Introduction to Mortgage Insurance

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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
• 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.
  – Risk in force – $23.5 billion (partial coverage).
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).
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.
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
Mortgage Insurance Process

• 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.
Mortgage Insurer Risk

Bank Risk

Product Structure

Purchase price = 100,000

Customer Deposit

15,000

Mortgage Insurer Coverage

20,000

Bank Financed (85% LTV)

65,000

Customer Risk

Mortgage Insurer Risk

Bank Risk

Customer Deposit

85%

Mortgage Insurer Coverage

65%

Bank Financed (85% LTV)

Purchase price = 100,000

Mortgage Insurer Coverage

Bank Risk

Customer Risk

Mortgage Insurer Risk

Bank Financed (85% LTV)
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.
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.
- 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.
- 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.