

# **Introduction to Mortgage Insurance**

*Mexico City  
November 2003*

# Agenda

- United Guaranty
- Mortgage guaranty insurance
  - Industry history
  - Product structure and risk factors
  - Advantages of mortgage insurance
  - Process
  - Regulatory requirements
- International experience: Israel, Hong Kong
- Mortgage insurance in evolving housing finance markets

# United Guaranty

## United Guaranty

- Formed in 1963; corporate offices in Greensboro, North Carolina.
- Wholly-owned subsidiary of AIG since 1981.
- Monoline provider of MI products and services.
- AAA-rated by Moody's, Standard & Poor's, and Fitch.
- Key statistics (in USD):
  - Total assets – \$2.5 billion.
  - Capital and surplus – \$2.0 billion.
  - Insurance in force (total outstanding loans insured) – \$108 billion.
  - New loans insured in 2002 – \$53 billion.
  - Risk in force – \$23.5 billion (partial coverage).

# **Mortgage Guaranty Insurance**

# Industry Background

- Product introduced in 1957.
- Strong regulatory framework.
  - Generally required for loans with loan-to-value ratios greater than 80%.
  - Strict requirements for eligible MI providers.
  - Allows for vibrant secondary mortgage market and development of residential mortgage-backed securities.
- Provides stability in economic crisis.
  - During the troubled economy of the 1980s, the MI industry paid more than US \$5 billion in claims.

# **Mortgage Insurance Role in the U.S. Housing Finance Industry**

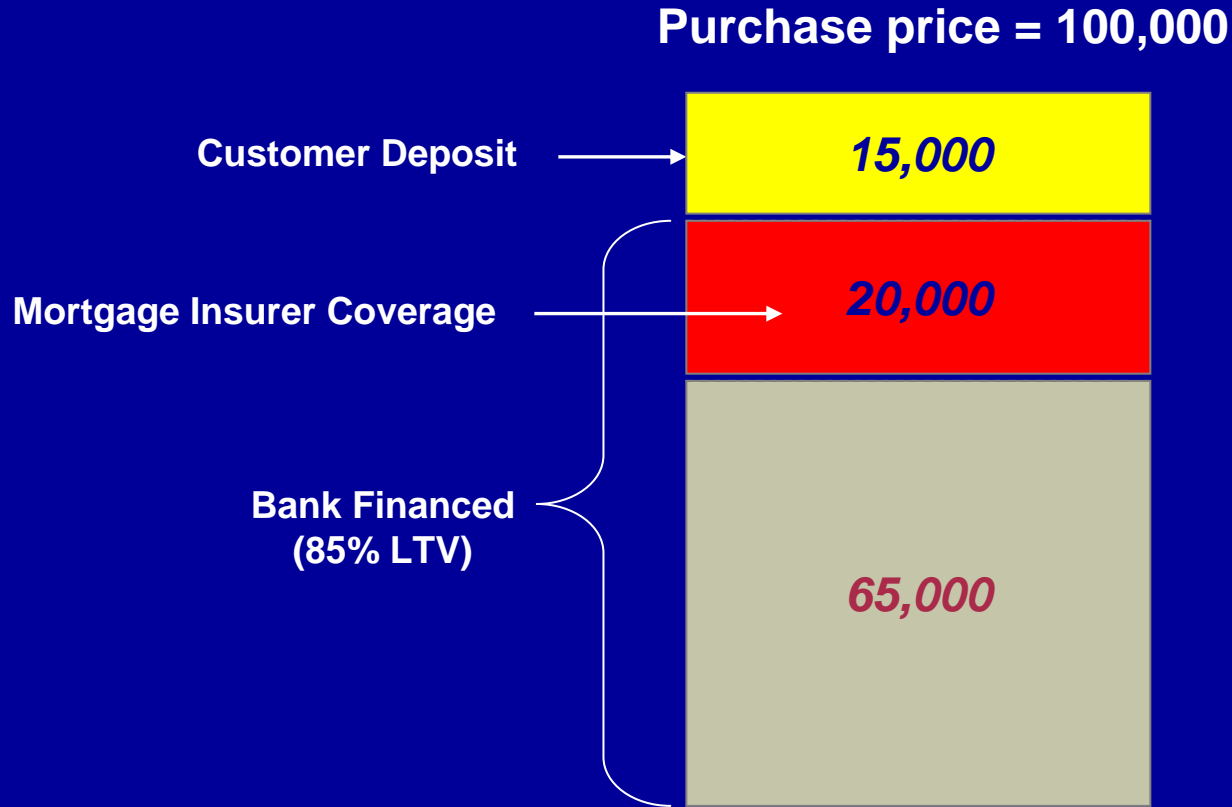
- Mortgage insurance has been a key factor in expansion of the mortgage industry; home ownership rate is now more than 67%.
  - Industry insured US \$337 billion of new mortgages in 2002 (13.5% of total mortgage loans).
  - US \$733 billion insurance-in-force at year-end 2002 (total primary residential mortgages more than **US \$3 trillion in 2002**).

# **Product Structure and Risk Factors**

## **Product Structure**

- Protects the lending institution or investor against borrower default for residential mortgage loans.
- Primarily insures loans with low down payments (< 30%), helping to increase home ownership.
- Covers losses that result from foreclosure.
- Intent is to provide stability in economic crisis and maintain the safety and soundness of the housing finance system.

# Product Structure



Coverage allows lenders to increase lending volumes without increasing risk exposure.

# **Mortgage Insurance Does Not Provide:**

**Payment of the loan upon borrower's death** (a form of life insurance).

**Payment protection insurance** – credit insurance that provides income support in the event of a borrower's unemployment or disability.

# Risks Covered by Mortgage Insurance

- Risks covered by mortgage insurance generally include:
  - Borrower inability to repay.
  - Borrower unwillingness to repay.
  - Market value loss on individual home.
  - Real estate market risk.
  - Local/regional economic recession.
  - Mortgage instrument risk.
  - Economic catastrophe.

# **Risks Not Covered by Mortgage Insurance**

- Risks typically excluded by mortgage insurance:
  - Failure to recover property after default.
  - Failure to secure clear title to the property.
  - Failure to complete proposed construction.
  - Physical damage to the property.
  - Fraud and material misrepresentation.
  - Loan servicer failure to perform.
  - Natural disaster.
  - Environmental risk.

## **Variables Affecting Default Rates**

- Loan-to-value ratio.
- Borrower credit history.
- Mortgage type (fixed-rate versus adjustable-rate).
- Loan term.
- Occupancy (primary residence, second home, investment property).
- Originator and servicer.
- Age of property and property type.

# **Mortgage Insurance Benefits**

# **Mortgage Insurance Benefits**

- Classic use of insurance vehicle: Spreads large number of individual risks over geography, time, and policyholders.
- Standardized underwriting, documentation, loan level data.
- Third-party oversight of loan quality.
- More borrowing with less borrower cash down.

## **Borrower Benefits**

- Home can be purchased with a reduced down payment.
- Housing affordability is accelerated – no need to spend years saving for a down payment.
- Home buyers can afford a more expensive home with available funds.
- Wealth is generated from home price appreciation.

## **Lender and Investor Benefits**

- Transfers credit risk outside banking system to highly-capitalized, well-regulated third parties.
- Provides independent secondary underwriting review.
- Enhances efficiency and effectiveness of asset securitization.
- Introduces improved lending and risk management practices.
  - Emphasis on improved property valuation systems.
  - Stimulates demand for high quality credit reporting.
  - Introduces new methods of delinquency measurement.
  - Independent risk review.

## **Economic Benefits**

- Greater borrower affordability.
- Increased housing construction and employment opportunities.
- Increased purchases of household goods.
- New techniques for loss mitigation and borrower workouts, helping to prevent foreclosure.
- Expands mortgage markets with sound risk management.

# **Mortgage Insurance Process**

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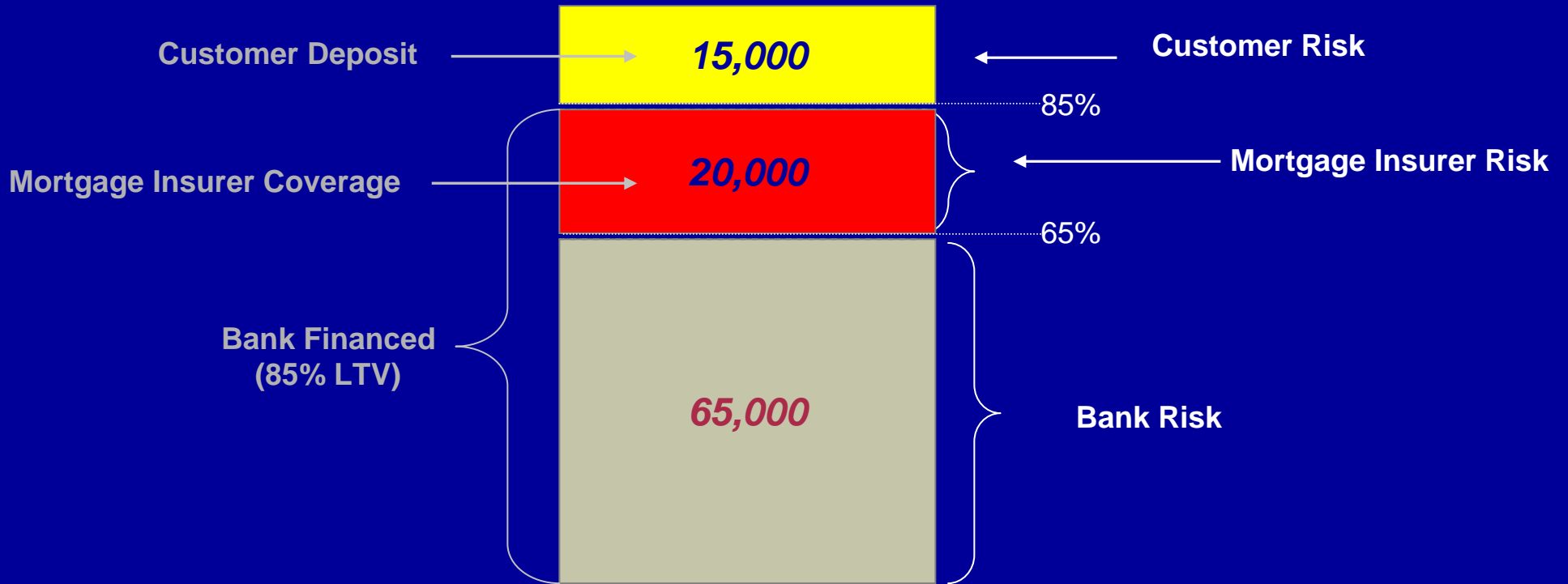
- Master insurance policy provided to lending institution – valid until either party has cause for cancellation.
- Insurer underwrites each loan and issues insurance commitment if approved.
- Single-premium structure covers loss over a defined period.

## **Mortgage Insurance Process, *continued***

- Typical coverage reduces risk, for example from 85% to 65% LTV (or 90% to 70% LTV).
- Mortgage insurance covers losses up to a specified amount.
- Coverage is structured so that all parties (borrower, lender, and mortgage insurer) have a risk position. Illustration follows.

# Product Structure

Purchase price = 100,000



## **Mortgage Insurance Process, *continued***

- Lender applies for MI for high-LTV loan.
- If loan meets eligibility and underwriting criteria, coverage becomes effective when loan closes.
- Coverage is for defined period – measured in years or level of loan amortization.
- In the event of foreclosure, lender files a claim.
- Claim is paid by the insurer.

# **Mortgage Insurance Regulatory Requirements**

## **U. S. Regulatory Requirements**

- All mortgage insurers must follow certain state and federal laws and requirements:
  - Monoline: company must provide only one form of coverage.
  - Minimum 25-to-1 ratio of risk to capital and surplus.
  - Contingency reserve: for catastrophic risk.
  - Unearned premium reserve.
  - Loss reserves: triggered by notice of delinquent payment.

## **U. S. Regulatory Requirements, *continued***

- All mortgage insurers must follow certain state and federal laws and requirements:
  - Minimum AA rating.
  - No commissions, rebates, inducements for referral of mortgage insurance business.
  - Management expertise: critical for new housing finance markets.
  - No conflict of interest: mortgage insurer may not insure affiliate company.

**International Experience:  
Israel  
Hong Kong**

## **International Experience**

- Committed to international expansion.
  - 1998: Opened the first (and still only) MI company in Israel.
  - 1999: Began reinsurance operations with Hong Kong Mortgage Corporation.
  - 2002: Began pilot in Taiwan.
- Operations in Israel, Hong Kong, and Taipei. Business development offices in London and Madrid.
- Investigating markets in other countries:
  - Americas: Mexico and Canada.
  - Europe: Spain and Italy.
  - Asia: China, India, Korea, Japan.
- Strong international support from AIG.

## **Israel: Ezer Mortgage Insurance, Ltd.**

- New industry, new company.
- Operations began in Jerusalem, April 1998.
- US-style mortgage insurance regulation.
- MI coverage provided up to 90% LTV.
- Insurance to date:
  - More than US \$1 billion of loans insured (almost 11,000 units).
  - Nearly 13% of all new mortgages granted.

# Hong Kong

- Hong Kong Mortgage Corporation (HKMC) formed in 1997 to develop securitization market.
- Mortgage insurance introduced in early 1999.
  - Expanded lending market from 70% to 90% LTV.
  - Improved housing affordability.
  - Lowered risk-based capital weighting for banks.
  - Improved risk management standards.
  - Strict insurer capital and rating requirements.
- More than 12,000 borrowers have used MI to obtain home ownership.
- US \$15 billion in annual mortgage loan originations.

# **Mortgage Insurance in Evolving Housing Finance Markets**

# **Why Mortgage Guaranty Insurance for Evolving Markets?**

- To increase capital flows into the housing sector (secondary mortgage market).
- To enhance housing affordability (primary mortgage market).
- To expand home ownership.
- To increase construction and provide economic stimulus.
- To help manage mortgage credit risk.

# **Essential Preconditions for Mortgage Insurance**

- Housing and mortgage markets large enough to generate sufficient insured loan volume and disburse risk.
- Stable economy and financial markets; supportive public policy.
- Affordable transaction costs, including property and mortgage transfer and registration.
- Contract enforceability, including lien priority, foreclosure and property repossession.

## **Essential Preconditions for Mortgage Insurance, *continued***

- Functioning private housing markets, including:
  - Active buyers and sellers, sales agents, appraisers
  - Home and land prices and building activity that reflect local supply and demand.
  - Reliable data on home sales transactions, including disclosure of true sales prices.
- Ability to access prospective borrower credit and employment history.

## **Essential Preconditions for Mortgage Insurance, *continued***

- Lenders' ability and willingness to retain some credit risk exposure.
- Sufficient lending data on home mortgage performance and risk experience.
- Lender acknowledgement and borrower understanding that mortgage insurance fulfills a specific need better than any available alternative.

# **Preconditions: Regulatory Support**

- Insurance regulations:
  - Strong reserve and capital requirements.
  - Minimum financial rating requirements or financial strength requirements for qualified mortgage insurers.
  - Monoline requirement.
- Banking regulations
  - Increased capital charges for high-LTV loans, unless coverage is with a qualified third-party insurer.
  - LTV limits for prudent mortgage lending, unless MI coverage is applied.

# **Conclusion: What MI Offers Evolving Housing Finance Markets**

- Helps to increase home ownership.
  - Reduced down payment.
  - Extends affordability to a broader range of home buyers.
- Supports existing mortgage markets through.
  - International standards and techniques of risk management.
  - Opportunity to introduce new and innovative mortgage products.
  - Support for future mortgage securitization.

# **Conclusion: What MI Offers Evolving Housing Finance Markets, *continued***

- Promotes prudent diversification of risks.
- Encourages sustainable growth of the housing finance industry.

## **In Closing**

I appreciate the opportunity to visit with you today.