Mortgage Insurance
What Have We Learned?
(Part 2)

Prepared for: CAS Special Interest Seminar
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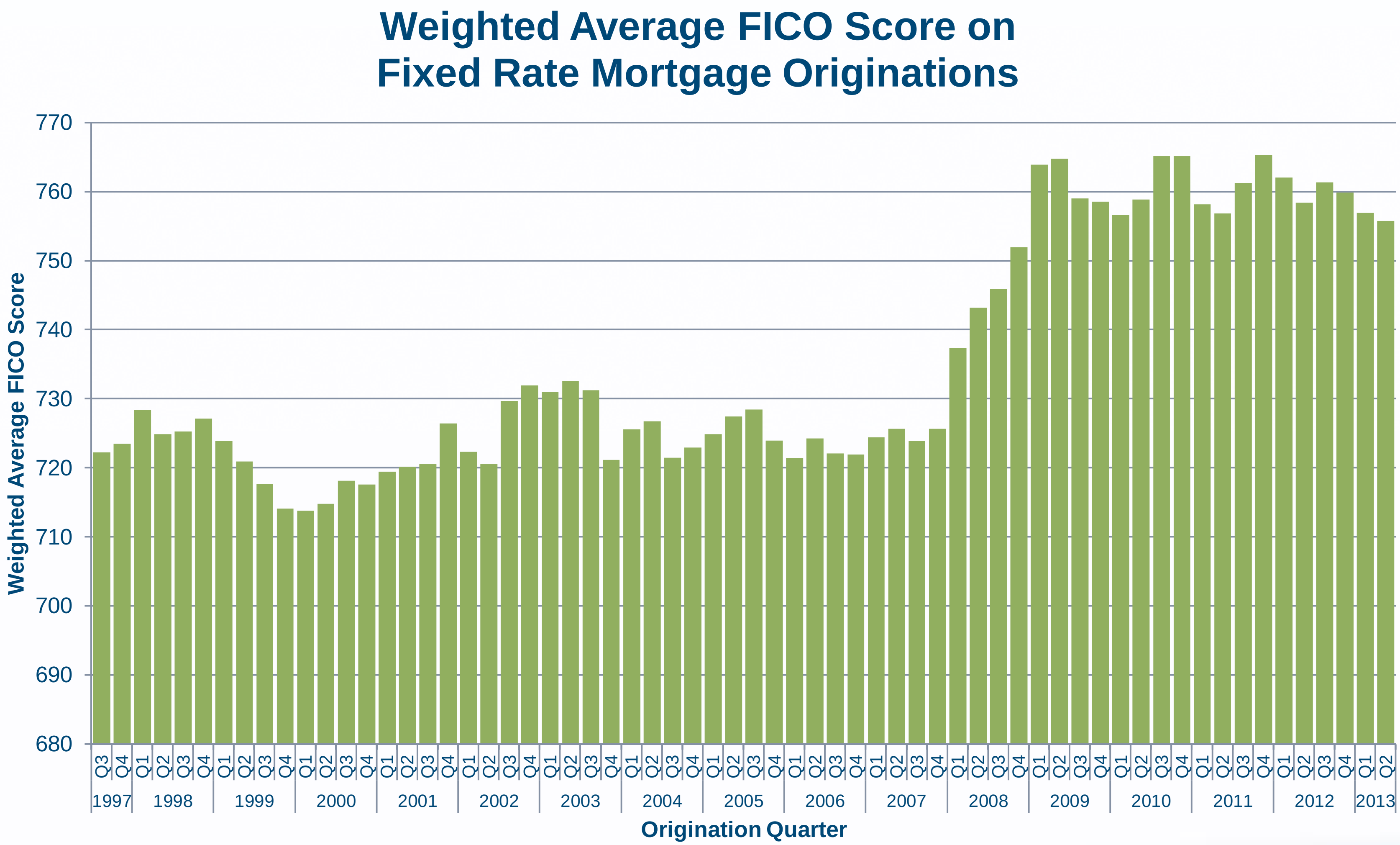
Overview

- The Credit Box
- The US Housing Cycle
- Where we've been… and where we might go…
- The Expanding PMI Market
- Qualified Mortgages v. Qualified Residential Mortgages
- Potential Industry Changes
    - IASB/FASB Accounting Standards Update
    - Proposed Legislation – PATH act
    - NAIC MI Working Group
- Predicting/Preventing the Next Crash/Trouble Spot(s)
- "Cautions" on MI Reserving

The Credit Box: Did Lenders Overreact?



Source: Truestandings Servicing Database

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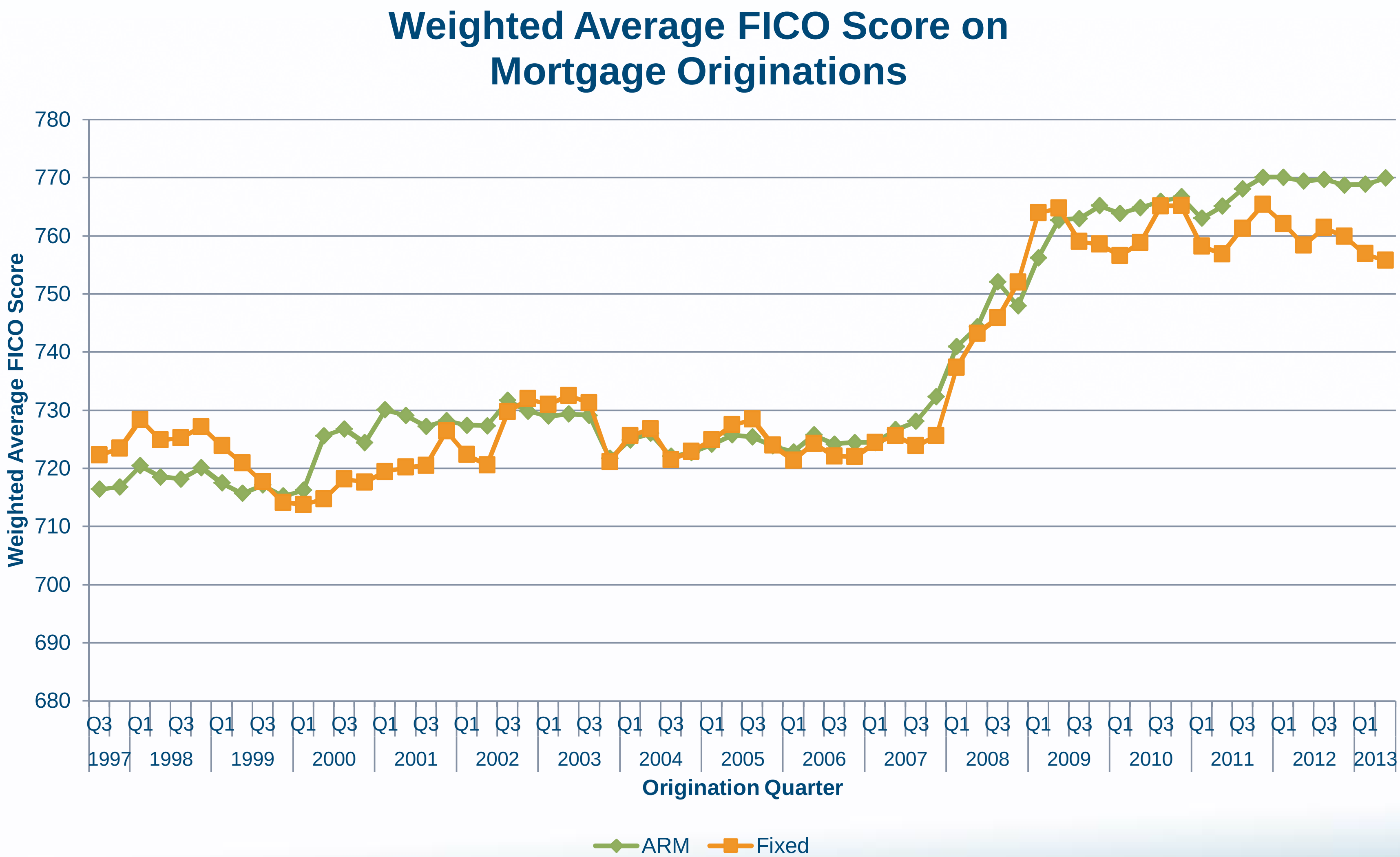

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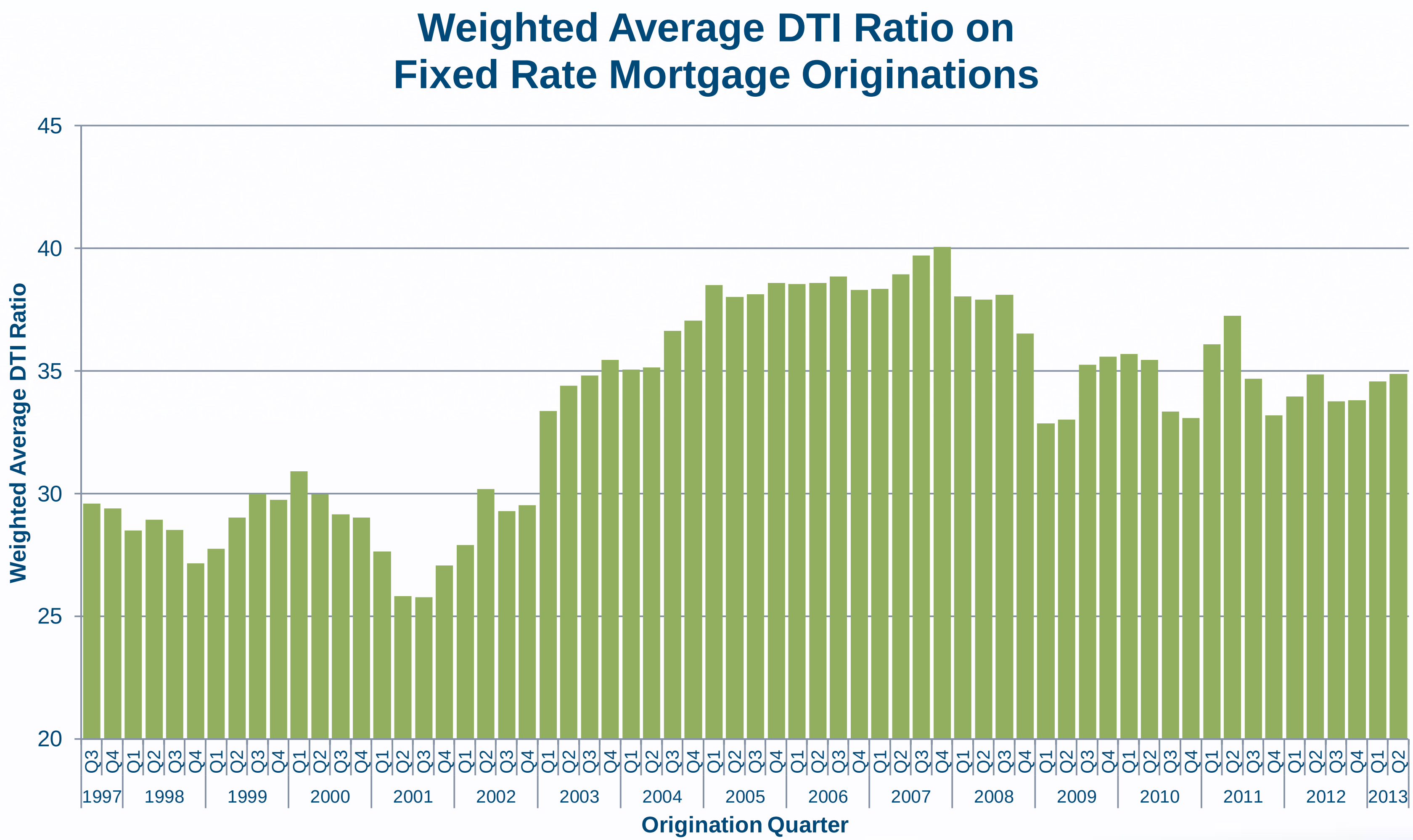

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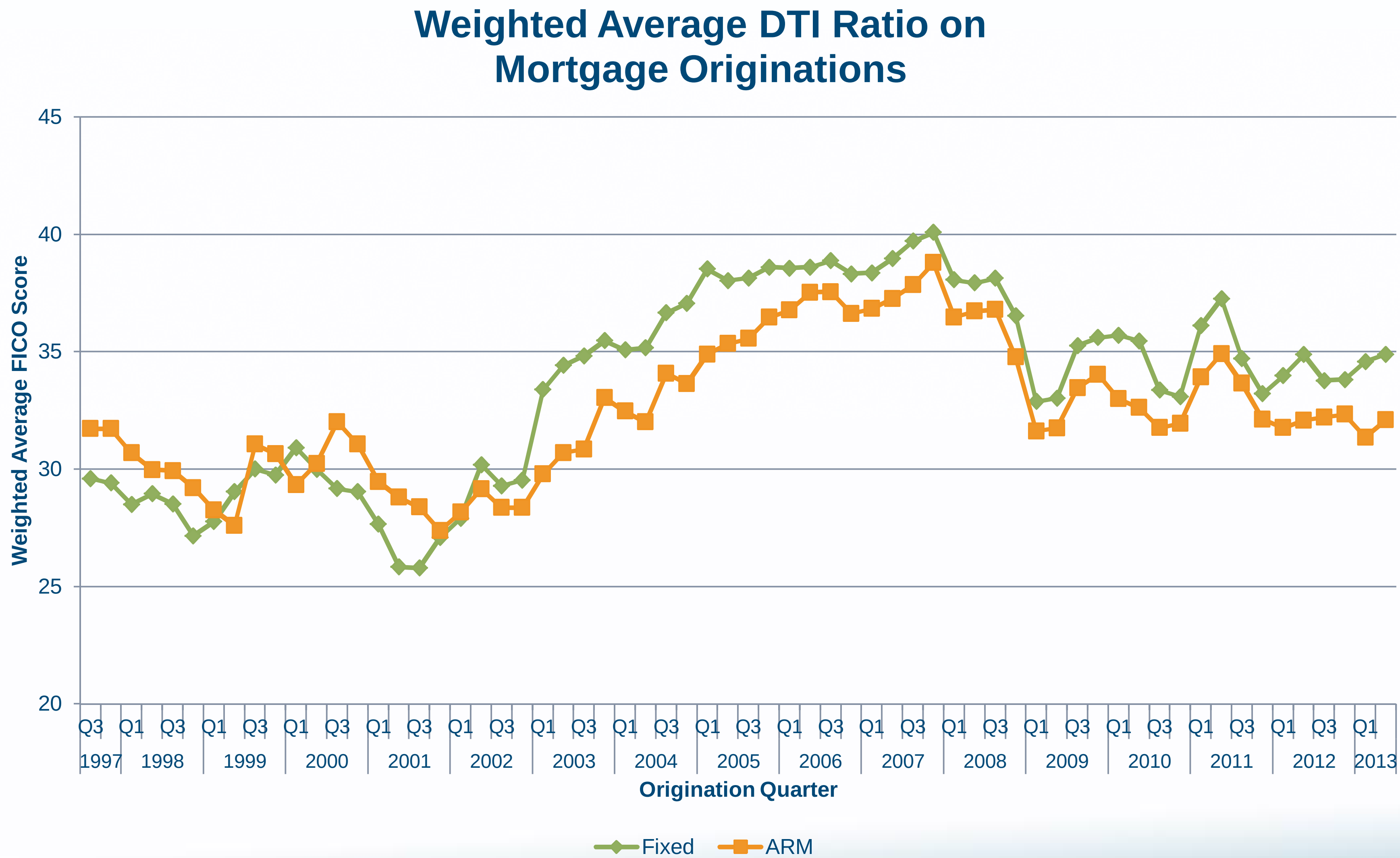

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The Credit Box: Did Lenders Overreact?

Ben Bernanke in November, 2012:

"Although the decline in the number of willing and qualified potential homebuyers explains some of the contraction in mortgage lending of the past few years, I believe that ***tight credit nevertheless remains an important factor*** *as well."*

The Credit Box: Did Lenders Overreact?

Ben Bernanke in November, 2012:

“Restrictive mortgage lending conditions do not seem to be linked to any insufficiency of bank capital or to a general unwillingness to lend.”

The Credit Box: Did Lenders Overreact?

Ben Bernanke in November, 2012:

*"It seems likely at this point that the **pendulum has swung too far the other way**, and that **overly tight lending standards may now be preventing creditworthy borrowers from buying homes**, thereby slowing the revival in housing and impeding the economic recovery"*

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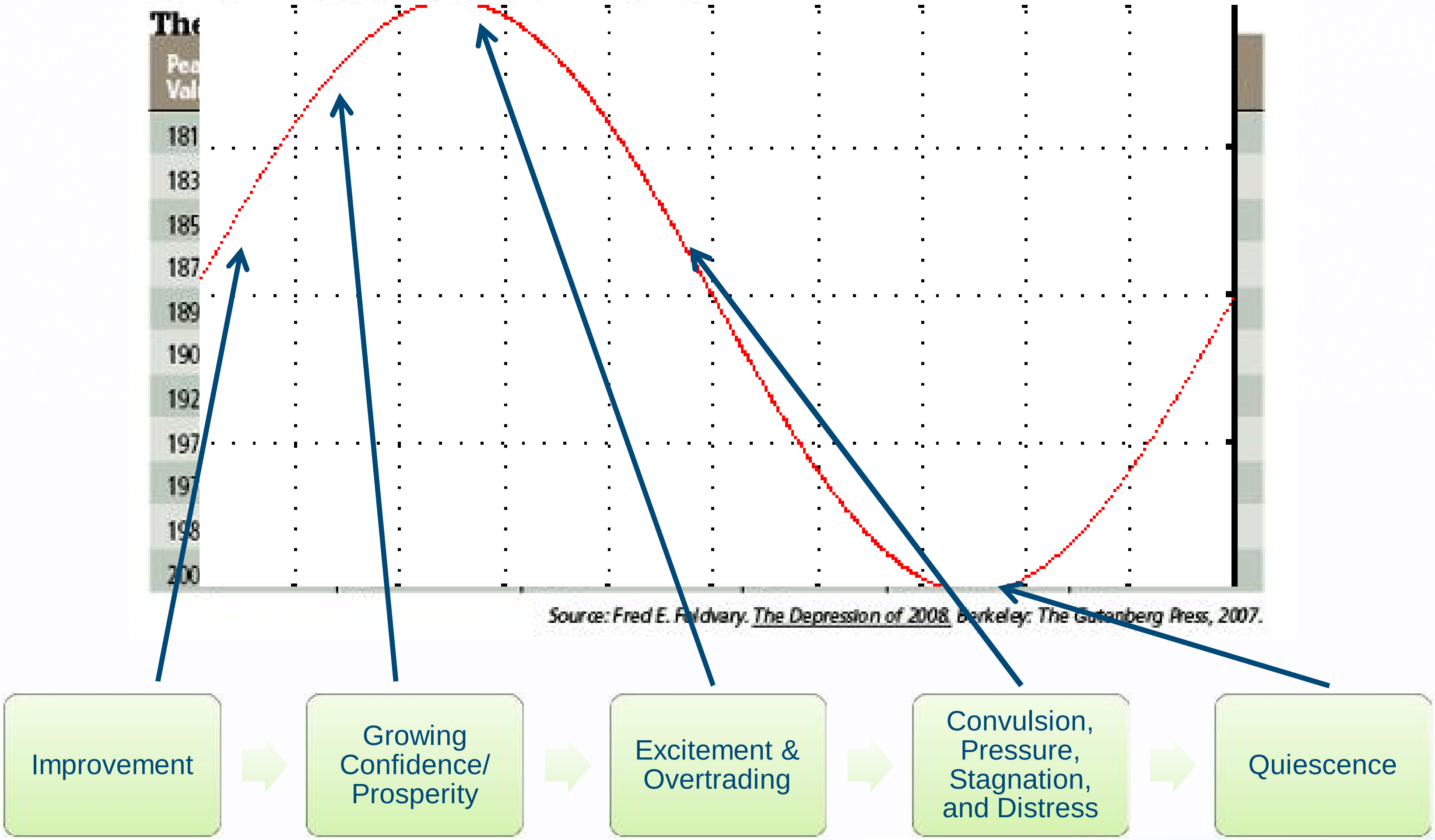
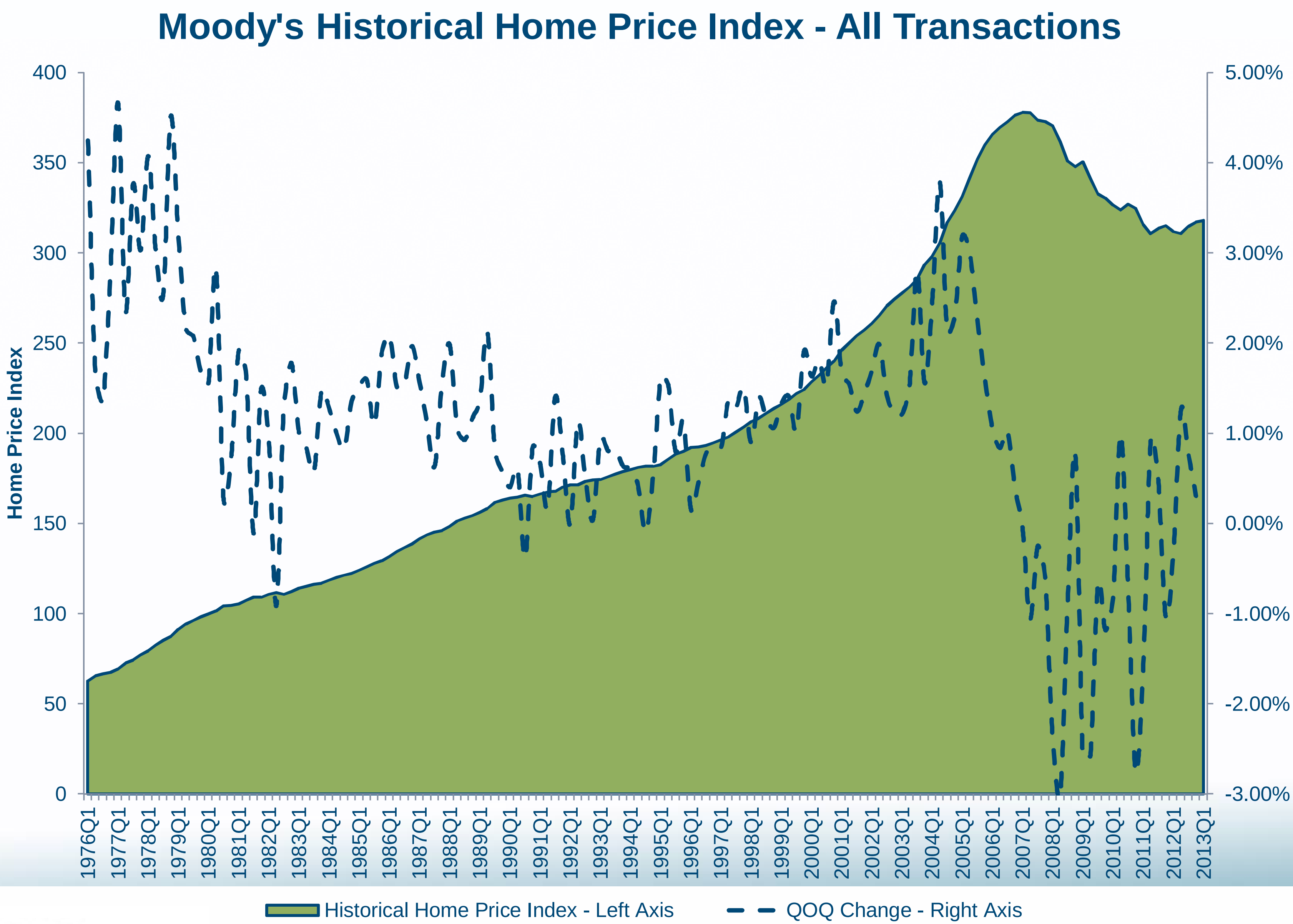
The US Housing Cycle



Where We've Been – And Where We Might Go



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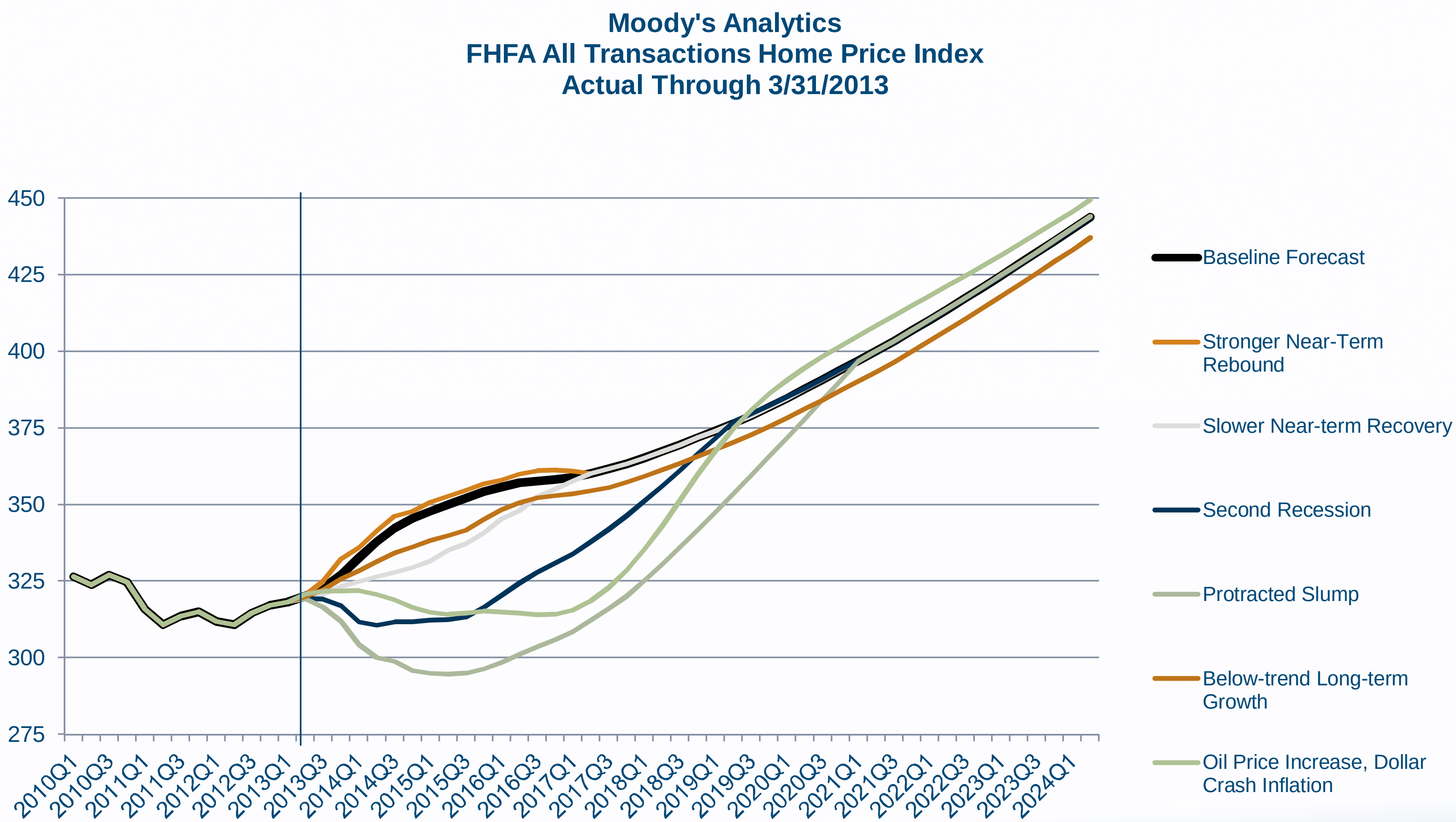

For Scenario Descriptions, See:
http://www.economy.com/home/products/samples/Moodys-Analytics-US-Alternative-Scenarios.pdf

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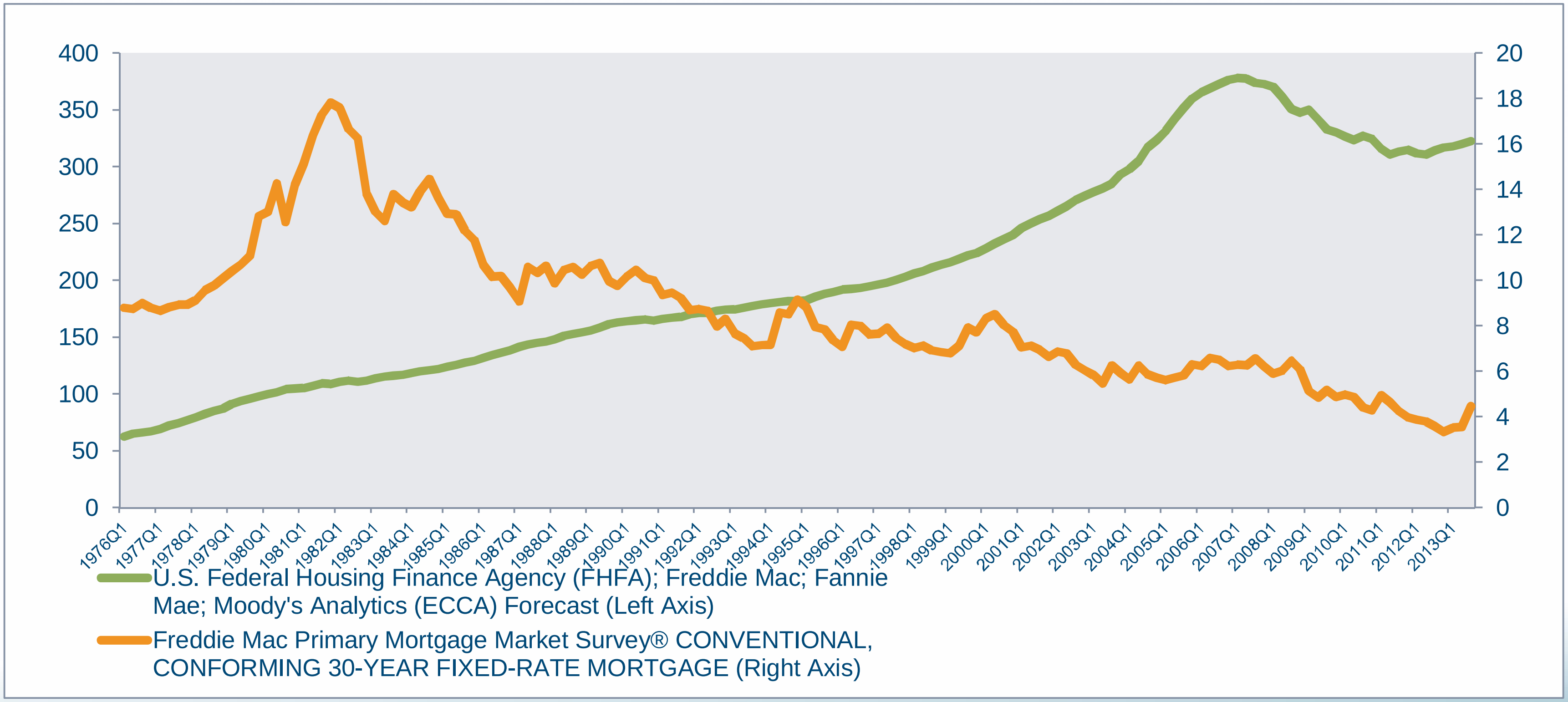
Interest Rates

No strong correlation between interest rates and home prices

Other Factors (specifically, the true strength of the underlying economy) have a larger impact on house prices than changes in mortgage rates



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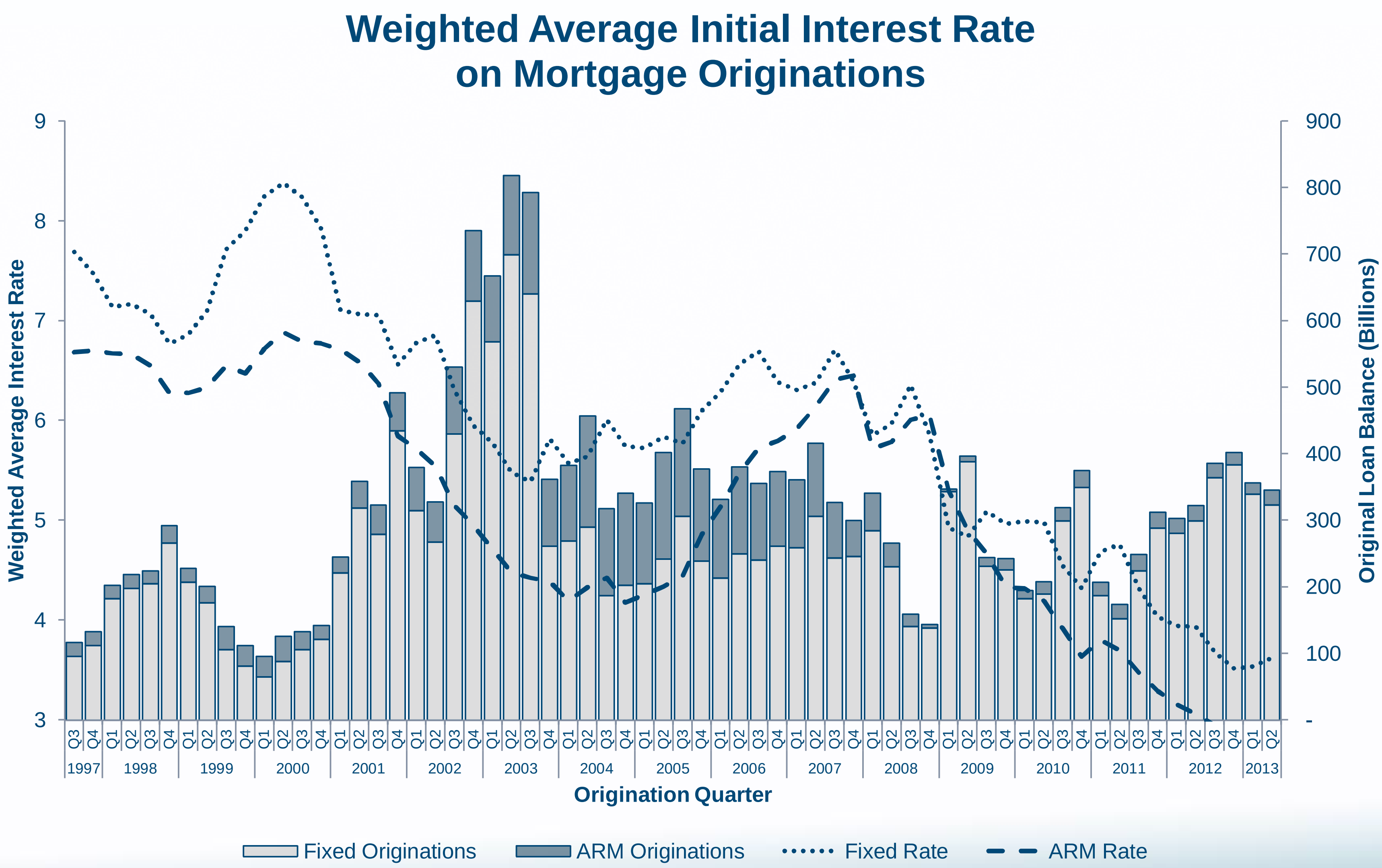
Interest Rates



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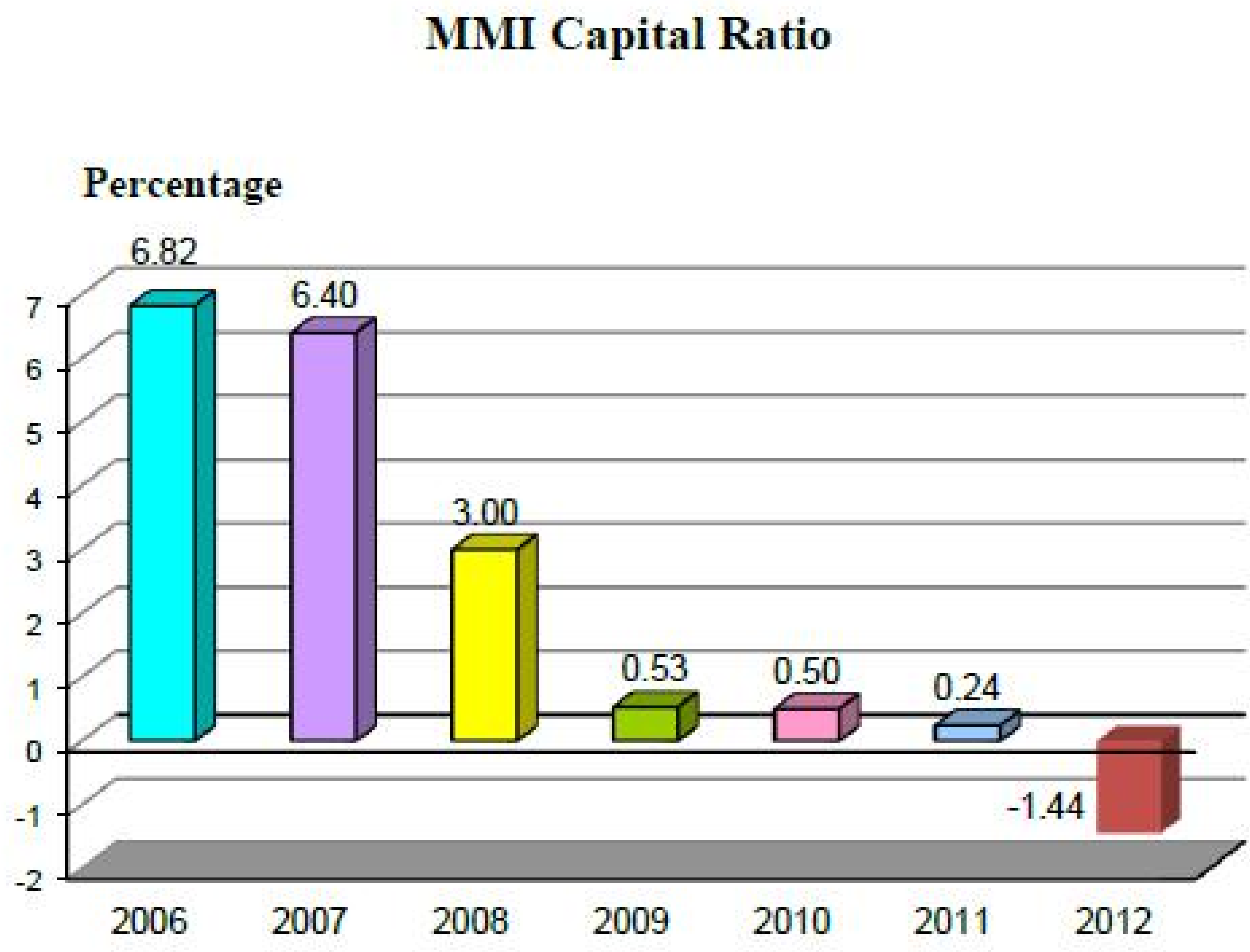
The Near Future: An Expanding (P)MI Market



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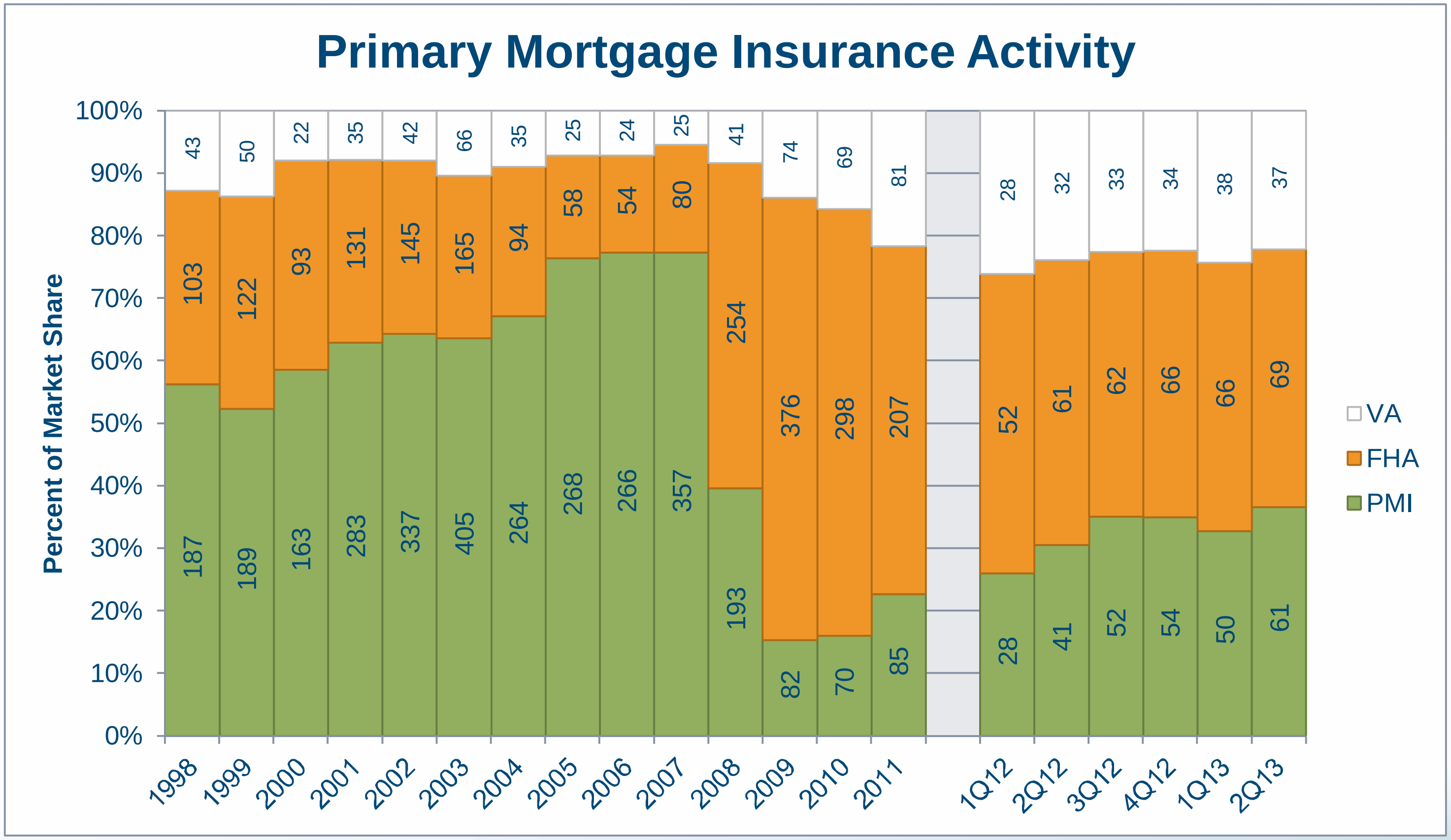
The Near Future: An Expanding (P)MI Market

MI Market Share is trending back towards pre-crisis levels



Source: Inside Mortgage Finance - Data on new primary private MI written up to 2Q03 are from MICA, from Inside Mortgage Finance after 3Q03. Starting 1Q11, total private MI is sum of traditional "flow," bulk and HARP originations. FHA endorsements include HECM.

Negative Equity – An Oncoming Flood?

- At month end May 2013, 7.3M mortgages in the US have negative equity (~15%)
- In Early 2011, negative equity mortgages peaked at ~17M
- Are these 7.3M loans an oncoming foreclosure flood, resulting in increased claims to mortgage insurers?
- Recent homebuyers with negative equity are likely less than 10% underwater
- Homeowners with significant negative equity were likely purchased in 2004 – 2006 – They've been paying their mortgage for 6 to 8 years… how likely is a claim in that case?

Negative Equity – The Real Concern?

- Negative Equity is less of a concern than the 3.7M homeowners currently 90+ Days Delinquent (or in foreclosure)

- Ultimately:
  - Distressed Sales, Foreclosures, or Short Sales
  - Lenders shifting from Foreclosures to Short Sales (less impact on house prices

- The current environment in terms of Supply & Demand:
  - Glut of foreclosures => Supply Shock
  - Basic Economics: Prices bottom when the supply peaks, not when it ends
  - Peak of the shock was in late 2008, secondary peak in 2010
  - But, prices didn't bottom! Why not?
    - Prices slightly "sticky downward"
    - Economic fundamentals still out of line

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Negative Equity – Is it Okay?

- Economic fundamentals have returned to (close) to normal.
- Any oncoming supply shock will be LESS dramatic than the peaks, and therefore won't drive prices further down.
- This scenario ignored demand (in fact, assumed stability)
- In reality, there was also a demand shock:
    - Tighter Lending
    - Borrower (and lender?) Psychology

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QRM/QM?

- What’s a QM?
- Three categories:
  - Generally Qualified Mortgages
  - Balloon Payment Qualified Mortgages
  - Transitional Qualified Mortgages (until 2021)
- MAY NOT:
  - Exceed a 30 year term
  - Include Fees/Points >= 3%
  - Be granted to borrower with DTI >=43%
  - Include “No-Doc” loans
  - Be Interest-Only
  - Be Negative Amortizing
- Few Exceptions (Small Lenders in Rural Areas)

QRM/QM?

- Federal Regulators have unveiled a new “Qualified Residential Mortgage” proposed rule
- QRM = Loan that can be sold by the lender in the secondary mortgage market
- New Proposal closely aligns the definition of a QRM with the CFPB’s finalized “Qualified Mortgage” rule
- Alignment should make it easier for market players to meet QRM standards for securitization and selling
- Rigid Underwriting standards make it difficult to offer anything but plain vanilla mortgages
- Proposal includes an “alternate requirement” of 30% down

QRM/QM?

- The proposal ignores the presence of private MI coverage
- Requires issuers of non-QRM backed MBS to retain 5% of the risk
- Under the current proposal, private MI's would have to sell their products based on economic value, not regulatory advantages
- Private MI's continue to push for insured loans to be eligible for QRM status

Proposed FASB/IASB Standards Update

- After the recent financial crisis, the current incurred loss approach has been criticized
- Proposed Enhancements:
  - FASB = Current Expected Credit Loss Model
  - IASB = Credit Deterioration Model
- G20 – Recommended that accounting principles related to loan loss reserving be improved to allow "a broader range of credit information"
- Financial Crisis Advisory Group – Crisis exposed weaknesses, particularly the delayed recognition of (credit) losses. Recommended the use of more forward-looking information

Proposed FASB/IASB Standards Update

- Both models remove constraints to timely recognition of credit losses, and allow more information to be used
- Both are a departure from the incurred loss model, and consider EXPECTED LOSSES that should be recognized each accounting period.
- Both models apply to financial assets that are subject to losses related to credit risk.
- This DOES apply to financial guarantee contracts, such as mortgage insurance
- Because mortgages are securitized and sold in the secondary market, and will need to be reserved for, this likely means that MI's will have to reserve for potential losses on PERFORMING loans

Proposed Legislation

- New MI Eligibility Standards?
  - Revised terms for Master Policies
  - Change in capital requirements
  - Coming Soon??

- Both houses of Congress have introduced bills that will potentially impact GSEs & the FHA

  - No resolution expected anytime soon
  - Both bills positive for the PMI Market

Proposed Legislation – PATH act

- “Protecting American Taxpayers & Homeowner’s” Act
- GSEs & FHA currently guarantee more than 85% of all new originations
- GSEs & FHA responsible for more than 99% of mortgage securitizations in 2012
- Crowding out private sector capital, investment, and innovation
- Goal: Sustainability:
  - For Homeowners
  - For Taxpayers
  - For the Economy

Proposed Legislation – PATH act

- Four Fundamental Goals
  - Clearly define the role of government – limit it to the protection of taxpayers, and elimination of moral hazard
  - Remove barriers to private capital
  - Provide Clear, transparent, and enforceable rules for transactions
  - Provide Choice to consumers

Proposed Legislation – PATH act

- Ending the Bailout:
  - 5 Year Limit to end conservatorship of GSEs
  - GSEs to Receivership
  - Lock in current GSE dividends
  - Shrink GSE Retained Portfolio of MBS
  - Eliminate GSE Cost of Funds advantage
  - Lower conforming loan limits in high risk areas
  - Establish credit risk sharing program
  - Prohibit GSEs from purchasing non “QM”

Proposed Legislation – PATH act

- Right-Sizing the FHA
  - Change the Mission
  - Maintain Countercyclical Role
  - Encourage Borrower Equity
  - Risk Sharing Program
  - Require Quarterly statements (GAAP)
  - Require Lender Repurchase

Proposed Legislation – PATH act

- Implementation of Market Reforms
  - A new non-gov't, NFP Mortgage Market Utility
  - Develops Best Practices
  - Prohibited from originating, servicing, or insuring any mortgage
  - Remove mortgage securitization from gov't control
  - Allow ALL QM and Non-QM loans to be eligible for securitization, and prohibit discriminatory fees
  - National Mortgage Data Repository

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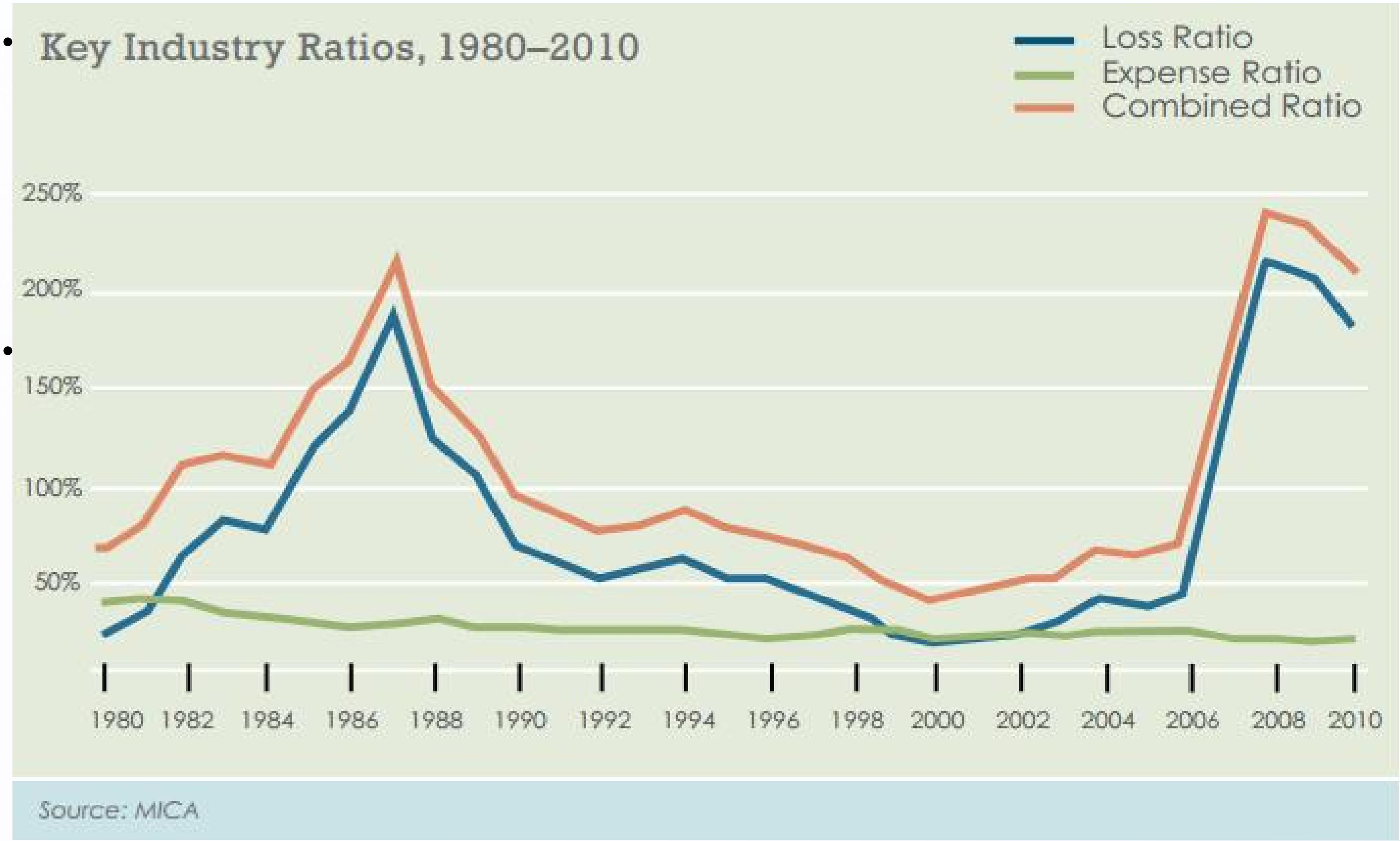
Proposed Legislation – PATH act

- Breakdown Barriers to Private Capital
  - 2 year “stop and study delay RE: Basel III Capital Rules
  - Delay Dodd-Frank Acts mortgage rules until at least 2015
  - Prevent discrimination against lenders with affiliates in the calculation of loan points and fees
  - Encourage lower costs and greater options for consumers

NAIC Mortgage Guaranty Insurance Working Group



NAIC Mortgage Guaranty Insurance Working Group

1. Required Minimum Underwriting Standards
2. Changes to Minimum Capital Requirements
3. Update and Modification of Contingency Reserve Requirements
4. Abolishment of Reinsurance Requirements to Concentrate Resources & Cut Overhead Expenses
5. Prohibition of Captive Reinsurance Arrangements with Originators
6. Additional Dividend Limitations
7. Creating a Mutual Reins company all MI’s are required to use
8. Create a mortgage insurance analog to the FDIC
9. New reporting requirement to specifically ID types of risks/exposures
10. Re-establishment of the Home Owners’ Loan Corporation
11. Modification of Investment Limitations
12. Establish Rights + Duties for MI’s concerning Rescissions

Prediction or Prevention – The Next Trouble Spot

- It's happened before, it will happen again:
  - Oil Patch
  - End of Cold War
  - Irrational Exuberance Crisis
- Negative Equity is a key indicator of potential mortgage defaults, so monitoring and forecasting loan level equity position is necessary
- Lenders, Servicers, and MI's must constantly monitor the mix of business in their portfolio
  - Delinquent Portfolio
  - Performing Portfolio – Predict Next Months Delqs

Questions?

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