/B+	7.386
1.E	A1/A+	0.657	4.B	B2/B	9.535
1.F	A2/A	0.816	4.C	B3/B-	12.428
1.G	A3/A-	1.016	5.A	Caa1/CCC+	16.942
2.A	Baa1/BBB+	1.261	5.B	Caa2/CCC	23.798
2.B	Baa2/BBB	1.523	5.C	Caa3/CCC-	30.000
2.C	Baa3/BBB-	2.168	6	All Lower	30.000

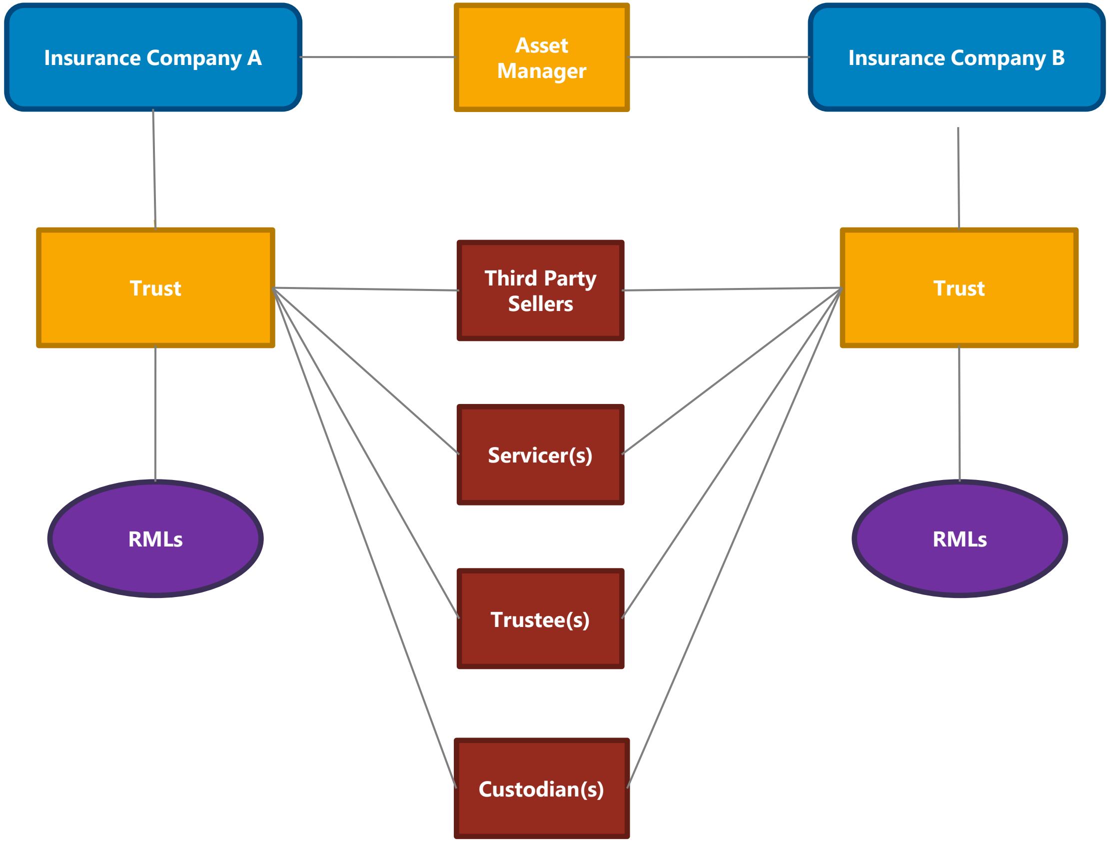
Comparison of Statutory Reporting Treatments

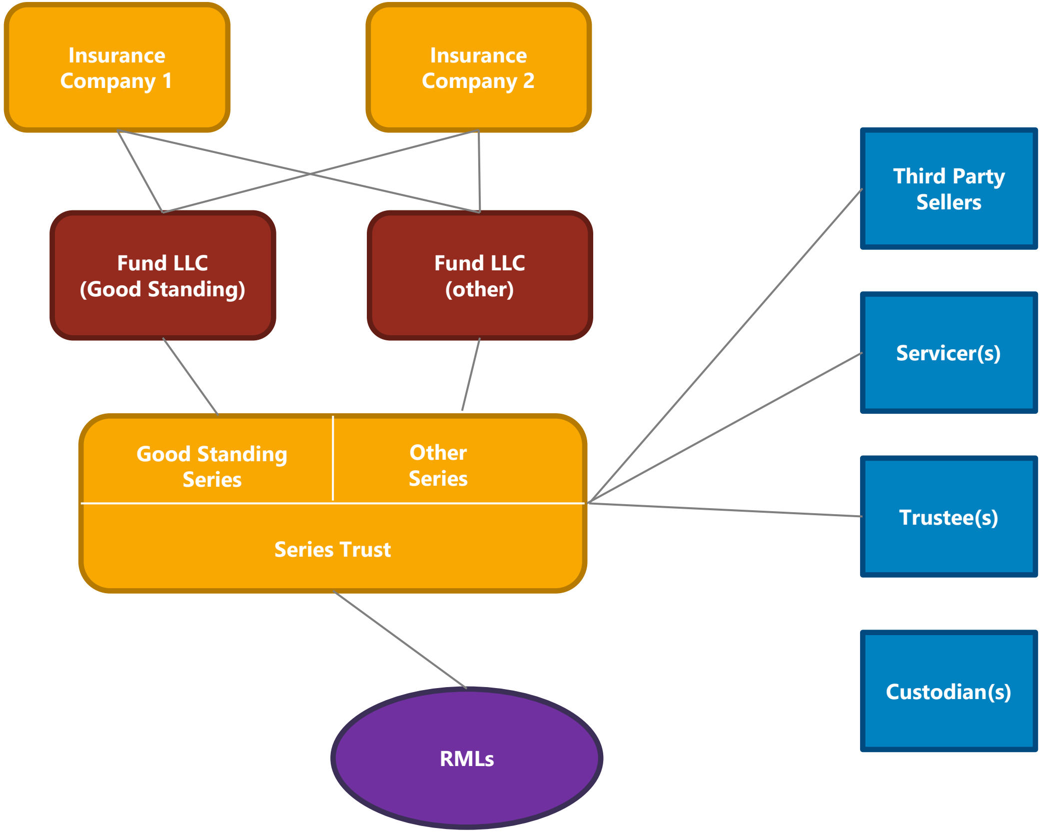
Reporting Schedule	How RBC Factor Is Derived	Mark to Market?
Schedule B (Residential)	Payment Status or Insured/Guarantee	No
Schedule B (Commercial)	Category Determined Based on Property Type, DSC and LTV	No
Schedule BA	Generally Use Commercial Mortgage Categories, Unless Held in Affiliated Structures	Yes
Schedule D	Credit Quality Designation Based on Modeling	No (if above NAIC-6)

Investment Subsidiaries

- Many state insurance codes have the concept of an “investment subsidiary” of an insurer whose sole purpose is to own and manage investments that the insurer could have owned and managed directly
- Investments made through an investment subsidiary are aggregated with an insurer’s direct investments for purposes of complying with any quantitative investment limitations
- RBC for investment subsidiaries is calculated on a “look through” basis
- Practice varies with regard to insurers’ statutory accounting and reporting of mortgage loan investments made through investment subsidiaries
  - Schedule D reporting based on audited GAAP equity of the subsidiary
  - Schedule B reporting based on a “look through” to the underlying individual mortgage loans

Investment Structures


Insurance Company A
Asset Manager
Insurance Company B
Trust
Third Party Sellers
Trust
Servicer(s)
RMLs
RMLs
Trustee(s)
Custodian(s)


Insurance Company 1
Insurance Company 2
Fund LLC (Good Standing)
Fund LLC (other)
Good Standing Series
Other Series
Series Trust
RMLs
Third Party Sellers
Servicer(s)
Trustee(s)
Custodian(s)

Conclusion

APPENDIX

SPEAKER BIOGRAPHIES

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Holly practices in the areas of residential mortgage banking and consumer finance and concentrates on issues of federal and state regulatory compliance and enforcement. Holly represents companies in the mortgage lending, title insurance and real estate industries on regulatory compliance matters and defends clients subject to government audits, investigations and enforcement proceedings. She also provides counsel on federal and state consumer credit and protection laws and regulations, including the Real Estate Settlement Procedures Act (RESPA), and reviews and analyzes existing and proposed business arrangements for compliance with federal and state requirements.

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Haukur's practice is focused on structured finance and other transactions involving all types of residential mortgage loans and other residential real property-related assets, including mortgage servicing rights, servicing advances, REO properties, single-family-related properties, home improvement loans and house equity products.

For more than 15 years, Haukur has represented his clients in a wide array of transactions involving virtually every type of residential real property-related asset, including several novel asset types, transactions and structures. Clients appreciate his thoughtful and creative approach to solving problems and successfully executing novel and complicated transactions.

Larry Hamilton

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Larry leads Mayer Brown's US Insurance Regulatory & Enforcement group. He advises insurance companies, insurance agencies and investment companies on a broad range of regulatory matters, including those associated with formation, licensing, portfolio investments, reinsurance, e-commerce, cybersecurity and outsourcing.

Larry regularly advises US and European financial institutions on the insurance regulatory issues associated with complex capital market and derivative structures, including the evolving changes in regulatory treatment of different types of investments by the National Association of Insurance Commissioners.

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Claire represents both sponsors and investors on a wide variety of investment matters. She has broad experience in the formation and structuring of open-end and closed-end private equity funds utilizing a variety of investment structures and investment strategies, with a particular focus on real estate, real estate-related and structured finance investments. Claire regularly represents institutional investors, including insurance companies, in investments in private equity funds, hedge funds, managed accounts, and other alternative investments. , Claire collaborates closely with colleagues to develop structures that optimize investment by insurance companies. This includes working on strategies for mortgage loan investments and the use of rated note feeders to obtain more favorable regulatory capital treatment for applicable investments. Her comprehensive knowledge and experience make her a valuable asset in navigating the complexities of investment management for insurance companies.

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Tameem represents issuers, borrowers, underwriters, lenders, investors, private equity funds, insurance companies and financial institutions in a broad range of lending, financing and securitization transactions.

His experience includes advising on the financing of residential mortgage loans, commercial mortgage loans, single family rentals, non-performing and re-performing loans, fix and flip loans, consumer loans, retail installment contracts, as well as the financing of servicing and corporate advances and mortgage servicing rights. Tameem's securitization experience includes public and private transactions involving various asset classes, including residential mortgage loans, commercial mortgage loans, aircraft leases, and commercial loans. In addition, Tameem has represented clients in connection with a variety mergers and acquisitions such as portfolio sales, acquisitions of mortgage companies and acquisitions of mortgage servicers.

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