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USMI®

U.S. Mortgage Insurers

OCTOBER 2020

PRIVATE MORTGAGE INSURANCE: STRONGER AND MORE RESILIENT

Putting our nation's housing finance system on a more stable path for the long-term remains a priority for federal policymakers. The recent health and economic crisis created by the COVID-19 pandemic has reiterated: 1) the need for private capital and taxpayer protection; and 2) the need for sustainable access to low down payment lending in the conventional market.

The pandemic represents an unprecedented challenge for the country and its housing finance system, particularly for borrowers who may be directly or indirectly impacted by health risks and economic fallout created by COVID-19. Because of the critical role our members play in the housing finance system, the private mortgage insurance (MI) industry is committed to supporting the federal government's robust foreclosure prevention programs, including the announcements issued by government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, regarding forbearance programs and other mortgage relief available to support borrowers impacted by COVID-19. The private MI industry has also ensured that homeownership remains affordable, particularly for first-time homebuyers, by enabling more buyers to access record-low interest rates in the conventional market while preserving their savings.

For more than 60 years, the MI industry has served the U.S. government and taxpayers as an effective and resilient form of private capital, standing as the first layer of protection against risk and mortgage defaults. Importantly, MI has enabled affordable homeownership for more than 33 million people.[1] As detailed below, the MI industry is well-prepared to serve as a source of strength through this crisis; it is more resilient than ever with enhanced capital and operational standards, as well as increased distribution of credit risk, which has put the industry in a stronger position to actively manage mortgage credit risk.

"Private mortgage insurers (PMIs) are now better positioned to withstand the impact of the COVID-19 pandemic versus during the [2008] financial crisis, as a result of much stricter underwriting standards and the widespread use of quota share reinsurance, among others."

– BTIG Analyst Mark Palmer[2]

There have been times over the past 60 years when our industry has been put to the test, and reforms over the past 10+ years have resulted in a stronger and more resilient private mortgage insurance industry.

In 2019 alone, more than 1.3 million borrowers purchased or refinanced a loan with private MI,[5] accounting for nearly $385 billion in new mortgages.[6] There is more than $1 trillion in mortgages guaranteed by the GSEs with MI protection.[7] Nearly 60 percent[8] of purchased loans with private MI went to first-time homebuyers and more than 40 percent had annual incomes below $75,000.[9] Mortgage insurance is one of the only forms of credit risk transfer (CRT) that begins on day one when the borrower assumes a mortgage, and persists with the lender, GSE, and mortgage-backed security.

Coming out of the 2008 financial crisis, it was essential that market participants all make enhancements to ensure that sustainable mortgage credit is offered going forward—and that all market participants have greater ability to withstand market downturns. These improvements have dramatically improved the mortgage finance system, providing prudent access to mortgage finance credit and safeguarding the mortgage and broader financial system.

MARKET & REGULATORY ENHANCEMENTS POST-FINANCIAL CRISIS	
Qualified Mortgage (QM) with measurable underwriting metrics	Loan quality has vastly improved, with single family serious delinquent rates remaining below 1% for Fannie Mae and Freddie Mac for several years after the 2008 financial crisis and before the onset of the COVID-19 disruption.[4] Much of this is the result of enhanced lending standards stemming from the implementation of QM.
Representations and Warranties (R&W) Framework	FHFA and the GSEs have engaged in a multi-year effort since 2012 to improve the R&W Framework. Prior to this effort, the GSEs had significant discretion to determine whether or not a loan had underwriting defects and what constituted an appropriate remedy for a defective loan.
Private Mortgage Insurance (MI)	In addition to higher capital and operational standards through PMIERs and updates to the Master Policy, MIs now do much more diligence, even on delegated underwritten loans, than was previously done. In fact, a significant increase in the industry's business is originated through non-delegated underwriting compared to the MI industry's historical rate of 10%-15% prior to the financial crisis. In addition, through MI's Rescission Relief Principles, lenders essentially have certainty from day one regarding the clarity and certainty of MI coverage.
Lenders	The lending community has made vast investments in all aspects of mortgage credit risk management including upgrading the risk management skill base; investing in analytical resources; introducing new processes, including pre-funding quality assurance (QA); and strengthening existing post-close QA.
GSEs	The GSEs have made enhancements to their underwriting engines (DU and LPA) and undergone a fundamental re-rationalization of credit policy; devoting attention and upgrading skills in QA areas, with multiple data integrity and quality checks. These efforts have created very key credit guardrails that preserve the quality of business. They've also instituted industry standards through the R&W framework and their quality control (QC) process.

MAKING MI STRONGER AND MORE RELIABLE

After assessing past operational practices, and the causes and implications of the 2008 downturn, the private MI industry took the appropriate steps to strengthen and improve its business model to better serve low down payment borrowers in the conventional market. With that goal, some of the enhancements made include:

PAST	PRESENT
Exposure-based capital (Statutory)	Risk-based capital (PMIERs)
Less granular, relatively static pricing	More granular, risk-based and dynamic competitive pricing
Manage risk through credit policy	Manage risk through credit policy and competitive pricing
Focus on avoiding adverse credit selection	Proactive portfolio selection based on economic value
"Buy and hold" risk-taker	Active risk manager (aggregate, manage, and distribute risk)

MORTGAGE INSURERS ABILITY TO PAY CLAIMS: *Private Mortgage Insurer Eligibility Requirements (PMIERs)*

PMIERs consist of a set of both operational and capital requirements for mortgage insurers to be approved to insure loans acquired by the GSEs. These were first approved in 2014 and in 2018 the revised PMIERs 2.0 further addressed the lessons learned from the housing downturn and provided greater confidence to market participants and policymakers. These new requirements delivered exactly what they were seeking in the role of private MI—greater confidence as permanent, dedicated sources of first-loss credit risk protection and as trusted "second sets of eyes" to protect long-term value in the housing finance system.

Since its first implementation in 2015, **PMIERs nearly doubled the amount of capital each mortgage insurer is required to hold.** USMI member companies have maintained levels significantly over the PMIERs requirements, and as of June 30, 2020, **USMI members collectively held more than $5.1 billion in excess of these requirements during the first few months of the COVID-19 crisis.** The mortgage insurance industry has consistently raised capital and recently has secured more than $2.2 billion in new capital during the COVID-19 pandemic using equity and debt offerings.[10]

PMIERs created a strong foundation for efforts to further "de-risk" the GSEs through expanded use of private capital with MI. This builds on the industry's track record of providing dedicated private capital ahead of the GSEs and taxpayers, **as evidenced by the more than $50 billion in claims paid to the GSEs since they entered conservatorship in 2008**, representing 100 percent of valid claims from the financial crisis. Earlier this year, Goldman Sachs recognized the value of the industry during the last downturn, noting that "[h]istorical agency mortgage default data suggests that average MI proceeds have in fact typically been close to coverage levels. We are relatively constructive on the high loan-to-value (LTV) agency CRT sector which can potentially benefit from credit enhancement via mortgage insurance."[11]

KEY COMPONENTS OF PMIERS	
Financial Requirements	Ensure "[a]pproved insurers have adequate liquidity and claims-paying capacity during periods of economic stress."
Risk-Based Capital Standard	Establishes minimum required assets of 5.6%.
Business/Operational Requirements	Identify, measure, and manage exposure to counterparty risk.
Quality Control Requirements	Set for underwriting and eligibility guidelines, data accuracy, and fraud prevention.
Dictates Allowable Timeframes	For document request, claim perfection, and decision of claims.

"[H]istorical agency mortgage default data suggests that average MI proceeds have in fact typically been close to coverage levels. We are relatively constructive on the high LTV agency CRT sector which can potentially benefit from credit enhancement via mortgage insurance."

- Goldman Sachs, 2020

MORTGAGE INSURERS' OBLIGATION TO PAY CLAIMS: *New Master Policy & Rescission Relief Principles*

NEW MASTER POLICY

The MI Master Policy—developed with substantial input from FHFA—has **increased clarity of terms and streamlined the payment of claims to ensure, in the event of borrower defaults, that MI results in reliable and predictable payments.** These new policies articulate in much greater detail the conditions, in some cases tied to quantitative thresholds, that must be met before certain errors and omissions can become grounds for rescission.

The new Master Policy **ensures timely, consistent, and accurate policy and claim administration**, creating high visibility and responsiveness for performing loss mitigation (workouts for homeowners who become delinquent on their payments). The MI companies work with investors and servicers to help homeowners facing foreclosure.

In 2019, USMI members developed a common Master Policy which became effective on March 1, 2020.

RESCISSION RELIEF PRINCIPLES

The Rescission Relief Principles were first published in 2013, and the GSEs issued Revised Rescission Relief Principles in December 2017. The revisions sought to align the principles with updates to the GSE R&W framework. The introduction of rescission relief has been well-received by the industry, which includes automatic relief after 36 timely payments (proven to be more popular with lenders), with early relief available after 12 timely payments with a full file review. It also provides MI companies with the ability to offer increased rescission relief.

In recent months, each MI company has released announcements[12] concerning the treatment of loans impacted by COVID-19, including those that receive COVID-19 related forbearance. **These individual announcements highlight how USMI members are working to support their customers and borrowers.**

- Allow for MIs to offer **day one certainty** to lenders of coverage
- **Automatic relief** after 36 timely payments, with early relief available after 12 timely payments with a full file review

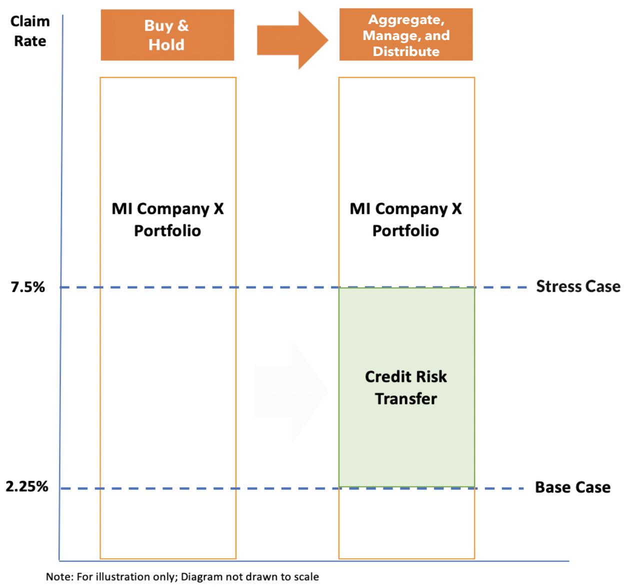
The MI industry has demonstrated a commitment to effect capital management through both reinsurance and programmatic Insurance-Linked Note (ILN) issuances, which have enabled MIs to become one of the strongest and most stable counterparties to the GSEs and investors and to play a greater role to support the U.S. housing finance system.

MORTGAGE INSURERS ARE ACTIVE MANAGERS OF MORTGAGE CREDIT RISK: *MI Credit Risk Transfer (MI-CRT) Structures*

While MI is one of the most stable and reliable sources of private capital that assumes mortgage credit risk through all market cycles, the industry has implemented innovative tools and structures to help better insulate the housing finance system from the cyclical nature of the mortgage market. In doing so, MIs have enhanced their ability to be more stable, long-term managers and distributors of risk. The industry now uses a combination of capital markets and reinsurance executions to reduce volatility and exposure of mortgage credit risk within the mortgage finance system, including to the GSEs and therefore taxpayers.

MI-CRT structures have developed and grown in the housing market since 2015, transforming the MI business model from "Buy-and-Hold" into "Aggregate-Manage-Distribute." MI-CRT demonstrates that MI companies are sophisticated experts in pricing and actively managing mortgage credit risk.

TRANSFORMATION OF THE PRIVATE MI INDUSTRY



- Given the cyclical and long-tail nature of the MI business, **the industry has evolved from a "Buy-and-Hold" approach into a more proactive and sophisticated "Aggregate-Manage-and-Distribute" operating model** by laying-off risk whenever presented with a favorable risk-reward trade-off.
- Deploying MI-CRT allows MIs to **hedge against adverse losses and mitigate volatility through housing and business cycles.**
- The MI industry's comprehensive CRT strategy, which combines Insurance-Linked Notes (ILNs) with third party reinsurance, **not only positions the industry well during the current economic downturn, but also ensures it will continue to operate as a going-concern through future economic stresses**, making private MIs strong and stable counterparties to the GSEs and investors.
- Transferring credit risk is not only an effective hedge to our exposure to cyclical mortgage risk but can also be **accretive to returns by freeing up capital at a fraction of the cost of equity capital without adding financial leverage to the balance sheet.**

As of October 2020, private MI companies have transferred nearly $41.4 billion in risk on approximately $1.8 trillion of insurance-in-force (IIF) since 2015.[13] The overall and transaction structure-specific numbers reflect the initial amount of risk transferred and IIF covered. In the reinsurance markets, MIs have executed 23 deals using Quota Share Reinsurance (QSR) and Excess of Loss (XOL) transactions to transfer more than $29 billion of risk on almost $580 billion of IIF.[14] As for using capital markets to distribute risk, the industry introduced MI ILN programs beginning in 2015. Since then, MIs have issued 30 ILN deals, transferring almost $12.3 billion of risk on more than $1.2 trillion of IIF.[15]

MIs underwrite and actively manage the mortgage credit risk, ensuring quality control and a "second pair of eyes" on risk within the financial system and for end-investors. Through CRT, MIs are able to access global financial markets to distribute risk, while not diluting their role in underwriting mortgage credit risk or serving as entity-based capital. The MI industry has demonstrated a commitment to effective capital management through both reinsurance and programmatic ILN issuances, which have enabled MIs to become the strongest and most stable counterparties to the GSEs and investors and to play a greater role in supporting the U.S. housing finance system.

MI BUSINESS MODEL TRANSFORMATION

	HISTORICAL MODEL: PRE-FINANCIAL CRISIS	CURRENT MODEL: AGGREGATE-MANAGE-DISTRIBUTE
HOW RISK IS PRICED	Published rate cards were utilized with price based on broad LTV ranges leading to: • mispriced credit tails • limitations in swiftly changing price in down cycles • reduced competitive advantage given published pricing • weakness in allocating capital based on individual borrower and loan attributes • limited ability to shape portfolio's risk and return profile • published industry pricing allowed for minimal opportunity to increase pricing	Deployment of more sophisticated risk-based pricing delivered through automated pricing engines: • enables pricing based on additional risk attributes • operationally, rates can be efficiently changed (providing a strong defense in a down cycle) • provides best rate to borrower based on their credit and loan attributes • enables shaping of the portfolio based on desired credit and return profiles • supports "best execution" lender strategies
HOW RISK IS MANAGED	The private MI industry did not utilize reinsurance in a manner consistent with P&C and Life insurers: • portfolios comprised long tail mortgage credit risk (typically with a 5-7 year life) • the private MI industry was significantly levered to U.S. housing and economic cycles • portfolios with uncapped liability were exposed to significant franchise and return volatility during down cycles • relied on equity as primary source of capital with minimal opportunities to diversify capital sources	Deployment of programmatic CRT transactions, such as ILN, XOL, and QSR agreements: • provides a layer of protection against adverse credit risk leading to a more sustainable franchise • minimizes franchise and return volatility during down cycles • provides 3rd party mortgage credit risk price discovery that can be incorporated back into front end risk-based pricing • provides additional sources of capital making for a stronger and more stable counterparty

Housing finance stakeholders have recognized the industry's innovation, expanded capabilities to expertly manage and distribute risk, and the benefits associated with MI-CRT programs. Laurie Goodman of the Urban Institute stated that "these transactions give the mortgage insurers information that is valuable for pricing the MI, through both the deal pricing and through discussions with investors," adding that MI-CRT will "also reduce the volatility of earnings, providing greater resiliency for the mortgage insurers under adverse market conditions."[16] **Equity research firm Dowling & Partners opined that "[w]e view the ILN market and its appetite for mortgage risk as a game changer in reducing MI loss exposure/managing the cycle more effectively."**[17]

"Analysts continue to explain that the diversification achieved and distribution of risk ultimately puts the [private MI industry] in a stronger position to manage expected increases of losses over the coming months, with a rise in defaults anticipated."

– Luke Gallin, Artemis[18]

BENEFITS OF MI-CRT

TO THE MI COMPANIES	TO THE HOUSING FINANCE SYSTEM
• Diversifies capital beyond entity-based equity capital.	• Strengthens MIs as counterparties.
• Protects portfolio against adverse losses in housing downturns.	• MIs underwrite/actively manage the mortgage credit risk, ensuring quality control and a "second pair of eyes" on risk within the financial system and for end-investors.
• Enhances counterparty strength.	• Reduces investor risk exposure, because MIs typically hold the first 185-250 basis points (bps) of risk for ILN and XOL transactions, ensuring alignment of incentives to instill quality underwriting.
• Provides capital credit for PMIERs, rating agencies, and state regulatory requirements.	• Significant potential for growth, deepening pool of liquidity for the market and options for investors in mortgage finance credit.
• Cost-effective source of funding that allows MIs to hold excess capital.	

EVOLUTION OF THE INDUSTRY:
Trends Among the MI Companies

Through significant enhancements to its capital structure and a clearer and more certain Master Policy, the industry has conveyed its willingness to learn from the financial crisis and adapt in order to prepare for future downturns. The industry has demonstrated an ability to tap multiple sources of capital available, including equity, debt, reinsurance, and capital markets, to support businesses and distribute risk. It has also shown its ability to work with lenders of all sizes and types, from the biggest money center banks to small community banks, credit unions, or independent mortgage bankers. This has created a wide array of trends and practices that further enhance the industry.

TREND	DESCRIPTION
Dynamic Industry Pricing	It allows companies to better price for mortgage credit risk and tailor their own risk profile through pricing.
Regular QA audits	MIs conduct regular QA audits to monitor manufacturing quality and provide timely feedback to lenders and underwriters.
MIs Rated	Within the last 2 years, nearly all MIs were upgraded by Moody's and a number of MIs were also rated by AM Best.
Risk management advocacy	Regular dialogue with the GSEs on credit guideline development, servicing practices, and emerging risk trends.
MI Given Credit in Updated MILAN Framework	Moody's proposed for public comment credit for MI, which was made part of its RMBS ratings methodology.
Higher credit scores and lower LTV and debt-to-income (DTI) ratios than FHA borrowers	Urban Institute's 2019 MI chart book details that private MI is more affordable than FHA-backed loans for the majority of combinations of FICO score and LTV ratios of 96.5%, 95%, 90%, and 85%. Importantly, GSE loans with private MI have lower loss severities than GSE loans without private MI, despite their higher LTV ratios.

CONCLUSION

Private MI is a critical feature of the housing finance system that enables homeownership for millions of Americans—and protects the GSEs, taxpayers and mortgage finance system from undue mortgage credit risk. After the financial crisis of 2008, the MI industry worked to dramatically improve its safety and soundness through enhanced capital and operational standards to be more resilient and withstand severe economic stress, and thus is an essential check on mortgage credit quality through the financial system, reducing systemic risk in the housing and financial markets.

Our nation's mortgage finance system is one that must balance access to mortgage credit for consumers while also shielding taxpayers. Fortunately, private mortgage insurance is uniquely and permanently dedicated to serving both objectives through all economic cycles. Today, the MI industry is stronger than it has ever been, making the industry even better poised to protect the GSEs, American taxpayers, and the mortgage finance system at large from mortgage credit risk in the future.

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[1] USMI Member Company Data and GSE Aggregate Data.
[2] Dey, Esha. *Bloomberg Government*, "Mortgage Insurers Now Well Positioned to Weather Downturn: BTIG" (April 6, 2020).
[3] Fannie Mae Monthly Summary (August 2020).
[4] Freddie Mac Monthly Volume Summary (August 2020).
[5] GSE Aggregate Data.
[6] *Inside Mortgage Finance*, Primary Mortgage Insurance Activity.
[7] GSE 2Q2020 10-Q Filings.
[8] GSE Aggregate Data.
[9] USMI Member Company Data.
[10] USMI Member Company 2Q2020 10-Q Filings.
[11] Goldman Sachs Credit Strategy Research, The Mortgage Trader, "Should investors apply a haircut to mortgage insurance proceeds? Not by much (January 24, 2020).
[12] Specific reporting and other requirements vary by company. Servicers should review the guidelines provided by each member company here: Essent Guaranty, Genworth Mortgage Insurance, MGIC, National MI, Radian.
[13] MI Company CRT Transaction Data.
[14] MI Company CRT Transaction Data.
[15] MI Company CRT Transaction Data.
[16] Urban Institute, "Credit Risk Transfer: A Fork in the Road" (June 7, 2018).
[17] Dowling & Partners Securities LLC, IBNR Weekly, IBNR #1, Volume XXVI (March 14, 2019).
[18] Gallin, Luke. *Artemis*, "Covid-19 expected to slow mortgage ILS issuance, say analysts" (March 31, 2020).