Private Mortgage Insurance in the United States

Traditionally, lenders have required a downpayment of at least 20% of a home's purchase price. For most first-time home buyers, saving money for such a sizeable downpayment is the greatest barrier to homeownership. Lenders will approve a mortgage with a smaller downpayment, however, if the mortgage is covered by private mortgage insurance.

Private mortgage insurance, also known as mortgage guaranty insurance, protects a lender if a homeowner defaults on a loan. Lenders generally require mortgage insurance on low downpayment loans because studies show that a borrower with less than 20% invested in a house is more likely to default on a mortgage. In effect, the mortgage insurance company shares the risk of foreclosure with the lender. Low downpayment loans also are referred to as high-ratio loans (loan-to-value ratio), indicating the relationship between the amount of the mortgage loan and the value of the property.

The home buyer and the mortgage insurer share a common interest in the mortgage financing transaction because they each stand to lose in the event of default. The borrower will lose the home and the equity invested in it, and the mortgage insurer will have to pay the lender's claim on the defaulted loan. Thus, both the insurer and the borrower are concerned that the home is affordable not only at the time of purchase, but throughout the years of homeownership.

This paper is excerpted from the Mortgage Insurance Companies of America (MICA) 1996-'97 *Fact Book and Membership Directory*. Founded in 1973, MICA is the trade association representing the private mortgage insurance industry.

Private mortgage insurance is the private sector alternative to non-conventional, government-insured home loans. Mortgages backed by the government are insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs.

Generally, home buyers must make a downpayment of at least 5% of a home's value to be considered for private mortgage insurance. The downpayment requirement drops to 3% for some affordable housing programs. Private mortgage insurance is available on a wide variety of conventional mortgages, including most fixed- and adjustable-rate home loans, giving borrowers the freedom to choose the type of loan that best suits their needs. Private mortgage insurance should not be confused with mortgage life insurance, which pays an outstanding mortgage debt if the borrower holding the insurance policy dies.

MEETING THE AFFORDABILITY CHALLENGE

Affordability continues to be the nation's most pressing housing problem, and the mortgage insurance industry plays a vital role in helping low- and moderate-income families become homeowners. Mortgage insurance is an aid to affordability because it allows families to buy homes with less cash. Almost 50% of the privately insured home loans issued in 1995 were made with downpayments of no more than 5%.

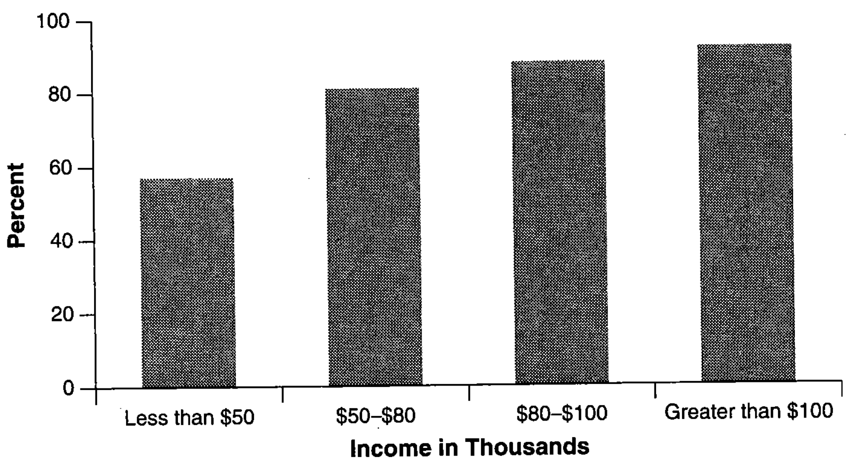
About two-thirds of the families in the United States own their own homes, but a look at the rate of homeownership broken down by income levels reveals an interesting picture. As Figure 1 shows, homeownership in America is skewed toward those with household incomes of more than $50,000. The homeownership rate for families earning more than $50,000 has increased in recent years, while the homeownership rate for people earning less than that has remained stagnant.

Statistics show that high-income households constitute a clear minority of U.S. households and most people in these categories already own homes. In 1993, only 6% of U.S. households had incomes over $100,000, and 92% of them owned homes. Four percent of households earned $80,000 to $100,000, and 88% owned homes. Seventeen percent had incomes between $50,000 and $80,000, and 81% owned homes. In contrast, 73% of households had incomes below $50,000, but only 57% owned homes.

Private Insurers Step in to Help

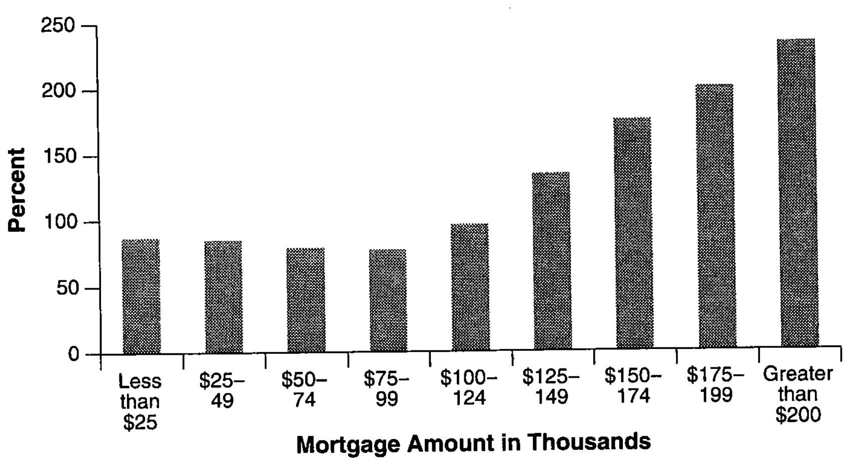
For years, members of the Mortgage Insurance Companies of America have worked with

Figure 1. Homeownership Rates by Income



Source: 1993 AmericanHousingSurvey

Figure 2. Incremental Risk for Higher Mortgage Amounts. MICA Ever-to-Date Claims Index All LTV's Policy Years 1981–1993* Claims as a Percentage of Average Claim Rate for All Loans Originated.



* Represents 7.8 million loans, claims through December 31, 1995
Source: MICA

the secondary market agencies, mortgage lenders and local consumer groups across the country to identify ways to better serve low- and moderate-income home buyers. These partnerships have increased the mortgage insurance industry's awareness of the unique needs of borrowers at the local level. They also have helped motivate individual insurers to develop special programs with flexible underwriting guidelines to help low- and moderate-income families qualify for financing. These programs demonstrate that by working together, communities, lenders, insurers and investors can expand homeownership opportunities for low- and moderate-income families.

Many of the new programs' features have been so successful that they now are used in all types of mortgage transactions, not just those targeted for low- and moderate-income families. One of the most popular features is the use of alternative credit verification methods. For instance, a record of prompt utility bill and rent payments can be substituted for the traditional credit report to verify a potential borrower's willingness to pay a mortgage loan. In addition, some programs enable home buyers to make a downpayment of just 3%.

Studies show that when low- and moderate-income people have the opportunity to own a home, they will go to great lengths to pay their bills on time. MICA data show that families who buy less expensive homes tend to default less than those who buy more costly homes. Data also show that for loans made with low downpayments, the risk of default goes up as the mortgage amount increases. In fact, of the 7.8 million loans insured by private insurers from 1981 to 1993, loans of $200,000 or more were nearly three times more likely to go into foreclosure than loans of $50,000 to $74,000, as Figure 2 shows.

A FINANCIAL INDUSTRY SUCCESS STORY

The modern private mortgage insurance industry was born in the 1950s, but the industry's roots go back to the late 1800s and the founding of title insurance companies in New York. The state passed the first legislation authorizing the insuring of mortgages in 1904.

In 1911, the law was expanded to allow title insurance companies to buy and resell mortgages—comparable to today's secondary mortgage market. To make loans more marketable, companies offered guarantees of payment as well as title, thus establishing the business of mortgage insurance. In addition to insuring mortgages, companies began offering participations, or mortgage bonds. These bonds allowed multiple investors to hold a mortgage or group of mortgages.

During the 1920s, rising real estate prices allowed most foreclosed properties to be sold at a profit, and more than 50 mortgage insurance companies flourished in New York. Since mortgage insurance was considered a low-risk business, the firms were virtually unregulated and thinly capitalized. Most had little experience with sound credit underwriting. This situation went relatively unnoticed until the Great Depression.

With the catastrophic collapse of real estate values in the 1930s, New York's entire mortgage insurance industry folded. As a result, the governor commissioned a study to examine the problems that had developed in mortgage lending and insurance. The study—known as the Alger Report—recommended prohibiting conflicts of interest; setting stringent capital and reserve requirements; and adopting sound appraisal, investment and accounting procedures. The report became a blueprint for a strong post-war mortgage insurance industry built on new regulations and financial structures. The industry's sound regulatory and financial foundation has ensured that even during difficult economic times, lenders are able to continue making low downpayment loans backed by mortgage insurance.

FHA Lends a Hand

During the Depression, the need to stimulate housing construction by encouraging mortgage investment became evident. The federal government entered the mortgage insurance business in 1934 with the creation of the Federal Housing Administration. With its promise of full repayment to lenders if borrowers defaulted on their home loans, the FHA home loan insurance program created new confidence in mortgage instruments and stimulated investment in housing.

To direct government assistance to those most in need, the FHA imposed ceilings on the insurable loan amount for single-family homes. After World War II, the government's mortgage insurance role expanded with a Veterans Affairs mortgage guarantee program to help veterans in their transition to civilian life. The FHA and VA insurance programs have helped stimulate the housing market for several decades.

The Private Sector Emerges

In 1957, a Milwaukee lawyer named Max Karl founded the first modern private mortgage insurance company, Mortgage Guaranty Insurance Corp., making the conventional low downpayment mortgage a viable product for mortgage lenders. A regulatory structure for private mortgage insurance was established that included strong conflict of interest provisions and a one-line-of-business structure to ensure that mortgage insurers' reserves would not be mixed with reserves for other lines of insurance. In addition, a unique contingency reserve structure and capital requirements were established to recognize the catastrophic nature of mortgage default risk and prevent companies from entering the mortgage insurance business without long-term commitments. This regulatory framework provided a foundation for establishing additional private mortgage insurance companies.

Housing's Heyday

The 1960s saw expansion of the modern private mortgage insurance industry, followed by dramatic growth in the early 1970s in conjunction with the emerging dominance of the secondary mortgage market. All mortgages originate in the primary mortgage market. In the secondary mortgage market, existing mortgages are bought, sold and traded to other lenders, government agencies or investors.

The federal government chartered two special-purpose organizations to enhance the availability and uniformity of mortgage credit across the nation. Those organizations, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp., provide direct links between the primary mortgage markets and the nation's capital markets. Fannie Mae, a government-sponsored but privately owned corporation established in 1938, creates mortgage-backed securities backed by FHA, VA and conventional loans. Freddie Mac, created in 1970, is structured and operates in a manner similar to Fannie Mae.

The demand by mortgage investors for investment-quality mortgage loans expanded the need for mortgage credit enhancement. The private mortgage insurance industry has helped fill this credit enhancement role, enabling Fannie Mae and Freddie Mac to buy and securitize low downpayment conventional loans. As a result, loans secured with minimal downpayments steadily increased as a percentage of total mortgage originations. Secondary market purchases of low downpayment loans helped fuel the tremendous expansion in home construction and sales during the 1970s and '80s, aiding many first-time and other home buyers. Privately insured mortgage loans became an important part of the mortgage finance system.

Put to the Test

The 1980s wrote a new chapter in the history of mortgage insurance. The first challenge of the early '80s was helping homeowners, lenders, real estate agents and builders cope with double-digit interest rates and inflation in a period of severe recession. To help qualify more borrowers, conventional low downpayment loans were paired with experimental adjustable-rate mortgages and features such as initially discounted "teaser rates," negative amortization and graduated payment increases. By 1984, more than half of all insured mortgage loans had downpayments of less than 10%, and many of these were adjustable-rate mortgages.

As economic conditions deteriorated—particularly in energy-oriented regions of the country—defaults began to rise, resulting in numerous foreclosures. The mortgage insurance industry paid more than $5 billion in claims to its policyholders during the 1980s. The recipients of these claim dollars included commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, Federal Deposit Insurance Corp., Federal Savings and Loan Insurance Corp., Fannie Mae and Freddie Mac. Mortgage insurance protected all these mortgage and capital providers from extensive losses on high-ratio loans.

Looking Ahead

Only third-party insurers can effectively disperse risk nationally, collecting premiums in strong markets while supporting policyholders in weaker markets. The unique and stringent capital and catastrophic loss reserve requirements that mortgage insurers must maintain passed the test of severe economic stress during the 1980s. The record claim payments made by the private mortgage insurance industry, coupled with its continued financial health, proved that lenders and investors can rely on mortgage insurance for credit enhancement and default protection.

The private mortgage insurance industry emerged from the 1980s financially strong and well positioned to meet the needs of the nation's home buyers, mortgage lenders and mortgage investors in the 1990s.

HOW MORTGAGE INSURANCE WORKS

The purpose of mortgage insurance is to protect lenders from default-related losses on conventional first mortgages made to home buyers who make downpayments of less than 20% of the purchase price. Without mortgage insurance, lenders would suffer significant losses on defaulting loans with high loan-to-value ratios.

Many expenses accompany a default. Interest charges accumulate during the delinquent period, as well as during foreclosure, a period that can total a year or more. Other costs include legal fees, home maintenance and repair expenses, real estate brokers' fees and other closing costs. These costs generally total 15% or more of the loan amount. Another frequent loss occurs when the foreclosed property is resold for less than its original sales price.

Private mortgage insurance companies insure against the losses associated with defaulted loans by guaranteeing payment to the lender of the top 20% to 30% of the claim amount. One of the mortgage insurer's key roles is to act as a review underwriter for credit and collateral risks related to individual loans, as well as for local, regional and national economic risks that could increase the loss from mortgage defaults.

Recognizing the near certainty of losses on most foreclosures, the major investors who supply liquidity to the mortgage market—such as Fannie Mae and Freddie Mac—require mortgage insurance on all low downpayment loans. The two agencies generally require that mortgages with loan-to-value ratios higher than 80% have insurance coverage on the amount of the loan greater than 70% of value.

The Claims Process

The type and amount of coverage selected by the lender determine how much the private mortgage insurer will pay if the borrower defaults and the lender must foreclose. The claim amount filed with the mortgage insurer generally includes principal and delinquent interest due on the loan, legal expenses incurred during foreclosure, the expense of maintaining the home and any advances the lender made to pay taxes or insurance.

Generally, after a lender has instituted foreclosure and acquired title to the property, it can submit a claim to the insurance company. The insurer has two options to satisfy the claim:

- Pay the lender the entire claim amount and take title to the property.
- Pay the percentage of coverage of the total claim amount stated in the policy (generally 20% to 30%) and let the lender retain title to the property.

Before making a decision, an insurer generally will try to determine the potential resale price of the property and the expenses resulting from the resale, including the real estate agent's commission and other settlement costs.

A more detailed description of how mortgage insurance operates is contained in the master policies of individual companies. Master policies, which differ from company to company, are contracts issued to lenders that formally set out the conditions of the insurance. They define the procedures lenders must follow to insure a loan, what to do if borrowers become delinquent on their payments and how to make a claim. They also define how the lender and insurer must manage mortgage default risk. Master policies are tailored to individual state regulations and incorporate the rights and responsibilities of the policyholder and the insurer. They are enforced in the same manner as other business contracts.

MANAGING RISK IN A VOLATILE ENVIRONMENT

The business environment changes constantly, and mortgage insurance is no exception. Deregulation of financial services, globalization of the economy, increased securitization of mortgage products and various legislative initiatives have increased the risk of mortgage lending for lenders, insurers and investors.

The major factors on which mortgage default risk is based include:

- Size of the downpayment
- Potential for property appreciation or depreciation.
- Borrower's credit history.

Other risk factors include:

- Purpose of the loan.
- Type of mortgage instrument.
- Whether the borrower will occupy the home.
- Interest rate.

The most unpredictable risk factor, by far, is the stability of the property's value. Mortgage insurers constantly monitor local, regional and national economic conditions. By studying population growth, employment growth, the supply of existing housing, housing starts and other economic factors, insurers can better evaluate the sensitivity of local economies to downturns as well as upturns. As a result, mortgage insurers are able to move with the ebb and flow of local and national change.

Long-Term Protection

Risk management is vital to the long-term protection of policyholders' reserves because of the unique nature of mortgage default risk. The risk cycle for mortgage insurance is significantly longer than for other property/liability insurance products. Although lenders may decide to cancel insurance when the default risk has been sufficiently reduced, coverage and risk can run for many years.

Mortgage insurance remains renewable at the option of the insured lender and at the renewal rate quoted when the policy commitment was issued. Mortgage insurers cannot raise premiums or cancel policies if risk increases over time. Because mortgage insurers make a long-term commitment on each loan they insure, a long-term risk management perspective is essential to protect policyholders' interests.

Risk Dispersion

Mortgage insurance helps lenders and investors balance the short-term need for increased mortgage originations with the long-term need for investment-quality business. Mortgage insurers offer the risk dispersion and pooling of risk that few individual mortgage lenders or investors could accomplish on their own.

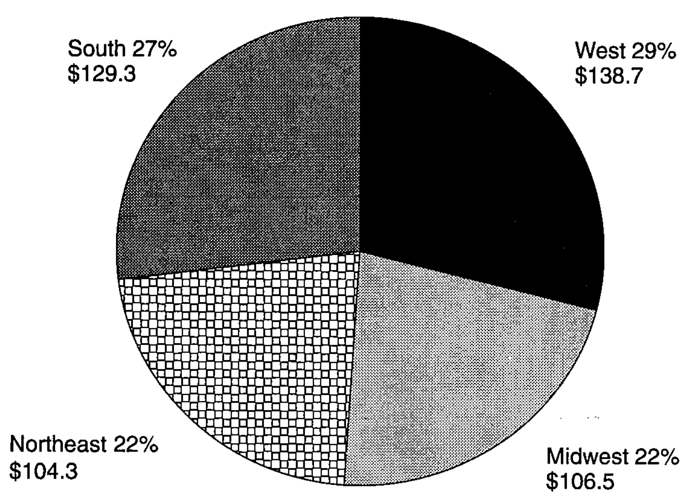
Geographic Distribution: Most mortgage insurers operate on a national basis, which provides the geographic dispersion necessary to protect policyholders during regional economic cycles. Figure 3 illustrates the geographic distribution of new mortgage insurance written from 1992 to 1995.

Temporal Distribution: Mortgage insurance also provides a reserve system that accumulates policyholders' reserves over time. Under today's business conditions, it is not possible for individual lenders and investors to accumulate similar reserves.

Loan-to-Value Distribution: Because risk increases as the loan-to-value ratio increases, mortgage insurers seek to balance their mix of 95%, 90% and lower loan-to-value ratio loans.

The mortgage insurance industry's sound underwriting and risk dispersion practices serve to produce higher quality originations for mortgage lenders and higher quality investments for investors.

Figure 3. Geographical Distribution of New Insurance Written, 1992–1995. Dollars in billions



THE EXPANDING MARKET FOR MORTGAGE INSURANCE

The market for mortgage insurance changed dramatically during the 1980s, resulting in a much stronger, healthier mortgage insurance industry in the 1990s. The industry overcame many problems that hampered it in the '80s, including increased self-insurance, restructuring within the industry and uncertain economic conditions.

The industry maintained a strong volume of business in 1995 and enjoyed its third best year ever. A number of factors contributed to the industry's success, including:

- Increased industry presence in the low- and moderate-income market.
- Increased lending in inner cities.
- Enhanced marketing efforts by individual companies and the industry as a whole.
- Single-digit interest rates drawing first-time home buyers into the market.
- Greater public awareness of the availability of private mortgage insurance.
- Greater emphasis on the use of mortgage insurance as a credit enhancement to meet risk-based capital requirements for banks and savings institutions.
- Increased use of mortgage insurance by trade-up buyers for tax benefits, since mortgage interest remains deductible.

The industry's 1992-'95 volume of insurance is shown in Figure 4, with 1995 statistics broken down by quarter. The numbers include primary, but not pool, insurance activity. From 1988 to 1990, new insurance written remained relatively constant at around $40 billion, before increasing to nearly $54 billion in 1991. New insurance written topped the $100 billion mark in 1992 and has remained above it since then. In 1993, it jumped to nearly $137 billion, the industry's most successful year. New insurance written totaled $131 billion in 1994 and $110 billion in 1995, making 1992 through 1995 the industry's best years ever.

Figure 4. 1995 Primary Insurance Activity (Net). $ in billions

Quarter	*Number of Applications*	*Number of Certificates*	*New Insurance Written*	*Insurance in Force*
1st	232,168	183,000	$20,644	$418,565
2nd	337,818	221,979	24,698	432,276
3rd	382,089	286,948	33,054	446,730
4th	329,416	268,829	31,229	460,817
1995	1,281,491	960,758	109,625	460,817
1994	1,373,502	1,148,696	131,402	406,250
1993	1,641,513	1,198,307	136,767	337,708
1992	1,235,033	907,511	101,047	384,552
%of change from 1994	−6.7%	−16.4%	−16.6%	13.4%

Source: MCA

FHA'S Role

The FHA, VA and private mortgage insurers play similar roles in providing affordable housing. Private mortgage insurance is basically the private sector alternative to FHA insurance, but there are several differences between the two.

Private insurance, for example, usually can be canceled at the option of the lender or investor when the homeowner builds up sufficient equity in the property to offset the lender's risk. In contrast, FHA insurance must be carried for the life of the loan. Private insurance generally covers the top 20% to 30% of the loan amount. The FHA insures 100% of the mortgage. Private mortgage insurance is available on a wider variety of mortgage loan products than FHA insurance, and it is not subject to maximum loan amounts.[1]

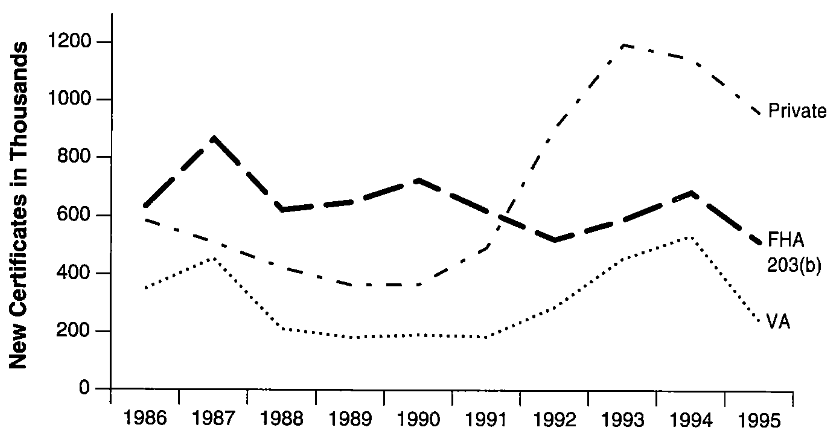
Volumes of business for the private and public sectors, as illustrated in Figure 5, are cyclical and rise and fall independently of each other. Dollar volume and numbers of originations for FHA, VA and private mortgage insurers are illustrated in Figures 6 and 7.

MORTGAGE POOL INSURANCE EXPLAINED

In addition to insuring individual mortgage loans, mortgage insurers insure pools of mortgages. Mortgages are pooled so they can be sold in the secondary market and can receive an investment grade rating. Securities backed by mortgages are a significant tool for attracting capital to home financing.

Pools can be formed with loans that may or may not have primary insurance. In most cases, pool insurance includes a liability limit for the mortgage insurer of 5% to 25% of the original principal balance of the mortgage pool. For example, a $10 million pool could incur default losses of $500,000 to $2.5 million without loss to the investor.

Figure 5. Certificate Comparison—FHA 203(b)/Private/VA



Source: FHA, MCA, VA

Figure 6. Dollar Volume of Insured Mortgage Originations ($ in billions)

	Total FHA	*VA*	*Private*	*Private as a % Insured*
1995	$45,311	$23,940	$109,625	61%
1994	91,622	49,474	131,402	48
1993	79,131	41,581	136,767	53
1992	48,315	25,169	101,047	58

Source: FHA, VA, MCA

Figure 7. Number of Insured Mortgage Originations

	Total FHA	*VA*	*Private*	*Private as a % Insured*
1995	$568,399	$243,838	$960,756	54.2%
1994	1,217,685	536,867	1,148,696	39.6
1993	1,065,832	457,675	1,198,307	44.0
1992	680,278	289,863	907,511	48.3

Source: FHA, VA, MCA

A FINANCIALLY HEALTHY INDUSTRY

A strong indicator of the mortgage insurance industry's financial health is the combined ratio, which is the percentage of a company's premium income that it pays out in claims and expenses. The lower the ratio, the better the industry's underwriting performance and profitability.

As Figure 8 illustrates, the industry has been successful in maintaining minimal losses in recent years. This is a result of sound underwriting and risk dispersion, as well as advanced market analysis, risk monitoring programs and management reports. In addition, the industry's expense ratio has remained nearly steady since the early '80s, reflecting the industry's ability to limit expenses.

The industry's underwriting experience for the past four years is detailed in Figure 9. The combined ratio has remained consistently profitable for six years in a row, and the industry recorded a positive income from underwriting for the sixth year in a row.

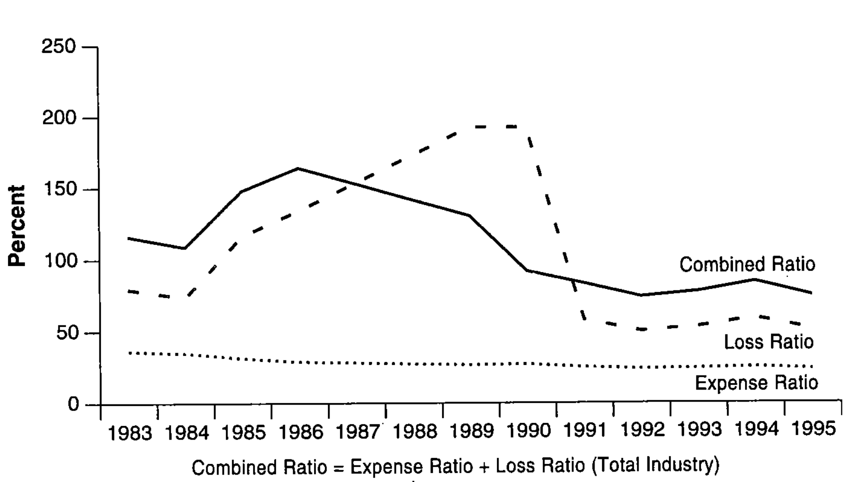
Key measures of the industry's financial health all point toward the same conclusion: the mortgage insurance industry has returned to profitability in the 1990s and is successfully building its reserves to pay future claims. The industry's profitability as a result of better risk management is shown in Figures 10 and 11.

It is important to note that industry trends are aggregate numbers and that individual company results will vary. The claims-paying ability ratings of individual mortgage insurance companies are available from bond rating agencies.

FINANCIAL STRENGTH OF THE SYSTEM

Recent trends in industry profitability provide a graphic picture of the cyclical risks of mortgage lending. It is against this pattern of peaks and valleys that mortgage insurance was designed to protect lenders.

Figure 8. Key Industry Ratios, 1986–1995. (Expenses and Loses as a Percentage of Earned Premiums)



Sources: MCA, Standard & Poors

Figure 9. Total Industry Underwriting Experience ($ in thousands)

Total Industry	*1992*	*1993*	*1994*	*1995*
Net Premiums Written	$1,230,992	$1,548,154	$1,635,646	$1,863,226
Net Premiums Earned	1,096,202	1,401,776	1,680,350	2,015,060
Losses	549,391	746,592	996,173	1,032,730
Expenses	294,539	377,288	411,685	440,281
Underwriting Income/(Loss)	252,272	277,896	272,492	542,049
Loss Ratio	50.12%	53.26%	59.28%	51.25%
Expense Ratio	23.93%	24.37%	25.17%	23.63%
Combined Ratio	74.04%	77.63%	84.45%	74.88%

Source: MCA

Figure 10. Total Industry Pre-Tax Profit (Loss)

	1992	*1993*	*1994*	*1995*
Underwriting Income/(Loss)	$151.272	$277,896	$272,492	$542,049
Investment Income	361,150	372,336	394,999	477,300
Other Income	(386)	2,677	758	2,289
Operating Income/(Loss)	613,036	52,910	668,249	1,021,638

Source: MCA

The backbone of the industry's financial strength is its unique reserve system. This system is designed to enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle.

Under the system, mortgage insurers are required to maintain three separate reserves to ensure adequate resources to pay claims:

Contingency reserves, required by law, protect policyholders against the type of catastrophic loss that can occur during a depressed economic period. Half of each premium dollar earned goes into the contingency reserve and cannot be touched by the mortgage insurance company for a 10-year period unless losses in a calendar year exceed 35% of earned premiums, depending on the state. Contingency reserves allow insurers to build reserves during the valley of the risk cycle to cover claims during peak years.

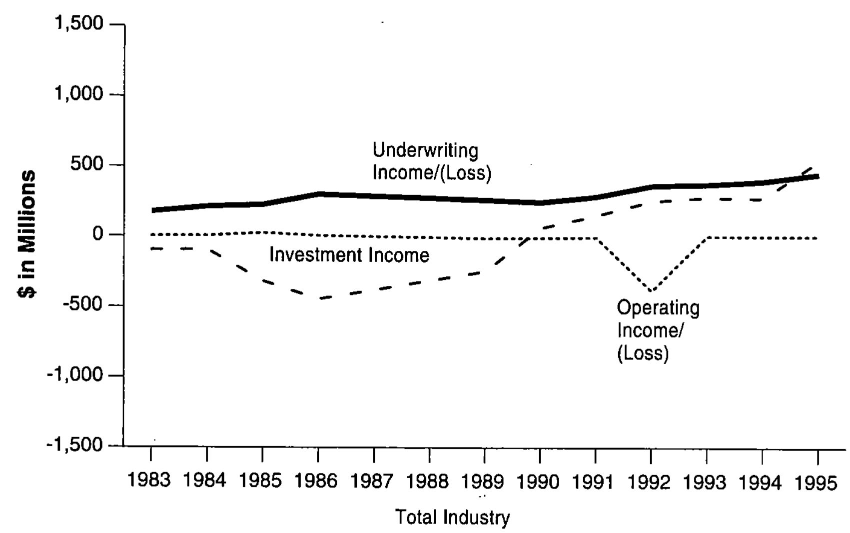
Case-basis **loss reserves** are established for losses on individual policies when the insurer is notified of defaults and foreclosures. This reserve account also includes a reserve for losses incurred but not reported.

Premiums received for the term of a policy are placed in **unearned premium reserves.** The method by which the premiums are earned from this reserve is established by each state to match premiums with loss and exposure.

The industry's financial strength is monitored closely by Fannie Mae and Freddie Mac. As the major buyers of low downpayment loans, they are concerned about the industry's long-term financial health.

Assets and reserves are important elements in measuring the industry's claims-paying ability. The industry's financial standing for the past four years is detailed in Figure 12.

Figure 11. Industry Pre-Tax Profit (Loss) 1987–1995



Sources: MCA, Standard & Poor's

Figure 12. Total Industry Assets and Reserves

	1992	*1993*	*1994*	*1995*
Admitted Assets	$5,113,366	$5,828,741	$6,536,586	$7,722,291
Unearned Reserve Premium	766,351	912,942	868,314	741,871
Loss Researve	798,912	909,343	1,150,091	1,386,432
Contingency Reserve	1,329,339	1,860,272	2,301,546	3,064,576

Source: MCA

Figure 13. Total Industry Risk/Capital ($ in thousands)

	1992	*1993*	*1994*	*1995*
Total Risk in Force	$61,036,808	$71,075,858	$82,191,016	$103,890,619
Policyholders Surplus	1,724,356	1,657,704	1,935,162	2,044,306
Contingency Reserve	1,329,339	1,860,272	2,301,546	2,064,675
Total Capital	3,053,695	3,517,976	4,236,708	5,108.882
Risk-to-Capital Ratio	19.99	20.20	19.40	20.34

Source: MCA

A Growing Capital Base

Mortgage insurers operate within a conservative risk-to-capital ratio, with capital guidelines established by state insurance departments. Mortgage insurers must operate within a 25-to-1 ratio of risk to capital, which means they set aside $1 of capital for every $25 of risk they insure. Insured risk is defined as the percentage of each loan covered by an insurance policy. By adhering to such strict criteria, mortgage insurers have been able to guarantee a continued source of capital for home buying, even in difficult times.

The industry's capital position, shown in Figure 13, is another measure of its ability to pay claims. It provides only a partial measure, however, for evaluating the industry's capacity to write mortgage insurance. It does not reflect availability of capital from outside sources, nor does it measure how much risk is reinsured with parties outside the industry. Since the industry has returned to profitability, subsidies from parent companies generally have not been necessary.

Reinsurance—insuring the risk of one insurance company (the reinsured) by another company (the reinsurer)—helps a company reduce its loss exposure. Under a reinsurance agreement, the reinsurer participates proportionally in the reinsured's premium and potential losses. State regulations normally do not allow mortgage insurers to write insurance coverage of more than 25% on any individual loan amount. If an insurer wishes to offer coverage above 25%, it must reinsure the additional portion so another company holds the risk.

Rating agencies use financial models that specify a level of loss tolerance for a mortgage insurance company to ensure that adequate funds will be available over time to cover claims. The evaluation of capital adequacy for individual mortgage insurers is typically conducted on the basis of depression-level projected losses. In most cases, the rating process takes into consideration capital made available from a parent company support agreement and reinsurance relationships.

INDUSTRY OUTLOOK: ENHANCING HOMEOWNERSHIP OPPORTUNITIES

The United States is enjoying one of the most affordable housing markets in two decades. Interest rates remain in the single digits, many properties are available and a wide range of financing options exists. Combined, these factors make it an opportune time for first-time home buyers to enter the market and trade-up buyers to make their move. As more people become homeowners, many will take advantage of private mortgage insurance to buy a home with a low downpayment.

Private mortgage insurers helped nearly a million families move into homes of their own in 1995. As mortgage insurers create new ways to reach out to low-income borrowers, more families should be able to access the mortgage market, opening further opportunities for growth. The Mortgage Insurance Companies of America will continue its role of helping the industry anticipate opportunities to enhance homeownership and explain the benefits of low downpayment financing to the public.

NOTES

[1] FHA loan limits vary geographically. The limit is set at 95% of the median single-family home price with a maximum amount equal to 75% of the conforming (Fannie Mae, Freddie Mac purchase) limit. The current maximum is $155,240.