RMBS Lenders' Mortgage Insurance Rating Criteria

Sector-Specific Criteria

Inside This Report

This report updates and replaces Fitch's Global Criteria for Lenders' Mortgage Insurance in RMBS, dated 29 July 2016

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Scope

This report addresses Fitch Ratings' criteria assumptions for analysing the use of lenders' mortgage insurance (LMI) in RMBS transactions for both new issuance and surveillance. The published criteria assumptions are used in conjunction with applicable RMBS criteria for rating RMBS transactions where LMI is present. The criteria also apply to covered bond programmes where the cover pool collateral includes residential mortgages with LMI.

These criteria are not applicable to certain types of insurance products, for example, Netherlands Nationale Hypotheek Garantie (NHG) and French Caution guarantees, the treatment of which is specified in the relevant sector specific criteria reports. All of the key ratings drivers listed below are equally important for analysis purposes.

Key Rating Drivers

Ability to Pay: Fitch gives credit to LMI through an adjustment to loss severity within RMBS transactions on the basis of the LMI provider's ability to pay. This is indicated by the provider's Insurer Financial Strength (IFS) Rating and is used as an input to the credit given to LMI in RMBS transactions. Credit given for the ability to pay is dependent on the ratings of the LMI provider and the RMBS notes.

As RMBS analysis is based on policyholders' recoveries, Fitch uses the IFS Ratings on the LMI providers. This takes into account many aspects of the LMI business in assessing credit risk for policy holders. In Australia and New Zealand, Fitch expects better recovery assumptions for policyholders as a result of regulatory actions and notches the IFS Rating up from the Issuer Default Rating. In Canada, Canada Mortgage and Housing Corporation is a crown corporation of the Canadian government and carries a 'AAA' rating via the sovereign rating.

Policy Quality, Operational Risk: Fitch expects LMI providers to pay all valid claims. However, due to various factors including, but not limited to, policy exclusions, invalid claims or operational risk within the claims process, there may be claim denials, claim reductions or claim rescissions. Fitch uses a quality adjustment (QA) to address the risk that any given policy may not cover all claims for a given RMBS transaction.

Background

LMI protects lenders and investors from principal and interest losses in the event that a borrower defaults and the property held as security is sold for less than the amount owed. LMI is principally designed to protect the lender and, in cases where loans are securitised, the investor. LMI has a long history of facilitating the sale and securitisation of higher loan-to-value ratio (LTV) mortgages globally and most particularly in Canada and Australia.

The LMI provider, either public or private, needs to have a full credit rating for Fitch to provide credit to the LMI policies.

Policy Terms

Fitch expects policy terms to be drafted with clarity and for the insurer, originator and servicer to comply with their contractual obligations.

Fitch expects the following:

- All policy exclusions are to be stated clearly, and any loss must always be covered in respect of all insured loans, unless the loss is a direct consequence of the exclusion event.
- The insurer is obliged to pay the insured amount within a specified number of days after receiving full claim documentation.
- The policy should state explicitly and clearly the information necessary to process the claim.
- Policy eligibility criteria should be specified clearly.
- The originator and/or servicer take responsibility for the insurance policies to remain in force.
- The originator and/or servicer will undertake all necessary steps to pursue all valid insured claim amounts under the policy.
- The seller and servicer have given appropriate representations and warranties that insured loans are compliant with the requirements of the LMI policy attaching to those loans.
- The seller has assigned its entire rights and interest under the LMI policies to the special-purpose vehicle or trust and the LMI provider has consented to the assignment.
- The LMI policy permits the then current servicer to process and submit claims to the LMI in the event the original lender or servicer has been replaced.

Calculation of Loss

When calculating credit for LMI coverage, Fitch first calculates the outstanding loan amount at foreclosure and subsequently subtracts recoveries to arrive at the loss on each loan. The amount outstanding at foreclosure is determined by adding foreclosure costs and accrued interest to the unpaid principal (for more details, see the respective country-specific residential mortgage criteria reports at www.fitchratings.com). In some cases, the amount outstanding after the sale will differ from the amount that can be claimed from the LMI provider due to policy exclusions or limits.

The gross claim amount to be paid by the LMI is the lower of the maximum coverage according to the LMI policy and the actual loss on the loan. For the purpose of assigning credit for the LMI policy, this expected claim amount is adjusted by the IFS Rating – which measures the ability of the insurer to pay – and the QA, to account for the potential risk arising from the policy not covering all potential losses as a result of the text of the policy itself or a differential between contractual coverage and the resulting actual coverage (which may be affected by denied and reduced claims and rescissions). A sample calculation is detailed in *Appendix 4*.

Related Criteria

Global Structured Finance Rating Criteria (May 2017)
EMEA RMBS Rating Criteria (November 2016)
U.S. RMBS Loan Loss Model Criteria (March 2017)
APAC Residential Mortgage Rating Criteria (April 2017)
Insurance Rating Methodology (April 2017)

Ability to Pay

The IFS Rating adjustment aims to capture the LMI provider's ability to pay the claim on an insured loan and is therefore related directly to the IFS Rating and the rating of the notes. Full credit is given whenever the IFS Rating is higher than, or equal to, the notes' rating. Limited or potentially no credit is given if the IFS Rating is below the notes' rating or where the LMI provider is not rated. Fitch gives no credit for insurers rated below 'A−' in a 'AAAsf' or 'AAsf' scenario. The level of credit given for LMI is shown in the table below.

IFS Rating Adjustment[a]

	Note Rating					
IFS of LMI provider (%)	**AAAsf**	**AAsf**	**Asf**	**BBBsf**	**BBsf**	**Bsf[b]**
AAA	100	100	100	100	100	100
AA	75	100	100	100	100	100
A	50	75	100	100	100	100
BBB	0	0	50	100	100	100
BB	0	0	0	50	100	100
B	0	0	0	0	25	100

[a] Notch-specific ratings will be interpolated between IFS Rating adjustments
[b] No credit will be given at the 'B'-rating level if the rating indicates a deteriorating financial position. No credit is given for a 'B-' insurer
Source: Fitch

Credit, as shown above, is given only where an insurer has an IFS Rating and will not apply to guarantors that are non-insurers and that do not have an IFS Rating.

As described in *Sensitivity Analysis* and *Appendix 4*, Fitch provides sensitivity analysis showing how ratings might change in response to a change in the IFS Rating of the LMI provider, which is the basis for this analysis.

The rationale for the IFS Rating-adjustment matrix is that in a 'AAAsf'-rating scenario, only 'AAA'-rated LMI providers are likely to survive the full stress and be able to pay claims for the entire stress period. Fitch therefore gives the benefit of full IFS Rating credit to a 'AAA' insurer in a 'AAAsf'-rating scenario and below. Where the notes' rating is higher than the rating of the LMI provider, the provider may survive to pay a certain amount of claims before exhausting its resources. Highly rated insurers have more claim paying resources than lower-rated insurers. As a result, the lower the IFS Rating of the LMI provider, the lower the credit given in higher-rating scenarios.

Policy Quality, Operational Risk

Fitch expects LMI providers to pay all valid claims. The QA aims to capture the risk from non-payment of claims due to various factors, including exclusions within a particular policy as well as denied and reduced claims and rescissions. A QA is applied to each issuer. If an issuer has multiple policies with significantly differing conditions or exclusions, multiple QAs will be applied to reflect the differences. These QAs will be applied at the individual loan level depending on the policy for that loan.

Quality Adjustment

QA level	Minimum (%)	Maximum (%)
QA1	95.0	97.5
QA2	90.0	94.9
QA3	80.0	89.9
QA4	50.0	79.9
QA5	0.0	49.9

Source: Fitch

The levels shown in the above table represent the range of adjustment given under each QA level, with the actual adjustment reflecting policy and jurisdiction-specific issues and historical data where available. In determining an individual QA within the range insurance policies, an issuer's historical claims and claim payments will be analysed. The QA level for an issuer will be disclosed in Fitch's rating reports.

The assessment of the QA is regularly reviewed through a credit committee process in light of evidence of unsatisfied claims. Where there are multiple LMI providers present in an RMBS transaction, one QA will be assigned for each issuer. If the issuer relationship with each LMI provider differs significantly or the issuer has policies in place with different conditions, multiple QAs will be applied.

Unpaid LMI claims depend on the overall relationship between the insurer and originator and/or servicer, as well as exclusions within the LMI policy. Fitch assesses the quality of the relationship and policies via its QA, leading to assessments ranging from very good quality grade (QA1) to low quality (QA5). QA definitions can be found in *Appendix 2*.

The following key components determine the QA, with more weight applied to the operational quality of the provider, originator and servicer:

- The operational quality of the LMI provider.
- The operational quality of the originator and servicer.
- Historical evidence of unsatisfied claims.
- The quality of the policy, including the range and breadth of exclusions.

The QA reflects that claim denials and rescissions be minimised only if all parties have a well-established and well-equipped process of credit assessment, monitoring, portfolio audits and claim submission and if the policy's terms show transparent underwriting guidelines and non-coverage events. A QA1-level would reflect best practice in these areas, with minimal exclusion events and a long record of minimal claim denials, reductions or rescissions.

If serious process or policy deficiencies raise concerns about the potential success of claiming insurance, a QA5-level is more likely, reflecting increased risk of higher claim adjustments, denials and rescissions. A QA3-level signifies an established and smooth relationship in processing LMI claims between an experienced insurer and established lender that has strong underwriting procedures and at least five years' experience working with LMI. See *Appendix 4* for an illustrative example of a QA assessment.

Single or multiple QAs applied to one or more RMBS transaction from the same issuer may vary over time due to improvement or deterioration in the factors considered within the QA. The QA-level is determined on an individual-issuer basis and will be affected where there is a lack of historical data or where historical data does not encompass a period of economic stress – and does not therefore provide an insight into the extent of unsatisfied claims that may arise in a stressed environment.

Recovery Timing

The originator/servicer can file a claim with the LMI provider as soon as the foreclosure process is completed and the loss is determined. It takes time for the insurer to check the claim and make payment. This time between the end of foreclosure and claim payment depends on several factors, such as the servicer's and LMI provider's claim management processes, systems and policy terms. Claim timing is generally specified in policy documents. Fitch relies on its individual RMBS criteria for recovery timing.

In some markets, such as Australia, Fitch does not differentiate its recovery timing between mortgages with or without LMI, as policy claim timing is relatively short.

Sensitivity Analysis

A downgrade of an LMI provider may cause a downgrade to one or more tranches within a transaction if the transaction contains significant LMI support. A subordinate tranche is more likely to bear the effect of a LMI provider downgrade because the rating of a subordinate tranche is often heavily based on the ratings of the mortgage insurers. The senior tranche may not be downgraded, depending on the degree of cushion to the rating from credit enhancement from the subordinate tranche or reserve funds, in addition to that provided by LMI. For senior and subordinate tranches, the effect of a downgrade is the result of, among other factors:

- the magnitude of the LMI provider downgrade
- what proportion of the pool and which loans are insured by the downgraded insurer.

Fitch provides investors with a sensitivity analysis showing the effect on tranche ratings within a transaction if the LMI IFS Rating is downgraded or removed (see examples in *Appendix 4*).

Data Sources

Fitch uses the following data to derive its key assumptions.

Ability to Pay

Fitch's insurance rating group provides IFS Ratings.

Quality Adjustments

Fitch uses the following information to derive lender QAs:

- Review of LMI provider, including market position, financial strength and historical claims payment record.
- Operational reviews of lender, including its risk management and operational procedures for LMI claims.
- Review of existing LMI policies.
- Aggregate and/or loan-level issuer or lender information on defaults, foreclosures, losses and related LMI claim amounts, and LMI claim payments and/or claim denials, adjustments and rescissions for Fitch-rated RMBS transactions in the relevant jurisdiction.

Fitch assesses the general reliability of the available data and conducts a reasonable investigation into the factual information it relies on before including the information in its analysis.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Appendix 1: LMI Product Description

LMI policies are structured so loss coverage is a certain portion of each individual loan. LMI policies cover not only losses from unpaid principal, but unpaid interest, normal property maintenance costs and foreclosure costs up to pre-defined limits.

LMI policies pay any claimable losses incurred on a loan after the lender has foreclosed on the property and any recoveries have been realised. Coverage differs in each market where LMI is present; in many markets cover provides for any losses “down to” a certain proportion of the property’s market value at origination (the “attachment point”). The term “down to” reflects the fact that LMI can be considered additional equity.

For example, a defaulted loan with an 80% original LTV ratio covered by LMI “down to” a 60% LTV ratio attachment point should experience a recovery amount equivalent to a 60% LTV ratio loan. The portion covered remains fixed over the life of the loan and does not amortise with the outstanding balance. In Australia, New Zealand and Canada, LMI policies provide up to 100% cover; they cover all losses (subject to exclusions), not just a layered-loss approach as described above.

Policies are tailored to specific lender needs and therefore entail particular product features or coverage limitations. For example, a first-loss position on the loan is sometimes kept by the lender so the LMI policy will only begin to pay if the loss exceeds a certain portion of the property value. The cover on the loan may amortise together with the outstanding balance or in proportion to the outstanding balance. Some policies also define maximum coverage on a portfolio level, called “stop loss”, up to which insurance is provided, especially under bulk or pool LMI (see the *Underwriting* section below). Losses beyond the “stop loss” for the portfolio as a whole would not be covered. Fitch assesses potential risks and benefits of such special characteristics on an individual basis and incorporates them into recovery calculations or the QA assessment.

An additional optional feature observed in the Australian RMBS market is that LMI policies are supplemented to provide liquidity to the transaction. Where timely payment cover is purchased by the insured, LMI policies will cover the timely payment of interest and principal instalments of delinquent mortgage loans for an agreed period, of up to 24 months. Fitch considers any such policies in its liquidity support analysis for a transaction.

Underwriting

Underwriting practices differ in each market, but the most common form of LMI follows an underwriting procedure called “delegated lending authority”. This means any loan originated within the guidelines of the master LMI policy is automatically covered. The insurer does not fully review or assess the documentation or underwriting decision in respect of each loan, but relies on the fact that the lender or originator has accurately represented that the loan complies with policy guidelines.

In some markets eligibility is checked on a sample basis during regular audits quarterly or at the latest, when a claim has been submitted. This differs from individual assessment on the eligibility of each loan by the insurer at the underwriting stage. The investor may be exposed to increased risk of the claim being denied or reduced if the mortgage insurer subsequently discovers the loan was originated outside agreed guidelines. This risk is taken into account in the QA assessment for operational risk and policy quality.

The insurer and lender work closely together to mitigate this risk, with the insurer regularly auditing the pool, providing reports to the lender and assisting in the review of origination guidelines and foreclosure procedures. LMI providers do not have direct contact with the borrower at any stage; neither at the point of underwriting the individual insurance policy nor acting as an intervening party during the foreclosure process. However, the insurer may require additional procedures in the foreclosure process, which can result in lower loan losses.

Insurance can be provided for all new loans on an ongoing basis as originations are generated (flow or primary LMI). LMI can also be provided for an existing pool of loans (bulk or pool LMI). Fitch does not make a distinction in its analysis between the two forms, as long as the cover under the insurance policies is otherwise identical. In addition, no distinction is made between borrower-paid LMI or lender-paid LMI, as long as the policies do not differ in other respects.

In the US, LMI premiums are paid on an ongoing basis from transaction cash flows until the policy is cancelled. This occurs when the current LTV ratio falls below 80% or an automatic cancellation occurs at 78% LTV ratio. Most other markets pay the LMI premium upfront before the point of securitisation, with some lenders allowing it to be capitalised to the loan balance and then to form part of the securitised pool. In the event that premiums are paid on an ongoing basis, credit is only given to the LMI policies if Fitch expects ongoing premiums to be paid in the relevant rating scenario. Furthermore, credit for LMI will only be given if the insurance policy is not cancellable until the maturity date of the relevant loan.

LMI Versus Financial Guarantees

There is a major difference between LMI policies and financial guarantees. The former are drafted as insurance contracts, with payment pre-conditions and coverage exclusions (see *Events of Non-Coverage* and *Procedural Requirements* below), allowing insurers to avail themselves of insurance contract defences to claim payments. This may be permitted by law in the relevant jurisdiction or by the contract; for example, the insured not disclosing material facts or not complying with LMI policy terms.

The terms of LMI policies Fitch sees are not financial guarantees. Financial guarantees, which may be issued by insurance companies such as monoline insurers, are drafted as “pay first/sue later” documents and expressly exclude insurance contract defences to payment. Financial guarantees are considered more valuable as credit enhancement for these reasons.

Events of Non-Coverage

The insurer is exempt from paying losses resulting from specific policy exclusion events, as is common among insurance policies. The list of such events varies between insurers and policies. The following is a list of exemptions seen in a sample of past LMI policies.

Losses arising from:

- earthquakes, floods, fires, lightning, explosions, storms, aircraft accidents or any act of God
- war, terrorism, invasion and similar events of hostile forces
- misrepresentation and fraud
- commotion or malicious damage
- contamination by toxic or hazardous waste, chemical, pollutant or other substances
- properties where construction has not been completed, and
- any defects in the construction of the property not identified in the application.

Claims may be reduced or adjusted, if negligence of the insured, the originator or servicer can be proven to have contributed to the loss amount claimed.

Additionally, adjustments may be made to claims for amounts such as:

- default interest
- fees and charges added to loan accounts
- costs of property restoration following damage or destruction
- costs of removal and clean-up of contamination
- additional funds provided to a borrower without the LMI provider's written consent
- legal fees above a specified cap
- fixed-rate loan break costs
- amounts owing by a borrower but voided due to non-compliance with legislated credit codes in the relevant market, and
- where a loss has been increased by the lender making a false or misleading statement or representation to a borrower.

Fitch reviews the extent of exclusions and reduces the credit given to LMI to for any supplementary risk deemed to arise from particular exclusions. This is incorporated in the QA assessment for operational risk and policy quality. Fitch will give no credit to the LMI policy if the exclusions bring the general enforceability of the insurance into question.

Procedural Requirements

Insurers require the originator and/or servicer to provide a regular performance report for loans in arrears. The insurer uses this report to make necessary provisions and detect risk concentrations that will potentially trigger special audits. The insurer assists in the management of delinquent loans and can be actively involved in mitigating potential losses arising from foreclosures.

A claim on the insurance policy cannot be submitted until the foreclosure process has finished and any recoveries and losses have crystallised. There are exceptions to this in some countries with particularly long and inefficient foreclosure proceedings. Where policies differ with respect to the exact definition of the date of loss, subject to the originator's and servicer's servicing practices, this has different implications for the expected date of claim payment.

The lender must submit a claim form to the insurer within an agreed period of one to 12 months, to keep its insurance cover. The insurer, in turn, must pay, reduce or deny the claimed amount within a certain period from receiving the complete claim documentation – generally a few days to several months, depending on practices in each market.

Appendix 2: Quality Adjustment Definitions

Quality Adjustment Scale

The QA aims to capture the potential risk arising from denied and reduced claims and rescissions. A QA is assigned on a scale of one to five, with one being the highest.

QA1 – Reflects Best Practice in all of the Following Areas

- A sound relationship exists between the LMI provider and originator/servicer.
- The LMI provider has a long and consistent claims paying record, particularly through stressed economic periods.
- The negotiating position for the originator /servicer is strong.
- The originator/servicer has extensive experience in administering loans with mortgage insurance and claims preparation.
- Strong loan underwriting procedures are in place, with a history of very low claim denials, reductions and rescissions, resulting in a very high level of LMI claim payments.
- The LMI policy has limited exclusions.
- Claims procedures and payment timelines are clear.
- The LMI provider is likely to be a sovereign or near-sovereign entity.

QA2 – Demonstrates

- a high level of performance in all the above QA1 factors
- historical claim payments with a higher level of denials, reductions and rescissions than a QA1, but remaining low and within the QA2 level, and
- a strong negotiating position for the originator/servicer, with the organisation likely to be a large major financial institution.

QA3 – Demonstrates

- a satisfactory level of performance in all the above QA1 factors
- an established and smooth running relationship in processing LMI between an experienced insurer and established originator, which has at least five years' experience working with LMI
- historical claims payments with a higher level of claim denials, reductions and rescissions than a QA2, but remaining low and within the QA3 level, and
- a negotiating position for the originator/servicer that is not as strong as that of a QA2.

QA4 – Demonstrates

- a weakening of the relationship between the LMI provider and the originator/servicer has occurred
- the negotiating position of the originator/servicer is biased towards the LMI provider, and
- historical claims payments with a significant level of claim denials, reductions and rescissions within the QA4 level.

QA5 – Demonstrates

- a significant breakdown in the relationship between the LMI provider and the originator/servicer has occurred
- the negotiating position of the originator/servicer is poor, resulting in a significant level of unsatisfied claims and leading to a low level of credit not exceeding 50%, and
- the level of unsatisfied claims and poor relationship could lead to heightened litigation risk between the parties, which will likely result in a further deterioration in the relationship.

Appendix 3: Illustrative Example of a QA Assessment

Example 1

LMI Provider

An active monoline mortgage insurer with a long record; established operations and several clients in the market in which it is operating; a dedicated local team and established risk management processes; maintains frequent contact with lenders; and performs regular audits and reports results to lenders.

Originator/Servicer

An established prime lender in the local market, mainly using a branch network with established risk management and monitoring systems, and not less than five years' experience of underwriting loans with mortgage insurance. An experienced servicer, with established operations and developed processes for filing mortgage insurance claims; not less than five years' experience of actually filing claims; and a claims payment rate from its LMI provider of approximately 92%.

Policy

Standard insurance policy with a clear definition of loan eligibility, accomplishable procedural requirements for filing claims (even in stress scenarios), a strict timeline for paying claims and standard exclusions.

Result

QA2.

Example 2

LMI Provider

An active monoline mortgage insurer with a long record; established operations and several clients in the market in which it is operating; a dedicated local team and established risk management processes; maintains frequent contact with lenders; and performs regular audits and reports results to lenders.

Originator/Servicer

An established smaller lender in the local market, mainly using a broker network with established risk management and monitoring systems; and not less than five years' experience of underwriting loans with mortgage insurance. An experienced servicer, with established operations and developed processes for filing mortgage insurance claims; not less than five years' experience of actually filing claims; and a claims payment rate from its LMI provider of approximately 87%.

Policy

Standard insurance policy with a clear definition of loan eligibility, accomplishable procedural requirements for filing claims (even in stress scenarios), a strict timeline for paying claims and standard exclusions.

Result

QA3.

Appendix 4: Worked Example of Credit to Lenders' Mortgage Insurance

Assumptions

- An RMBS transaction with an expected loss (including accrued interest) at the 'AAAsf' scenario of 12%, excluding any consideration regarding the presence of LMI policy in the pool.
- The arranger has structured the transaction with 6% credit enhancement.
- All loans have 100% individual LMI coverage from a 'AA'/Stable-rated LMI provider.
- The lender is evaluated as a QA3, with a QA credit of 85%.
- Credit to LMI is calculated on a loan-by-loan basis.

Both tables below indicate the credit given based on the note rating, the LMI provider's IFS Rating and QA.

Credit based on IFS Rating and Note Rating (%) – Initial and Subsequent Ratings

	Note Rating					
IFS[a] of LMI provider	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf[b]
AAA	100.0	100.0	100.0	100.0	100.0	100.0
AA	75.0	100.0	100.0	100.0	100.0	100.0
A	50.0	75.0	100.0	100.0	100.0	100.0
BBB	0.0	0.0	50.0	100.0	100.0	100.0
BB	0.0	0.0	0.0	50.0	100.0	100.0
B[b]	0.0	0.0	0.0	0.0	25.0	100.0

[a] Notch-specific ratings will be interpolated between IFS Rating adjustments
[b] No credit will be given at the 'B' rating level if the rating indicates a deteriorating financial position. No credit is given for a 'B-' insurer
Source: Fitch

QA

QA level	Credit range (%)
QA1	95.0-97.5
QA2	90.0-94.9
QA3	80.0-89.9
QA4	50.0-79.9
QA5	0.0-49.9

Source: Fitch

Result

- Credit for the 'AA'-rated LMI provider at 'AAAsf' will be 75.0% (see *Credit based on IFS Rating and Note Rating (%) – Initial and Subsequent Ratings*), multiplied by a QA credit of 85.0% = 63.8%.
- The LMI-dependent credit enhancement to 'AAAsf' is 4.4%; [12.0%*(1-(75.0%*85%))].

The above transaction's expected loss sensitivity to a downgrade of the LMI provider's rating is shown in Example 1 below.

Example 1: Rating Sensitivity to Insurer IFS Rating

	'AAAsf' expected loss (%)	Note Rating
Original rating – 'AA'	4.4	AAAsf
1 notch downgrade – 'AA–'	5.2	AAAsf
2 notch downgrade – 'A+'	6.1	AA+sf
3 notch downgrade – 'A'	6.9	AA+sf
No LMI	12.0	A-sf

Source: Fitch

The ratings shown in Example 2 below might be achievable if the transaction is structured to provide credit enhancement of 6.0%, given the assumptions at the beginning of the worked example.

Example 2: RMBS Transaction with ‘AA’-Rated LMI on All Loans

With LMI credit	Without LMI credit
‘AAAsf’	‘A-sf’

Source: Fitch

This indicates the transaction, with an expected loss of 12.0% and credit enhancement of 6.0%, would be able to achieve a rating of ‘A−sf’ if there was no LMI in the transaction or no credit was given to the presence of LMI. The ‘A-sf’ rating would be sensitive to the performance of the underlying assets.

The overlay of LMI from a ‘AA’ LMI provider with a QA of 85% would allow the transaction to achieve a rating of ‘AAAsf’. The ‘AAAsf’ rating would be sensitive to the performance of the underlying assets and the LMI provider’s rating. As shown in *Example 1: Rating Sensitivity to Insurer IFS Rating*, if the insurer’s IFS Rating was downgraded by 1 notch to ‘AA-’, the notes’ rating would remain at ‘AAAsf’, as the 6.0% credit enhancement is higher than the ‘AAAsf’ expected loss of 5.2%. If the insurer’s IFS Rating was downgraded to ‘A+’, the notes might be downgraded to ‘AA+sf’.

A stressed economic environment, where the frequency of foreclosure increases, can potentially affect the LMI provider’s IFS Rating and the level of foreclosures within RMBS transactions, considering the correlation between economic conditions, foreclosures and LMI claims. Example 3 below shows the potential rating changes caused by economic stress that affects the foreclosure frequency within the above RMBS transaction and the LMI provider’s IFS Rating.

Example 3: Rating Sensitivity to Insurer IFS Rating and Weighted-Average Foreclosure Frequency (WAFF)

	Note Rating		
LMI rating	No increase in WAFF	15% increase in WAFF	30% increase in WAFF
Original Rating – ‘AA’	AAAsf	AAAsf	AAAsf
1 notch downgrade – ‘AA-’	AAAsf	AAAsf	AA+sf
2 notch downgrade – ‘A+’	AA+sf	AA+sf	AA+sf
3 notch downgrade – ‘A’	AA+sf	AA+sf	AAsf
4 notch downgrade – ‘A-’	AA+sf	AAsf	AAsf
No LMI	A-sf	BBB+sf	BBBsf

Source: Fitch

Example 3 above shows that, had the LMI provider’s IFS Rating been downgraded by 1 notch to ‘AA-’ and the WAFF increased by 15% above the original WAFF, the notes’ rating would remain at ‘AAAsf’. However, if the WAFF increased by 30% above the original WAFF, the notes’ rating might be downgraded to ‘AA+sf’.

The effect on the notes’ rating would be more significant if the 30% increase in WAFF was accompanied by a downgrade of the LMI provider’s IFS Rating to ‘A’: In this case, the notes’ rating might be downgraded to ‘AAsf’.

Example 4 below shows the potential rating effects of changes in the QA together with changes in the foreclosure frequency within the above RMBS transaction, where all loans have 100% individual LMI coverage from a ‘AA’/Stable-rated LMI provider.

Example 4: Rating Sensitivity to QA and Weighted-Average Foreclosure Frequency

	Note Rating		
LMI Rating – 'AA' QA	No increase in WAFF	15% increase in WAFF	30% increase in WAFF
97.5%	AAAsf	AAAsf	AAAsf
90.0%	AAAsf	AAAsf	AAAsf
75.0%	AAAsf	AA+sf	AA+sf
50.0%	AA+sf	AAsf	AAsf
0.0%	A-sf	BBB+sf	BBBsf

Source: Fitch