

The Role of Mortgage Insurance under the New Global Regulatory Frameworks

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Summary and Overview

The introduction of fundamental changes to the regulatory requirements means that lenders are going through an immense period of change in the way they will conduct their business. This brings with it the opportunity to revisit current business strategies and to consider whether alternative products offer greater benefits under the new regulatory framework in terms of risk and capital management.

The aim of this article is to consider the role that MI might play under the new capital requirements regime. The increased risk sensitivity introduced by the Capital Requirements Directive (CRD) will mean that some business lines are more capital intensive than they have historically been. Even where this is not the case, the broader recognition of credit risk mitigants provides lenders with the opportunity to better manage their risk and reduce their capital requirements. Lenders should be encouraged to investigate the benefits of using credit risk mitigants, such as MI, guarantees and credit derivatives within their capital calculations.

How does MI work?

There are several forms of MI but for the purposes of this article, reference will be made to “flow” MI.¹

Flow MI is a form of credit risk cover that protects lenders from losses on residential mortgages where the borrower has defaulted and the proceeds from the sale of the foreclosed property are insufficient to cover the outstanding debt. The product works by providing first loss cover on a loan-by-loan basis for all residential mortgage loans covered by the policy. The current practice is for this cover to be subject to the maximum claim amount agreed with the lender. The level of cover varies throughout the industry but can cover all losses related to borrower default: unrecovered principal outstanding, normal past due interest up to the date of the claim, and reasonable recovery and foreclosure costs.

The amount of cover provided under the policy is established at the time of mortgage origination; the level of cover is usually tied to the initial borrower deposit and the preference of the lender, with higher LTV mortgages generally requiring higher levels of cover. The level of cover provided usually ranges between 20% and 30% of the total loan amount at origination.

If the borrower defaults on the mortgage, and a foreclosure on the property results, where the proceeds from the foreclosure of the property are insufficient to cover the debt outstanding, the lender will submit a claim and will receive payment within a reasonably short time period, possibly as little as 15 days.

An example of how MI works in practice at origination is set out in Example 1.

The role of MI

In the US, Canada and Australia, MI is a well-established product, and its use is actively encouraged by financial regulators. For example, in Canada, a loan above 75% loan-to-value (LTV) must either be guaranteed by the Government, or covered by MI provided by a licensed mortgage insurance company, and in the US, mortgages over 80% LTV must be covered by MI provided from a monoline provider rated at least AA, before being admitted to a Government Sponsored Enterprise scheme.² The MI market within Europe is also gathering pace as the risk mitigating benefits of MI are increasingly recognised, although currently only Italy reflects these benefits in the risk weight applicable to a mortgage covered by the product.³

¹ For more details on other forms of MI please see MITA Mercer Oliver Wyman joint study (2005), Risk and Funding in European Residential Mortgages: Responding to Changes in Mortgage Demand.

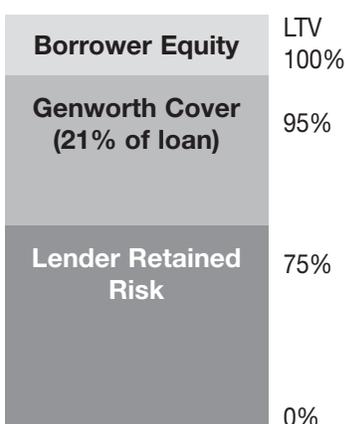
² For example Freddie Mac or Fannie Mae. Use of MI for mortgages with an LTV greater than 90% in the US, and 80% in Australia also has capital benefits, see later discussion.

³ Under the existing UK and Spanish regimes, use of MI does not provide capital relief to lenders, even where the benefits are explicitly recognised, for example see IPRU (BSOC) Chapter 8, Mortgage Indemnity Insurance.

Example 1

Purchase price = £200,000
 Original mortgage = £190,000
 Borrower deposit = £10,000
 LTV = 95%
 Lender cover down to = 75% LTV
 Genworth MI covers 21%

Maximum claim amount:
 21% * £190,000 = £40,000



Loss on foreclosure (£)	Without MI	With MI
Outstanding debt	(180,000)	(180,000)
Past due interest	(20,000)	(20,000)
Foreclosure costs	(10,000)	(10,000)
Total exposure	(210,000)	(210,000)
Sale price	175,000	175,000
Total gross loss	(35,000)	(35,000)
MI claim payment	0	35,000
Net loss for lender	(35,000)	0

MI is a new concept in most European countries but its acceptance as a good product for consumers, lenders and regulators is steadily growing. Consumers are able to gain access to housing through higher loan-to-values than are traditionally available, as lenders can mitigate the higher credit risk associated with high LTV lending. For regulators, having a second pair of eyes from a global mortgage risk expert who is reviewing lending practices is an added benefit.

How Would MI Be Recognised Under the New Framework?

The implementation of the Capital Requirements Directive (CRD) in Europe,⁴ and the Basel II Accord across the rest of the globe creates the opportunity for regulators to recognise the benefits of MI. Within Europe, regulators are starting to consider implementation of the Directive; in the UK the Financial Services Authority (FSA) is the first regulator to give an indication of its intended approach to implementation of the CRD, and more

specifically to the future proposed treatment of MI in the UK,⁵ and as such provides the starting point for comparable treatment of MI across the rest of Europe.

MI in the UK

Under the new regime, the FSA intends to recognise the risk mitigating benefits of MI under retail IRB by allowing MI to be taken into account in the loss given default (LGD) calculation.⁶ Whilst the probability of default (PD) remains the same, banks are able to reduce their capital requirements by reflecting the lower LGD generated where MI, or another credit risk mitigant, is used. The lower LGD reflects the fact that the use of a risk mitigant reduces losses by transferring credit risk to another party.

The treatment of MI for lenders using the Standardised Approach is still under consideration. However, it is arguable that, provided the credit risk transfer benefits of MI can be proven, consistent recognition of the benefits of MI under both the Standardised and IRB Approaches should be allowed.

Existing practice of the recognition of MI, and the indication given in the FSA CP, suggest that there are two options for recognition of MI under the Standardised Approach, the first option is to reflect the use of MI in the applicable risk weight, and the second is to recognise MI as a credit risk mitigant.

Under the first option MI could be recognised in the following way; under the FSA's current proposals⁷ a 35% risk weight is applied to mortgages with a LTV of 80% and below, and a marginal risk weight of 75% is applied to the portion of the mortgage over 80% LTV. If MI is recognised

⁴ The implementation of the Basel II rules within Europe. The implementation of the Capital Requirements Directive runs in parallel to the implementation of Basel II in countries outside of the EU.

⁵ Financial Services Authority CP 05/3 (2005), "Strengthening Capital Standards",

⁶ CP 05/3 (2005), "Strengthening Capital Standards", paragraph 7.202, footnote 177.

⁷ CP 05/3 (2005), "Strengthening Capital Standards", paragraph 5.10 onwards.

in the applicable risk weight, the FSA could allow the application of the 35% risk weight up to a higher LTV level for mortgages with MI. An example of how this would work in practice can be seen in the approach currently employed in Italy and the US; in Italy additional guarantees, which can include MI, are required for mortgages with an LTV greater than 80% in order to maintain a 50% risk weight. Similarly, in the US, mortgages with an LTV greater than 90% apply a 100% risk weight to the whole loan unless MI is used, in which case a 50% risk weight is applicable. This approach is also currently employed in Australia, and the Australian Prudential Regulation Authority (APRA) has recently stated that it intends to continue to reflect use of MI in this way.⁸

The second option is to consider MI in terms of recognition under the credit risk mitigation (CRM) rules.⁹ This would explicitly recognise the benefits of transferring credit risk to a third party, and would place the use of MI on a par with guarantees and credit derivatives. When considering the nature of MI, and the definition of unfunded credit protection in the CRD,¹⁰ there is a strong argument for recognising MI in this way. Application of the CRM rules would allow lenders to recognise the credit quality and capability of the MI provider through the application of the substitution approach,¹¹ and it should be carefully considered whether blanket recognition through a risk weight, which ignores the credit rating of individual MI providers, maintains a lender's incentive to ensure that protection is provided by the most appropriate and best qualified MI company.

However, irrespective of which approach is chosen by a national regulator, use of MI will

enhance a lender's risk management strategy.

Can MI Be Recognised as a Credit Risk Mitigant Under Basel II or the CRD?

Recognition of MI as a credit risk mitigant is a new approach which was not directly considered in either the Basel Accord or the CRD. As such, it needs to be fully understood how MI can be recognised within the credit risk mitigation rules¹². Article 4(32) of the CRD contains the definition of unfunded credit protection.¹³ Although there is no explicit mention of MI, or insurance products more generally, the presumption is that, provided a product meets the criteria contained in Article VIII of the CRD, it can be recognised as a credit risk mitigant.¹⁴

On the basis that MI could be recognised, we then need to ask the question, what would it be recognised as? There is no explicit mention of MI or insurance products in Annex VIII, therefore the product would need to be recognised as either a guarantee or a credit derivative. The Basel Committee QIS 3 FAQ response suggests that MI could be recognised as a guarantee, and this seems to fit more logically with the way the product works. The characteristics of MI, and the way it works in practice are more closely aligned to a guarantee than a credit derivative. In practice, the legal and economic effect of MI is similar to a guarantee, and therefore could be recognised as such.

Should MI Be Recognised as a Credit Risk Mitigant Under the CRD?

The other issue to be considered is whether MI should be recognised as a credit risk mitigant. This requires a consideration of the extent to which credit risk is transferred, and the benefits of transferring credit risk to a third party rather than managing it internally.

There are a number of reasons why MI should be recognised as an eligible credit risk mitigant under the CRM rules:

The first is that it is important to recognise the benefits to a lender where a significant level of credit risk is transferred. MI reduces the LGD by acting as a "first loss cover", where the proceeds of sale on foreclosure are insufficient to cover the outstanding debt of the borrower and foreclosure costs. The flexible nature of the product means that lenders can set the level of cover to ensure that losses can either be completely eliminated, or substantially reduced.

MI can reduce both the frequency of loss and the total amount of loss incurred by the lender; these two factors combine to reduce both expected and unexpected losses. The extent to which MI reduces unexpected losses means that the capital held by a lender could be reduced to bring about a closer alignment of regulatory capital to retained risks.

MI can also play a role in a lender's risk management strategy. The CRD places greater emphasis on risk management, both in general terms, and more specifically under Pillar 2. A lender's risk management

⁸ APRA Discussion Paper (2005), "Implementation of the Basel II Capital Framework – Standardised Approach to Credit Risk." .

⁹ The credit risk mitigation rules are contained in Annex VIII of the Capital Requirements Directive. The indication from the FSA appears to be that MI could be recognised in this way; paragraph 5.13 of the FSA's CP discusses MI in terms of "unfunded protection", suggesting the application of the CRM rules.

¹⁰ CRD, Article 4(32).

¹¹ The substitution approach applies a risk weight which is linked to the credit rating of the counterparty providing the protection.

¹² Contained in Annex VIII of the CRD and paragraph 189 onwards of the Basel Accord.

¹³ CRD Article 4(32) defines unfunded credit protection as, "a technique of credit risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the undertaking of a third party to pay an amount in the event of the default of the borrower or on the occurrence of other specified events."

¹⁴ This suggestion is supported by the Basel Committee, BIS, (2003) QIS3 FAQ:E. Credit Risk Mitigation, question 6.

processes can be improved through the use of more sophisticated underwriting, risk management and loss mitigation techniques as a result of third party oversight and involvement in the mortgage lending process. MI providers are also able to use their experience of the mortgage market to provide a third party perspective of the credit risk in a lender's mortgage portfolio. Furthermore, third party provision of mortgage scoring mechanisms,¹⁵ in addition to origination data and performance data required by MI providers will help to improve a lender's internal risk management, and will also improve transparency.

The second reason concerns consistency of treatment between credit derivatives and guarantees. Recognition that the economic effect and commercial use of MI is equivalent to a guarantee product would reduce inconsistencies between the treatment of guarantees and credit derivatives. Under the CRD,¹⁶ transactions which are "economically effectively similar" to credit derivatives transactions can be recognised, however, there is no corresponding language for products which have a similar economic effect to a guarantee. In addition, allowing for flexibility in the interpretation of guarantees and credit derivatives will allow for future product innovation without the need for legislative intervention to amend the Directive, thereby reducing the time delay in introducing new products to the market.

The third reason is that recognition of a broader range of products, and the institutions which can provide those products, affords lenders a wider choice of risk management techniques, thereby allowing lenders to use a product which best meets their particular needs.

Why use MI?

The Basel Accord and the CRD allow broader recognition of credit risk mitigants,

both guarantees and credit derivatives can be considered by lenders as viable credit risk mitigants, as can MI. However, when deciding which product best meets the needs of the lender a balance will need to be struck between the level of credit risk transferred, the cost of protection, the asset being protected and whether the product also provides other benefits. Furthermore, third party oversight of the underwriting process and improvements to risk management are services which are unique to MI and are not available under other forms of credit protection.

Willingness to Pay

A further consideration will be whether an MI provider is willing to pay a claim. In the UK, MI in the 1980s and 1990s tended to be provided by multiline insurers which underestimated the risk of high loan-to-value lending and offered the product simply to obtain the building and contents business. They tended to have inadequate underwriting standards and less rigorous independent oversight and many of them suffered heavy losses and subsequently exited the market. They also typically did not have separately rated entities providing the coverage.

MI companies operating around the world today are more likely to be writing the business out of separately rated entities where the sole business line is the provision of MI. These monoline insurers have a specialist expertise in high loan-to-value mortgage risk and since they take only one type of risk, they are not exposed to other general insurance risks. Australia and the US both have specific monoline requirements for MI providers and although European regulators do not require mortgage insurers to be a monoline, the vast majority of MI providers which are currently active in the EU work on a monoline basis. In the UK, MI continues to be provided by both monoline and general insurers.

The MI industry in the UK as a whole has matured substantially since the previous downturn and has addressed the problems encountered, such as lack of underwriting rigour, in order to provide a strong and legally robust insurance product which withstands scrutiny and which will ensure payments in the event of default.

In relation to the broader concerns regarding an insurer's willingness to pay claims, it is important to note that, unlike other forms of insurance, monoline MI providers have an economic incentive to pay all valid insurance claims on a timely basis. First, the size of individual mortgage claims arising under an MI policy makes it uneconomic for an MI provider to routinely challenge its obligation to pay a claim to the lender. Second, the future growth and development of MI is reliant on the fact that providers will pay claims in a timely manner. In other words, failing to pay an individual claim would have profound business consequences, which would not be offset by any financial gains.

Conclusion

MI has the potential to meet the growing needs of lenders under the new approach to the calculation of capital. Under the CRD, use of MI allows lenders to transfer credit risk to a third party, thereby potentially allowing for a reduction in capital requirements and an improvement in the lender's internal risk management.

Note

This article is not intended to contain definitive tax accounting or legal advice, which should be sought as appropriate in relation to any particular transaction.

References

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¹⁵ Mortgage scoring is more sophisticated than credit scoring, which takes into account only the borrower's credit score. Mortgage scoring considers not only this variable, but also takes into account the mortgage product, duration of the mortgage, repayment type, property type etc.

¹⁶ CRD, Annex VIII, Part 1, paragraph 29.

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