Private Capital and Private Mortgage Insurance

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Why Understanding the MI Industry Is Important

- MI industry is only 10% of market, but they are raising capital.
- Affordable lending programs are generally done with low, or no, down payments
- Key competitors to MIs
  - Junior liens from banks
  - FHA/VA
  - GSEs themselves!
- Down payment requirements: What will they be in a reconstituted housing finance system?
- MI industry is an artifact of the GSE structure that is being debated

Green Shoots

- MGIC
  - March 2008--$1 billion
  - April 2010--$1 billion
- Radian
  - May 2010--$550 million
- PMI
  - April 2010--$739 million
- Essent–De novo MI, has raised $600M in capital
- Why private capital raises for an industry that specializes in high LTV mortgages?
  - Shut down of private market
  - Reason we have a MI industry: statutory requirement with GSEs that any loan with < 20% down payment be “credit enhanced”

MI Industry Background/Composition

- Industry either “pure play” MI or insurance

Mortgage Insurer's Credit Ratings from Moody's August 2010				
Rank	**Firm**	**Structure**	**Firm**	**Rating/Outlook**
1	Mortgage Guaranty Insurance Corp.	Pure Play	Holding	B3/Positive
			MI Company	Ba3/Positive
2	PMI Mortgage Insurance Company	Pure Play	Holding	Caa2/Positive
			MI Company	B2/Positive
3	Radian Guaranty Inc.	Pure Play	Holding	Caa1/Positive
			MI Company	Ba3/Positive
4	Genworth Financial	Insurance	Holding	Baa3/Stable
			MI Company	Baa2/Negative
5	United Guaranty Corp. (owned by AIG)	Insurance	Holding	A3/Negative
			MI Company	A3/Negative
6	Republic Mortgage Insurance Co.	Insurance	Holding	Baa1/Stable
		Title Co.	MI Company	Ba1/Negative
7	Essent Group, Ltd.	Pure Play	Holding	NR
			MI Company	NR

Source: "US Mortgage Insurance: Developing Outlook", Moody's Investor Services, 8/17/2010.

MI Industry Background/Composition

- Mortgage banking separated from mortgage insurance
- MIs provide a % of coverage on the mortgage loan

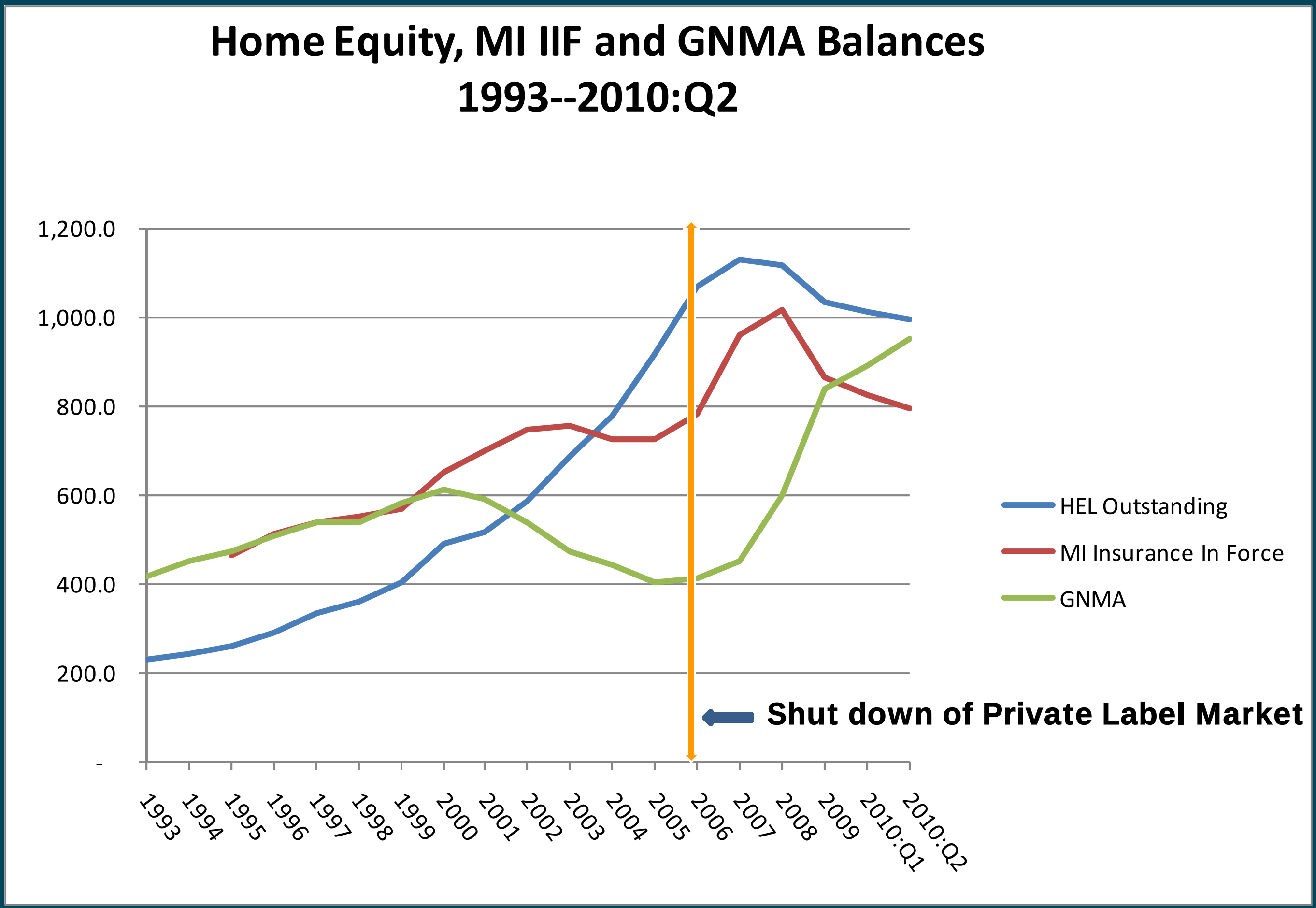
MI Guide Coverage Before 2008	
LTV	Coverage %
>80-85	20
>85-90	25
>90-95	30
>95-103	35
Source: MI Guides	

- MIs charge premiums to borrowers in the form of borrower paid MI or seller paid MI
  - BP was the dominant form
  - MI premiums approved at the state level
- Rating agencies <u>maximum</u> rating for an MI is AA

Challenges to MIs Came From Many Places

- GSEs set underwriting standards and adversely selected MIs
  - Many loans approved <u>only</u> because they had MI
- Junior liens
  - Banks adversely selected MIs in the underwriting by directing the best credits to jr. liens
- Lenders practices were geared toward bringing in business
  - Before crisis, pricing generally uniform across MIs
  - Lenders typically chose a subset of MIs to do business with; willingness to do business a criteria for selection
- MIs most effective recourse: the right of rescission
- Bottom line: GSEs/lenders primarily set guidelines and drove the business; MIs retained a right of rescission

Dramatically Different Composition Pre- and Post-Crisis



Analysts Contend GSEs/MIs Were "Take Out" for Private Label Market in 2007

Share of Originations by Investor 2000--2010 (August)	Private Label Sec.	GSE (76 < LTV <= 80)	GSE (80 < LTV <= 95)	GSE (LTV > 95)	GNMA
2000	22.6%	14.5%	14.3%	1.4%	16.2%
2001	17.6%	17.5%	12.3%	0.9%	13.6%
2002	22.3%	15.7%	8.5%	1.0%	8.5%
2003	21.3%	15.6%	6.9%	1.1%	6.6%
2004	37.7%	14.4%	5.3%	1.1%	5.4%
2005	45.1%	14.2%	3.9%	1.0%	3.2%
2006	46.2%	15.1%	3.8%	1.4%	3.3%
2007	24.9%	17.2%	8.3%	3.4%	4.4%
2008	4.8%	15.5%	11.0%	0.9%	22.0%
2009	2.1%	14.6%	6.3%	0.7%	30.3%
2010	3.3%	12.3%	7.5%	1.4%	27.3%
2007Q1	40.1%	16.0%	4.6%	2.1%	2.8%
2007Q2	28.9%	17.9%	6.8%	3.9%	3.7%
2007Q3	14.7%	17.8%	10.0%	4.2%	5.0%
2007Q4	8.1%	17.2%	14.4%	3.8%	7.3%
2008Q1	5.4%	16.5%	12.7%	1.9%	9.8%
2008Q2	4.6%	15.1%	11.5%	0.7%	21.2%
2008Q3	4.7%	14.8%	10.0%	0.2%	33.2%
2008Q4	3.9%	14.7%	8.1%	0.1%	33.8%

Source: LPS Applied Analytics

- Large shift in originations from 2007 from private label to GSEs—and MIs
  - Over 40% of MGIC's 2007 risk in force was >97% LTV
- Why did GSEs take so much high LTV business in 2007?
  - One reason: 35% credit enhancement on 100 LTVs from MIs

Current Performance By Vintage

Percentage of GSE Loans Seriously Delinquent or Gone to Foreclosure and REO 2000--2010 (August)					
Time Period	GSE (76 < LTV <= 80)	GSE (80 < LTV <= 95)	GSE (LTV > 95)	GSE (76 < LTV <= 80) Uninsured	Other GSE Uninsured
2000	8.9%	2.2%	3.3%	1.1%	1.5%
2001	7.6%	2.5%	3.5%	1.2%	1.0%
2002	6.7%	3.2%	4.3%	1.5%	1.0%
2003	4.4%	3.4%	4.8%	1.8%	1.1%
2004	4.6%	5.3%	8.6%	2.9%	2.0%
2005	7.8%	8.6%	13.0%	5.5%	3.4%
2006	10.8%	12.1%	17.0%	8.8%	5.5%
2007	11.7%	14.7%	18.2%	9.7%	6.0%
2008	5.9%	7.0%	8.8%	3.6%	2.5%
2009	0.2%	0.2%	0.8%	0.2%	0.2%
2010	0.0%	0.0%	0.1%	0.0%	0.0%
2007Q1	11.7%	13.8%	18.8%	10.9%	6.0%
2007Q2	11.2%	14.4%	19.2%	9.9%	5.9%
2007Q3	11.2%	15.0%	18.2%	8.8%	6.0%
2007Q4	12.7%	15.1%	15.9%	8.7%	6.1%
2008Q1	8.9%	10.2%	10.3%	5.2%	3.3%
2008Q2	5.1%	6.1%	5.2%	3.6%	2.5%
2008Q3	4.2%	4.3%	2.8%	2.5%	1.9%
2008Q4	2.3%	2.1%	2.4%	1.4%	1.0%

Source: LPS Applied Analytics

- Some evidence to support this hypothesis
- GSE loans that were booked with MI during the “take out” period have performed worse than any other vintages.
- Insured high LTV vintages originated as recently as early 2008 are still performing poorly.

Why Are MIs Surviving, GSEs Bust?

- Statutory capital versus regulatory capital
  - MIs required to set up contingency reserves—set aside 50 cents from every premium dollar and hold for 10 years
  - Rating agency oversight applied stress tests and other oversight
- Rescissions
  - Rescission rates normally 7%
  - According to Moody's, currently 20—25%
- Forbearance
  - GSEs relaxed their AA- rating requirement
- MIs face different reserving requirements
  - Only required to reserve after a "notice of default" (45-60 days)

Future

- Is a largely "pure play" AA-rated mortgage industry concentrated in high LTV end of market an effective insurance mechanism?
- Benefits
  - Has attracted private capital, albeit with a proviso
  - Conservative statutory capital requirements (less so for reserving)
- Challenges
  - Adverse selection of MIs partly driven by separation of mortgage banking and insurance—and the current GSE structure
  - Right of rescission by MIs exercised most during stress periods
- Without changes, market will return to previous dynamic of dominant lenders/GSE replacement
  - Junior lien market will return
  - Strong incentives for adverse selection
  - Refurbished GNMA role has diminished MIs' share further

Policy considerations

- Address rescission issue
  - Short term: more clarity around rules, timing
  - Longer term: Address conflicts due to separation of mortgage banking and mortgage insurance
  - Jack Guttentag: “Separating mortgage insurance from mortgage banking…may have been a mistake.”*
- Drop borrower paid MI, replace with seller paid or pool
  - BP MI much more an inducement for second liens
  - Tax benefits of MI payments limited
  - Could even develop pool level insurance through securities
- Could we replace a state-based MI premium structure with one set at a national level?
  - Present state-based system adds pricing rigidities

- *”A Brief History of Mortgage Insurance: Where Did We Take a Wrong Turn?” http://www.mtgprofessor.com/A%20-%20PMI/A%20Brief%20History%20of%20Mortgage%20Insurance.html

Policy considerations

- Where does a private MI industry fit in reconstituted housing finance system?
  - Fits in most neatly with a public utility replacement
  - Private sector alternatives would likely prefer to self-insure
- Huge potential upside: GSE replacement could be partly driven by reconstituted MI industry with a broader, more expansive, mission
  - MIs not likely to want to give up a certain benefit for an uncertain, even if much larger, upside