

Topic of the Month: MI Armageddon – Survival of the Fittest

An excerpt from Compass Analytics February 2009 *Month in Review*

As we begin 2009, no one will ever forget 2008, it truly is a year that will live in infamy. The sudden conservatorship of the GSEs surprised the market last year. Conventional wisdom assumed the MIs would fail before the GSEs, with the exception of Triad (Triad was put into run-off in 2008) this has not been the case although the industry is currently fighting for survival.

There is no current new issue market for Non-Agency MBS, but at some point this market will need to come back. There is only so much risk-based capital to support Jumbo whole-loan portfolios. The US covered bond market may help liquidity at the money-center banks, but the banks still own all the credit risk. The Federal Home Loan Banking system of secured collateral advances has helped liquidity, but again the banks still own this credit risk.

The Non-Agency MBS market is a future opportunity for the MIs to provide external credit enhancements by putting loan level MI on all LTVs as BULK LPMI on Non-Agency collateral (Jumbo) would be a start to restoring investor confidence. In addition, the originator needs to meet new rating agency guidelines on the reps and warrants for the credit underwriting and collateral valuation. This is another opportunity for the MIs to be relevant by putting on a special insurance policy to manage this risk of rep and warrants for certain select originators. The MIs have been managing this risk for years in contract underwriting.

The Survivors

The MIs that can raise capital will survive. So, who can raise capital in the MI industry or has recently raised capital?

1. AIG-UG (owned by the US Government) - spinoff or sale is not likely in this current environment
2. RMIC - Old Republic International is RMIC's parent and recently injected \$150MM in new capital into RMIC
3. Genworth (recently purchased a bank holding company in MN) - now can borrow money from TARP.
4. PMI – recently sold off their Australian MI business for approx. \$900mm
5. MGIC – raised capital in early 2008 and reinsured book with HCC Insurance in Houston, TX.
6. Radian – The SMART MI securitizations have helped their capital position
7. CMG (JV MI between PMI and CUNA) - only MI still AA rated; focused on only credit unions segment, PMI may need to sell off their interest in the JV to raise capital

In general, the mortgage market needs all the MIs to survive for capacity reasons, however, there are reasons to worry. MIs are regulated by their domicile state insurance regulator. North Carolina has the most with three MIs with UG, RMIC, and Genworth being domiciled in the state. Once the MI exceeds a risk in force to statutory capital ratio of 25:1 the MI is put into mandated run-off (no new risk being can be insured). This is what happened to Triad in 2008.

Who is MICA?

Mortgage Insurance Companies of America is the trade group that represents the PMI industry in Washington, DC. They do have a historical loss severity database but they share it only with their membership. MICA has been reluctant to share this info with the public for a number of reasons, mainly that their actual loss severity was minimal over the last twenty years.

This has changed since 2006. The actual loss severity has been increasing over the last three years with the decline in home prices. Sharing this data with mortgage market participants would be a significant value-add since the MIs can leverage the value of mortgage insurance and its relevance today. The PMI industry paid out \$5.4B in losses in 2007 and an estimated \$17B in losses in 2008 with most of these claims covering losses at Fannie and Freddie.

Contingency Reserves

The MIs business model is based on capital, a strong and liquid balance sheet, and a systemic process of building reserves for risk in force. The concept of contingency reserves is based upon the process of reserving 50% of all paid MI premiums (from day one for ten years) which are then placed in a special reserve trust account for 10 years. Only when the MI's loss ratio exceeds 100% can an MI access this capital. This conservative reserving methodology (first introduced by Max Carl, founder of MGIC) has helped MIs to survive the credit crisis so far.

This reserving process also enables MIs to set premiums based on estimates of losses over long periods, so premium rates change infrequently. This specific structure of reserving creates an incentive for long-term credit performance. MIs care about loan performance since they want to capture these reserves as income in the future. This is an incentive not to put too many high risk loans on their books since MIs can't accrue the benefits immediately.

What is a Master Policy?

A Master Policy is a contractual relationship with your mortgage insurance provider. A Mortgage Insurer has a fiduciary relationship to the lender as its insured. Any firm with MI production over the last five years should carefully review each master policy in place with its respective MI providers. One key concept to understand is the period of incontestability. Usually this period is 12 months for most MIs. If there is a fraud or material misrep in the loan file, but the insured was not aware of these facts and the borrower made at least 12 consecutive payments, then MI is contractually obligated to pay the claim.

Contract Underwriting

One great service the MIs offer is contract underwriting. In this current market environment using MI contract underwriting resources might be a good fit, except in the case of primarily FHA originations.

Most MIs still have underwriting offices and their current turn times with MI are 24 hours. From a quality control perspective using an MI underwriting office as a second set of eyes is a valuable quality control tool. MIs are good at underwriting the good risks, and denying the bad risks. There is more value in using the MI underwriting office than using on-site MI contract underwriters because of their independence. One thought is to use the MI contract underwriting offices to help

wholesalers ferret out all the bad risks in this channel. Some large originators use contract underwriting solely to mitigate their wholesale channel risk. Other large originators have their approved brokers submit all files directly to their MI partners for underwriting and mortgage insurance.

Loss Mitigation Opportunities

MIs have the ability to rescind coverage due to fraud and material misrepresentations. This is their current primary loss mitigation tool. However, other loss mitigation tools are also being used actively by all MIs. Advanced claim payment and loan modification are being actively used to keep at risk borrowers in their homes. Most MIs are being proactive on their high risk mix of future claims. There is an opportunity for originators to review all its high risk MI loans produced from 2005-2008 vintages for potential loss mitigation outreach programs. Some examples of high risk loans are: Fannie Mae's EA-I/EA-II/EA-III; FICOs <680 and high LTV >95; reduced doc loans (NINJA – no Income no Asset no Job); IO, and Option-ARMs.

A loss mitigation strategy for servicers is charge-off loss mitigation strategy. If a servicer already has a number of REOs in a certain MSA/zip code, e.g., Detroit, MI, then they could ask the MI for a charge off payment today. Does a servicer want other REOs in a severely depressed market? Probably not, so the MIs will pay out a claim today at a 50% discount to the current covered loss. This is appealing to some servicers with large advances because they can get paid today rather than waiting for title to transfer back during the foreclosure process, then having to sell the house. If the servicer does not want title to the property, then they should pursue a charge-off strategy. MI claim payment is made after clear merchantable title is transferred back to the investor/servicer and the home is in the same condition as it was when the MI policy was first originated.

As the MIs continue to fight for survival and relevance there is light at the end of the tunnel. Home prices will stabilize and delinquencies will peak in the next two years and they do have the capital and reserves to make it to the other side of the market. *–Chris Kennedy*