MORTGAGE INSURANCE: WHAT HAVE WE LEARNED? (PART 1)

David McLaughry, FCAS, MAAA
CAS Special Interest Seminar, Chicago, IL
October 1, 2013

Copyright © 2013 United Guaranty Corporation

UNITED GUARANTY. 50 1963-2013

ANTI-TRUST NOTICE

- The Casualty Actuarial Society is committed to adhering strictly to the letter and spirit of the antitrust laws. Seminars conducted under the auspices of the CAS are designed solely to provide a forum for the expression of various points of view on topics described in the programs or agendas for such meetings.
- Under no circumstances shall CAS seminars be used as a means for competing companies or firms to reach any understanding—expressed or implied—that restricts competition or in any way impairs the ability of members to exercise independent business judgment regarding matters affecting competition.
- It is the responsibility of all seminar participants to be aware of antitrust regulations, to prevent any written or verbal discussions that appear to violate these laws, and to adhere in every respect to the CAS antitrust compliance policy.

2
Copyright © 2013 United Guaranty Corporation

UNITED GUARANTY. 50 1963-2013

OUTLINE

- Overview of Mortgage Guaranty Insurance ("MI").
- Brief history of MI.
- How the industry has fared since 1980.
- What went wrong?
- Fallout from the crisis.

3
Copyright © 2013 United Guaranty Corporation

UNITED GUARANTY. 50 1963-2013

WHAT MI IS AND HOW IT WORKS

Lenders or Borrowers pay MI premium for MI coverage, typically on loans exceeding 80% LTV.

Banks provide high-LTV loans. MI is required for >80% LTV loans to be sold to Freddie Mac and Fannie Mae.

Mortgage Insurer provides coverage against borrower default.

Mortgage Insurance…

- Provides a form of credit risk transfer to protect financial institutions, allowing financial institutions to offer high-LTV residential mortgages.
  - It **does not** insure the borrower.
  - It insures the financial institution's loss due to borrower default.
- Covers mortgage loans with LTV ratios higher than 80%.
- Aims to provide stability and soundness to the housing financing system.

Mortgage Insurance benefits…

Benefits the Borrower
- Purchase home with lower down payment.
- Afford a larger home.
- Increase home ownership rate.

Benefits the Lender
- Reduces credit risk exposure.
- Provides independent secondary underwriting review.
- Expands mortgage markets.

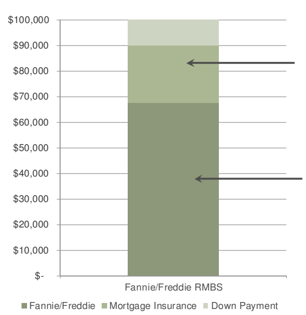
Copyright © 2013 United Guaranty Corporation

WHAT MI IS AND HOW IT WORKS

- The policy insures a lender—who may pass the premium cost directly to the borrower—against borrower default on a mortgage loan.
- Coverage spans the life of a loan and is generally cancellable only under the following circumstances:
  - MI premium is not paid.
  - The loan amortizes below an LTV of 78%, under the Homeowners Protection Act (HPA).
  - The loan prepays completely.
- Insurers provide proportional coverage in the U.S.
  - Insured risk amount ("risk") = (loan amount) x (coverage percentage).
- To settle a claim, the insurer chooses from three options:
  - Approve a short sale of the property and pay remaining deficiency.
  - Purchase the property for the balance due and sell the property.
  - Pay "optional" settlement equal to (coverage percentage) x (loan amount) + (covered fees).
- The claim payment is made to the investor.

Copyright © 2013 United Guaranty Corporation

MI COVERAGE LAYERS – 90% LTV EXAMPLE



Typically, 25% private MI coverage is provided on a 90% LTV loan. ($90,000 X .25 = $22,500)

Fannie Mae / Freddie Mac layer (the lender may also hold the loan in its portfolio).

Copyright © 2013 United Guaranty Corporation

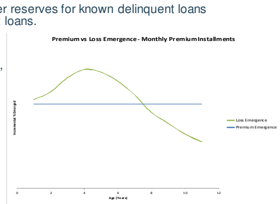
MI PREMIUM

- The policy premium can be paid by the lender or can be passed through to the borrower—in the U.S., borrower-paid MI is the predominant form of insurance.
- Several premium payment options are typically available.
  - Single premium.
  - Annual installment, based upon original or declining balance.
  - Monthly installment, based upon original or declining balance.
  - Split premium, a hybrid premium type in which the up-front rate is typically higher than the installment rate.
- Single premiums are earned based on a prescribed earnings pattern.
- Installment premiums are typically earned over the installment period.
- Installment premiums cannot be changed once the policy is written.

Copyright © 2013 United Guaranty Corporation

MI LOSSES AND RESERVES

- Loss reserves are established at the date of the first missed payment (the "Accident Date").
- Servicers typically report delinquent loans to the MI provider after a loan has been delinquent for 60 days.
- Given the length of time it takes to complete the foreclosure process, it typically takes 1.5–2.0 years before a claim payment is made.
- The short reporting lag results in much larger reserves for known delinquent loans ("Case Reserves") than for IBNR delinquent loans.
- A mismatch of premiums and losses occurs, particularly for installment premiums:



- No explicit reserve for future delinquencies, except if a Premium Deficiency Reserve is indicated.

Copyright © 2013 United Guaranty Corporation

MI – UNIQUE FINANCIAL FEATURES

- First-lien mortgage insurers are monoline—they insure only first-lien home mortgages.
- MI is commercial insurance—customers are financial institutions (banks, credit unions, etc.).
  - Borrowers are neither a party to nor a beneficiary of the insurance.
- Once a mortgage insurer has issued insurance, it can generally only cancel for non-payment of premium.
  - Cannot re-underwrite at any time during coverage.
- The rate / premium charged remains fixed throughout the life of the coverage.
  - Cannot re-rate during the term of coverage.
- The mortgage insurer must maintain a statutory contingency reserve of 50% of earned premium.
- If the coverage on the loan exceeds 25%, the mortgage insurer must reinsure any coverage above 25%.

Copyright © 2013 United Guaranty Corporation

MI – SOME HISTORY

- Written on a non-monoline basis prior to the Great Depression.
- Fifty mortgage insurers were founded in the early 1900s; the industry was profitable until the 1930s
- During the Great Depression, all companies went under (all 50 were liquidated by 1950).
  - Largest insurance company liquidation the New York Department of Insurance had ever done.
- In 1934, the FHA was established to fill the void; Fannie Mae was established in 1938.
- Private Mortgage Insurance was outlawed throughout the U.S. until the 1950s.

Copyright © 2013 United Guaranty Corporation
UNITED GUARANTY. 50 1963-2013

MI – SOME HISTORY

Safeguards were built into state laws beginning in 1956; the resulting NAIC model law:

- Recognized the catastrophic nature of MI.
- Established the requirement of a Contingency Reserve (segregated surplus).
  - Contingency Reserves are initially established at 50% of the earned premium amount.
  - Must be held for 10 years and are only allowed to be released under certain conditions, typically driven by incurred loss levels.
- Required that first-lien MI carriers be monoline—only insure first-lien home mortgages.
- Capital requirements:
  - Certain states require risk-to-capital levels of less than 25:1.
  - The GSEs and rating agencies require even lower risk-to-capital ratios in order to maintain eligibility to write MI and to sustain investment grade ratings, respectively.
  - The net result is that MI companies maintain premium-to-surplus ratios of ~0.30.
- Investment restrictions: MI companies cannot originate mortgages or invest in mortgages or real estate.

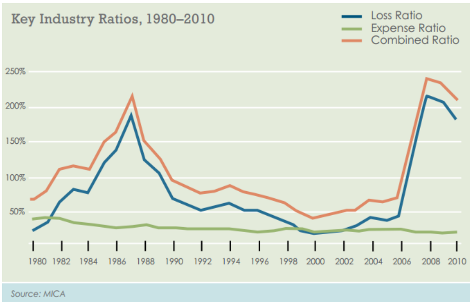
Copyright © 2013 United Guaranty Corporation
UNITED GUARANTY. 50 1963-2013

MI – HOW THE INDUSTRY HAS FARED

- At least 11 mortgage insurance groups were formed between 1957 and 1987.
- The industry suffered significant losses in 1980s and 2000s.
- Flagship carriers of at least four groups ceased writing new business by 1990.
- Of the seven mortgage insurers in business in 2008, three have gone into runoff.
  - Those three are paying their claims at the 50–60% level and issue a deferred payment obligation for the remainder.
- MI companies that survived are still struggling with legacy exposure to loans insured prior to 2009.
- Two new companies have recently entered the market (Essent and NMI).

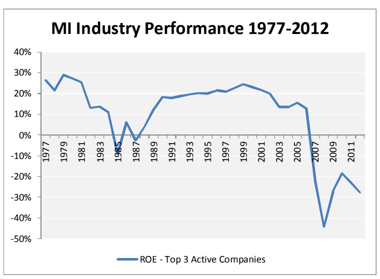
Copyright © 2013 United Guaranty Corporation
UNITED GUARANTY. 50 1963-2013

MI – HOW THE INDUSTRY HAS FARED



Copyright © 2013 United Guaranty Corporation

MI – HOW THE INDUSTRY HAS FARED

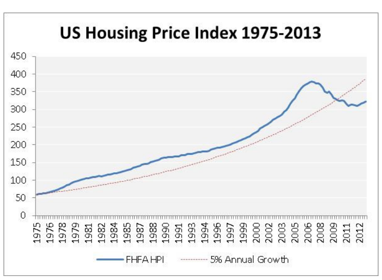


Source: Company Financial Statements (Net Inc / Stat Capital incl Contingency Reserve)

Average ROE 1977–2012 = 9.4%

Copyright © 2013 United Guaranty Corporation

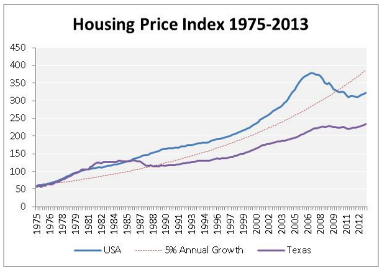
MI – WHAT WENT WRONG?



Source: FHFA All Transactions Index (not seasonally adjusted)

Copyright © 2013 United Guaranty Corporation

MI – WHAT WENT WRONG?

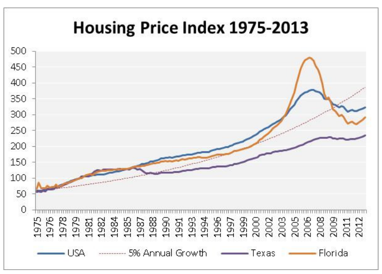


Source: FHFA All Transactions Index (not seasonally adjusted)

16

Copyright © 2013 United Guaranty Corporation

MI – WHAT WENT WRONG?

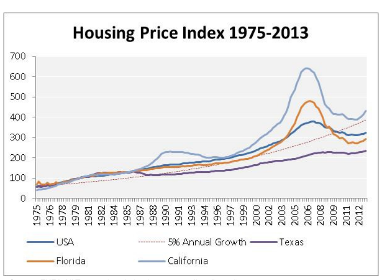


Source: FHFA All Transactions Index (not seasonally adjusted)

17

Copyright © 2013 United Guaranty Corporation

MI – WHAT WENT WRONG?



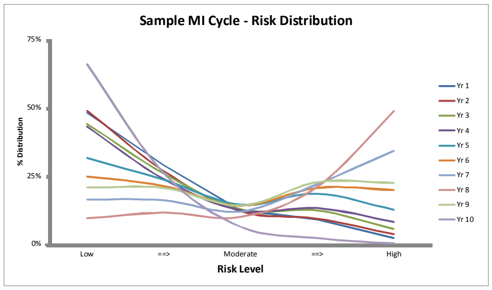
Source: FHFA All Transactions Index (not seasonally adjusted)

Local shocks drive MI losses, often masked by aggregate trends.

18

Copyright © 2013 United Guaranty Corporation

MI UNDERWRITING CYCLE



Copyright © 2013 United Guaranty Corporation

MI – WHAT WENT WRONG?

- Industry accommodated risky lender behavior, rather than safeguard against it:
  - Delegated underwriting model.
  - Bulk and Pool coverage.
  - Product expansion (low-doc, interest-only, ARMs, etc.) .
  - Minimal pricing segmentation.
- The mortgage system failed on many fronts, and mortgage insurers participated in that failure.

Copyright © 2013 United Guaranty Corporation

MI – FALLOUT FROM THE CRISIS

- MI failures/ratings downgrades.
- Sharp drop in private MI market share.
  - FHA/VA share of insured loans rose from less than 25% in 2007 to more than 80% in 2009.
- Lender dissatisfaction: rescinded coverage and denied claims.
- Profits of many years wiped out.
- Future of industry regulation and government participation uncertain.

Copyright © 2013 United Guaranty Corporation

MI – WHAT HAVE WE LEARNED?

Questions?

Copyright © 2013 United Guaranty Corporation

UNITED GUARANTY. 50 1963-2013