



Institute  
and Faculty  
of Actuaries

# Mortgage Insurance: Market Structure, Underwriting Cycle and Policy Implications

The Joint Forum

30 April 2013

## **About the Institute and Faculty of Actuaries**

The Institute and Faculty of Actuaries (IFoA) is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the actuarial society in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the actuarial profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



The Secretariat of the Joint Forum  
(BCBS Secretariat)  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

30 April 2013

Dear Sir/Madam

### **Mortgage Insurance: Market Structure, Underwriting Cycle and Policy Implications**

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the consultative document, 'Mortgage insurance: market structure, underwriting Cycle and Policy Implications' issued by the Basel Committee on Banking Supervision in February 2013. This response has been provided by members of the IFoA who work in the general insurance market.

We have commented on the first four of the six recommendations contained in the consultative document, but we first wish to make two general points.

The first general point is that the consultative document does not address the question of whether or not mortgage insurance (MI) is a valuable market product that ought to be encouraged. If it is to be available in all jurisdictions, then the question of whether lenders should be compelled to take it may arise. We will not address this question in any further detail, as it was not considered in the consultative document, but there are a number of points that we believe are worth considering in some detail.

- It is evident from the examples in Annex B of the consultative document that the arrangements for lending money to individuals to buy homes vary widely between different countries. The MI arrangements in each country must fit appropriately with the lending arrangements, as well as with local cultural norms<sup>1</sup>. However, different types of MI will have different effects on the markets in which they operate, which may affect the answers to the six recommendations. These necessary differences mean that the recommendations in the consultative document can be of less general application than we might wish.
- As pointed out in the matrix, the existence of MI covering a loan inevitably reduces the risk to the lender and may make the lender less vigilant. However, this is a general problem for insurance and it is by no means peculiar to MI.

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<sup>1</sup> We use the term "MI", or mortgage insurance as a generic one. The use of a mortgage instrument to provide collateral may not be universal, but "MI" should be interpreted as meaning credit insurance for loans that are made for buying houses, rather than necessarily applying to mortgages.

- MI transfers the risk of default; it does not remove it. Capital needs to be held against that risk and it may be held by insurers, or by the lending institution. MI does allow the lender to charge a *de facto* higher interest rate. If the mortgage repayments must also finance a premium for MI, the repayments would be higher in comparison to lending with no MI. This represents a risk premium, even if it is generally a modest premium.

The second general point is that the consultative document alludes to the question of whether mortgage insurers should be monolines or diversified insurers, yet it does not make any recommendation on the issue. Monoline is the model most-often adopted in the USA but not, as far as we are aware, anywhere within the EU. The benefits of the monoline model are not obvious: it abandons the benefits of diversification between different classes of business.

If there were to be an extreme market event, it appears that monolines are less able to withstand the loss and would be more likely to go bankrupt, or have their credit ratings reduced to junk status. This seems to be the experience of the American writers of MI business. This would probably mean that they would be no longer be able to write business, possibly leaving the market without available cover at a time when lending has become difficult. It is true that if all mortgage insurers were monolines, full-service insurers would be less likely to have their capital at risk in severe housing-market downturns, although the capital has to be exposed somewhere if this insurance is to be written. Indeed, even if mortgage insurance is not written the capital has to be exposed because banks would retain the risk. There have been monoline credit insurance companies in the United Kingdom, but, although these may have provided some mortgage insurance, their principal business was the insurance of trade and other business credit.

Our views are naturally shaped by the history of this type of insurance in the United Kingdom. Until the early 1990s, MI was almost universal for mortgage loans that were a high proportion of the property value (usually above 75%). The slump in the price of houses at that time and a large increase in rates of default led to severe market-wide losses. The cover had normally been provided to a lender by an insurer, or a panel of insurers. The insurer(s) agreed to accept every risk offered for a single premium paid at the start of the loan, which was normally financed by being added to the amount lent. Premium and claim amounts would be calculated by the lender and advised to the insurer by bordereau.

Following the substantial losses of the early 1990s, many insurers withdrew from the market. Replacement products were introduced, but there was less uniformity than previously. Cover was still available, but on a more-restricted basis, with insurers imposing limits on cover and insisting on co-insurance, with premiums increased. Building societies (mutual savings and lending institutions) were required by their trade body to effect mortgage insurance on loans that were a large proportion of properties' values, although these rules did not apply to banks. During this period, a number of building societies demutualised to become banks. Some lenders established captive insurance companies in order to provide this cover, or to provide the cover for the gaps that were left by the restrictions on commercial policies.

We will now turn to the six recommendations.

### **1. Policymakers should consider requiring that mortgage originators and mortgage insurers align their interests.**

This appears to mean that the insurance should not cover all of a lender's loss in the event of default. Any such sharing would diminish the value of the insurance to the lender and would be likely to moderate the lender's behaviour only if the lender were to retain a significant proportion of the loss.

The United Kingdom experience of the early 1990s was that lenders retained a significant proportion of the loss. The sum insured had been limited to the excess of the original loan over the threshold loan-to-value (“LTV”) ratio, which was usually 75%. The policy may not have covered all costs. This occurred at a time of relatively high interest rates. We can illustrate this by means of an example:

- The loan was at 90% LTV;
- The interest rate on the loan was 10%;
- The repayments were eighteen months in arrears before the repossessed property is sold; and
- The costs of maintenance and sale were 5% of the original value of the property.
- Then the total loss to the lender before insurance is 108.5% of the original value ( $90\% \times 1.15 + 5\%$ ).
- If property prices had fallen 10% since the loan had been granted, then the loss to the lender after selling its collateral would be 18.5% of the original value. The insurance, which has a maximum sum insured of 15% of the original value, covers only 81% of the lender’s loss.<sup>2</sup>

In practice, losses could have been significantly higher than this example. Some borrowers allowed, or indeed caused, the condition of their properties to deteriorate before repossession. This frequently led either to significant repair costs, or to a sale price that was below the market norm.

This feature arises from the particular design of those policies. There is no imperative that policies should limit claims to a particular level. It might be better policy design to cover all losses but with only a proportion of the loss being payable. Some of the new policies that were launched in the wake of the slump in the housing market in the United Kingdom in the early 1990s did precisely this. However, this still gives rise to the problem mentioned above: if the proportion of the loss retained by the lender is substantial, it reduces the value of the insurance and will require the lender to carry risk capital against the possibility of loss. If it is not substantial, it is unlikely to act as a significant influence on the lender’s behaviour.

It is probably true that until the end of the 1980s United Kingdom lenders did not expect to incur losses on defaulted loans that were covered by MI. The extent of the reductions in property prices and the amounts of loss were greater than would have been considered likely.

The recommendation states “it is important that claims costs are controlled by the party with the greatest exposure. In most cases, this will be the mortgage insurer”. This was not the practice in the United Kingdom. It should be noted that in the United Kingdom the losses were not shared proportionately. Once the loss exceeded the sum insured, any further loss would fall to the lender, so that for small losses the entire loss would fall on the insurer, who might reasonably be expected to control the claim. However, for larger losses, control of the loss would benefit the lender.

This is more than a matter of simply competence in claims control. Important decisions about when, and whether, to foreclose and the management of the sale of repossessed properties can have a significant effect on the amount of losses. Instead, all repossessions were handled by the lender, who merely advised the insurer of the claim amount.

We also note that a lender may have extensive expertise in the handling of delinquent loans that it can usefully apply to the handling of housing loans in arrears. Insurers are unlikely to have this expertise unless they are monolines, or have a book of MI business that is large enough to justify the maintenance of a specialist department.

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<sup>2</sup> This ignores any repayment that has been made on the loan, in effect assuming that the loan is interest-only. If some of the loan had been repaid then the loss would be reduced but if the loss occurred early in the loan period and normal repayments had been made the effect of this would be minor.

## **2. Supervisors should ensure that mortgage insurers and mortgage originators maintain strong underwriting standards.**

This appears to be a sensible suggestion. It is entirely contrary to the general practice in the United Kingdom in the period when MI was common, which may of course, at least partly explain the losses. Indeed, the United Kingdom practice until the early 1990s appeared to be designed to produce moral hazard: the lender was entirely responsible for credit underwriting and loan granting, or rejection, while the insurer was expected to bear the losses in the event of default (even if, in the event, the lender participated more than it might have expected). Lenders would not have been prepared to allow insurers to overrule their lending decisions and would have switched insurers if the insurers had tried to impose such a regime. We cannot now know whether they would have continued to buy MI, if all insurers had insisted on it. If regulation required the purchase of MI for high-LTV loans and required both parties to have full credit underwriting, lenders and insurers would, of course, be forced to comply, or not write the business.

We are aware that the United Kingdom approach was not universal practice. For example, in the United States insurers would underwrite individual loans and reject those that appeared to be inappropriate. This would usually lead to the lender declining to lend. American insurers have suggested that they suspected lenders sometimes applied for cover when they did not want to lend, confident that the insurer would reject the application. This prevented them from lending, but spared them any opprobrium connected with refusing the loan. Any such practice is clearly contrary to the recommendation. However, the American market structure, in which many lenders were small and had close community links, while mortgage insurers were few and were national institutions, easily explains why the practice could arise.

Good credit underwriting is fundamental to providing loans. A lender that does not undertake it is a danger to not only itself but, given the systemic interdependence of the banking sector, the banking system itself. The underwriting standards tend to lower when house prices are rising very fast: the need for decent underwriting is reduced when collateral worth, for example, 125% of a loan is confidently expected to become collateral worth 150% of the loan within a short period. Once market participants start to believe that house prices can never fall - a view articulated explicitly in the U.K. in the late 1980s and in the USA in the mid 2000s - when a house is collateral, the need to underwrite a loan seems to evaporate and a lender believes it can simply lend as much as possible.

The purpose of this recommendation is, of course, to prevent such things happening through supervision. However, regulators may also be faced with conflicting objectives. If a regulator prevents the population from getting loans, it is likely to face public odium. Alternatively, stimulating the housing market and making sure that everyone who wants a house can buy one are often seen as desirable outcomes of public policy, which tends to deprecate strict credit-underwriting policies. Public (and possibly political) pressure is more likely to be placed on regulators to ensure that loans are available rather than to ensure that strong underwriting standards are met.

A general belief that house prices never fall, or worse still, only rise, is the very worst environment for MI, especially if accompanied by low general inflation. Given what actually happened in the United Kingdom in the late 1980s and in the United States in the mid 2000s it is possible that some supervisors also came to believe it too.

### **3. Supervisors should be alert to – and correct for – deterioration in underwriting standards stemming from behavioural incentives influencing mortgage originators and mortgage insurers.**

This recommendation is clearly related to the second recommendation, so some of our comments also apply here. The recommendation does assume that supervision is sufficiently close to the day-to-day practices of lenders and insurers to identify the rigour of underwriting standards and is sufficiently authoritative to require changes.

We note that the “fair” treatment of customers is mentioned as an important objective. It would be helpful to know what is meant by “fair” in this context. Different market participants may view fairness in different ways, although the word is often used as if it had a straightforward meaning. What appears to be good underwriting to a lender, or an insurer, may look like unfair discrimination to a prospective borrower or policyholder. Such underwriting may conflict with public-policy objectives to avoid discrimination or to spread home-ownership more widely. Supervisors may face tension between objectives. Conflicting regulatory priorities and differing notions of fairness may make this recommendation difficult to achieve in practice.

### **4. Supervisors should require mortgage insurers to build long-term capital buffers and reserves during the valleys of the underwriting cycle to cover claims during its peaks.**

This recommendation is basically that mortgage insurers should keep equalisation reserves. These have never been widely used and in the European Union should disappear when Solvency II comes into effect. They were originally introduced in Finland to allow domestic insurers to build up capital tax-free. This reduced the need for reinsurance and the need for local insurers to remit money out of the country to foreign reinsurers. They are more widely used to allow insurers to build up capital to absorb the cost of catastrophes and thus to spread the cost of catastrophes over a number of financial years. They have also been used to smooth profitability.

One objection is that they are really a form of capital requirement and that if they are appropriate then they should be presented as such. If they are only a mechanism for smoothing out results then they are misleading and ought not to be permitted. However, there may be more justification for them in mortgage insurance than in other classes. A very bad year in property catastrophe that dips deeply into the equalisation reserve may be followed by another, but if the equalisation reserve had been used to fund the first catastrophic year, it would not be available for the second. However, a bad mortgage-indemnity experience (which may not be contained within a single year) may well be the result of a set of market movements that ends up with lower house prices, the worst risks on the book removed and underwriting standards restored. Apart from the fact that the value of the collateral is now lower, the economic conditions of a housing bubble are now removed and the immediate risk of a disastrous claims experience no longer exists. The nature of the business is that, unless housing boom and bust can be made a thing of the past, there will be occasional disastrous periods in the middle of long periods of benign experience.

However, the basic objection still holds. If insurers (or possibly lenders, if they retain the risk) need funds to support the risks they run, they need them whether or not they have had good profits in the past from which they have been able to build up a substantial equalisation reserve. For companies that have been in the market for years this approach may work, but there will be a question mark over newer companies, although they will take some time to build up large sums at risk. The only reliable way to assess whether companies have enough funds for their risks (whether they call them capital or equalisation reserve) is to make that assessment directly, perhaps through internal models. It should certainly require some proper valuation, which would be far better than simply building up extra reserves that were not based on sums at risk or the probability of claims.

For such a valuation to be possible, insurers would need detailed and updated information on insured loans. This is contrary to the former practice in the United Kingdom, in which minimal information on individual loans was typically provided to insurers.

If you require any further information from the IFoA about this response, you should contact Philip Duggart ([Philip.Duggart@actuaries.org.uk](mailto:Philip.Duggart@actuaries.org.uk) or +44 131 2401319) in the first instance.

Yours faithfully

A handwritten signature in black ink, appearing to read 'W David Brown'. The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

W David Brown  
Chair, Communication and Consultation Working Party (General Insurance)  
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