

## MI Corner - The Three Cs of MI Relationship Management: Capital, Credit and Counterparty Risk

### *An excerpt from Compass Analytics March 2008 Month in Review*

The US Mortgage Insurance Industry is going through another catastrophic credit cycle. The MI industry last saw its business models stressed some twenty years ago in the late 1980s and came through this challenging period just fine. In order to help us weather the current housing crisis, let's remember the three C's of an MI relationship management: Capital, Credit, and Counterparty Risk.

#### Capital

Capital is king going forward; all mortgage insurers will need to preserve their balance sheets by raising mortgage insurance premiums and tightening underwriting guidelines. The MI industry no longer has excess capital over its AA rating by the rating agencies -- Fitch, Moody's, and S&P. In fact, the rating agencies have started to put the MIs on their negative watch list for possible downgrades. The AA credit rating is important to MIs to maintain in order to continue insuring loans bought by Fannie and Freddie.

In some respect, paying claims makes the MI industry relevant again. The reason mortgage insurance exists is to protect mortgage lenders from credit defaults. In good markets, mortgage insurers build their balance sheets to pay out claims during catastrophic credit cycles.

MI penetration was 18% in the 4th quarter of 2007. This is a huge increase from the 6% penetration rate we saw in 2006. So the MIs are paying out claims at a historic rate and writing much more new MI business -- this is stressing mortgage insurers' balance sheets. It is quite possible by the 2nd half of 2008 that most mortgage insurers will need to start raising capital to maintain their AA credit ratings.

#### Credit:

As the credit markets continue to work through the hangover of mis-priced credit risk, mortgage insurers have been very diligently managing their credit risk exposure. Most mortgage insurers have made multiple credit policy tightenings in their underwriting guidelines, and have made MI premium rate increases.

In today's market, there is very little liquidity for high risk products. High risk products with multiple layered risks are an uninsurable product. Mortgage insurers have pulled back on high risk products with layered risks:

- Alt-A with LTVs>90,
- A- with LTVs>95 and,
- LTVs>97 due to poor loan performance.

The latest caveat is declining markets policy. It is critical for all mortgage bankers to fully understand both their investors and GSEs declining markets policies, and to enforce declining

markets policies into their underwriting guidelines. A prudent strategy is to implement all GSE and investor declining market policies into your underwriting guidelines to protect your institution from repurchase risk.

Counterparty Risk:

As Secondary Marketing professionals, these credit policy changes have been so hard and so fast that you may still be waiting for the dust to settle, before adding new MI partners. This is a flawed strategy because counterparty risk is more important today than ever. MIs have failed in the past; for example, Tigor and Verex failed in the late 80's. Reducing your counterparty exposure to any one mortgage insurer is a prudent strategy. One thought is to use a quantitative model approach to allocate a maximum MI share of up to maximum of 25% for each MI partner.

Mortgage Bankers selling to the conduits may not care about their MI counterparty risk since they have no interest in the servicing. However, the investors' servicing departments care about MI counterparty risk and may counterparty adjust their SRPs based on your loan performance and scorecard results.

The good news is the current credit crisis will end. The market will get through this mess over the next 18-24 months and it will be a much better market for the coming years. *—Contributed from industry MI sources*