Affordability and Credit Risk: Mortgage Guarantee Insurance in Emerging Markets

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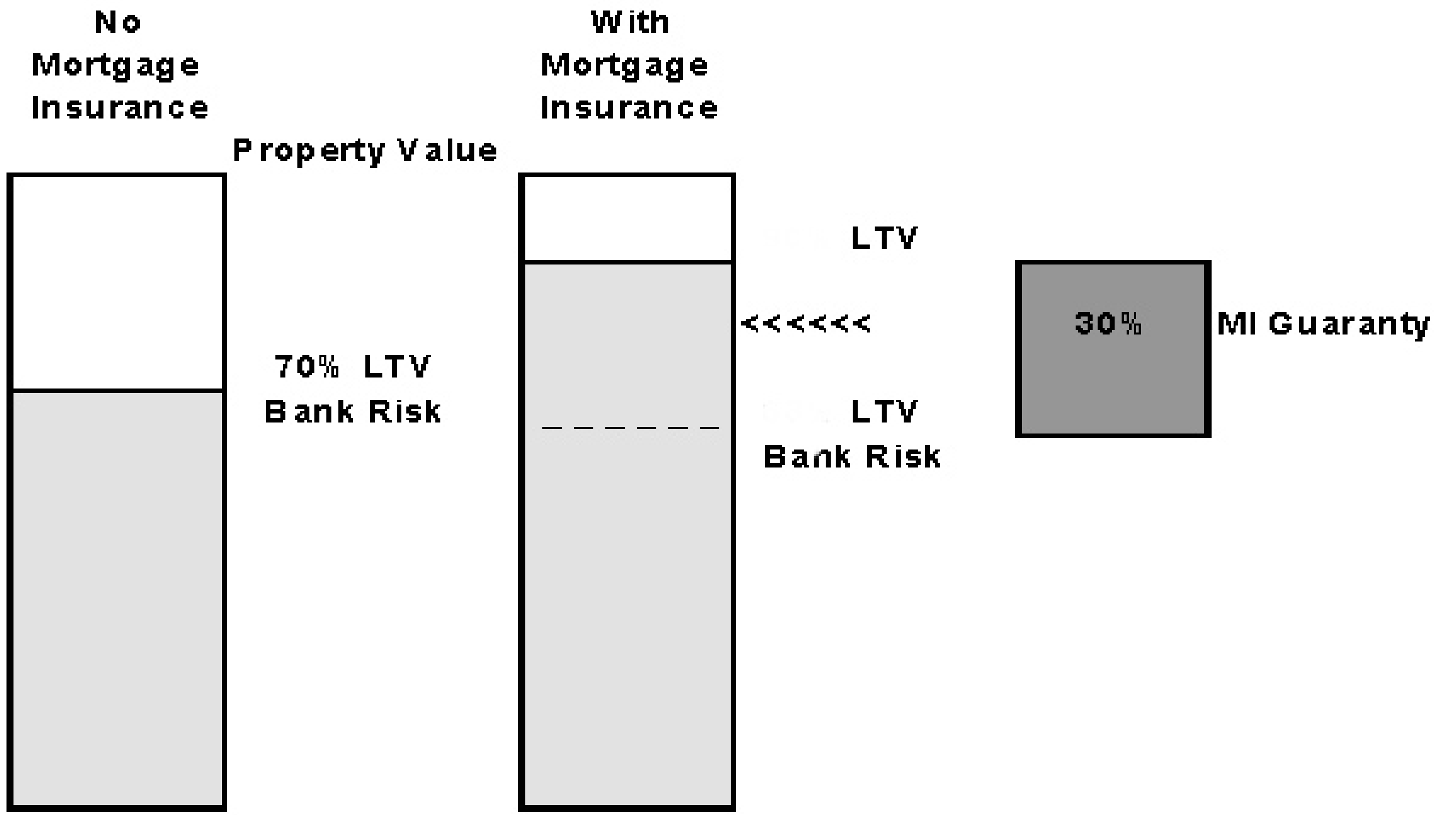
Topics for Discussion

- What is Mortgage Insurance (MI)?
- MI is spreading worldwide
- Potential benefits of MI
- Is there a need for MI in emerging and transition countries?
- Market prerequisites for MI
- MI structure and potential risks

What is MI?

- MI is a special form of credit insurance that protects lenders against loss from borrower default on residential mortgage loans
- MI allows market expansion via lower down payment/higher LTV loans
- MI shares risk with lenders: MI generally insures the “top tier” of the loan: the insurer is usually in first loss position
- MI is “credit enhancement” at the loan level

MI with 30% Coverage



What MI is Not!

- MI is not a form a life insurance that pays for death or disability
- MI is not mandatory
- MI is not for everyone
  - MI is best targeted at specific market segments, such as first-time buyers, young professionals, and modest income groups

Summary of Mortgage-related Insurance Products

Property Insurance	Ensures against collateral risk	*Should be mandatory*
Mortgage Life Insurance	Ensures against death	*Useful for some borrowers*
Mortgage Guarantee Ins.	Ensures against long-term credit & RE risk	*Targeted to specific types of borrowers*
Disaster Insurance	Ensures against earthquake, e.g.	*Difficult to provide?*

How Commercial MI Works

- Insurance contract between MI Company and approved lenders
- Borrower pays the premium
- Commercial MI insures only the “top tier”
- Top tier coverage generally 20% - 40%
- Typical LTV is 70% to 80%; MI insures loans with higher LTVs: 80% - 95%

How MI Works (2)

- Borrower defaults on mortgage loan
- Bank/borrower workout does not succeed
- Bank initiates foreclosure process
- Bank sells property at auction
- MI claim submitted if bank suffers loss
- MI can also covers delinquent interest, legal costs, property maintenance & taxes

MI Programs Worldwide

MI Expanding Worldwide

- Major feature of market in U.S. and Canada: public and private MI (FHA, CMHC, MGIC, GE, AIG, PMI);
- MI also widely used in UK, Australia, New Zealand
- Smaller public MI programs traditional in Europe
- **New wave: private MI now in Italy, Ireland, Spain, Portugal, Sweden, Germany, Belgium**
- **New wave: MI now in emerging and transition markets**

MI in Emerging Markets

- MI established: Hong Kong, South Africa, Latvia, Estonia, Lithuania, Mexico, Kazakhstan, Israel, Dominican Republic, Algeria, Morocco, Mali
- MI now being developed: Thailand, India, Korea, China
- MI now being studied for Romania, Russia, Poland, Ukraine, Kenya

What are MI's potential benefits?

Types of Risk Assumed by MI

- Credit risk: After borrower defaults on a mortgage loan, the bank faces real estate market risks in recovering the outstanding balance and related costs:

- Real estate market risk
  - Loss of individual home market value
  - Local or regional recession
  - Major economic downturn

MI Addresses both Systemic & Individual Risks

RISK ISSUE	SYSTEMIC	INDIVIDUAL BORROWER
Credit Risk	Economic Downturn	Change in income situation
Asset Depreciation	Housing cycles boom & bust	Neighborhood & spot declines
Lesser access to Mortgage Loans	Lower homeownership; slower development	Must wait to save larger downpayment

Systemic Real Estate Risk:

The fundamental risk MI is designed to cover--namely economic catastrophe throughout the whole economy--sets the product wholly apart from all other types of insurance and necessitates very special analytic and regulatory tools"

Arthur D. Little, Inc., "Distinguishing Characteristics of Mortgage Default Insurance", 1980

MI Can Help Qualify More Borrowers

MI can assist specific types of borrowers in obtaining mortgage loans with lower down payments (higher LTV)

- Households with limited down payments but good income – young professionals
- First time homebuyers
- Households with modest income and/or variable income and/or “unofficial” income and those with with non-standard profiles

MI Benefits to Banks

- Increases size of loan portfolio/market share by adding new types of borrowers
- Increases loan portfolio suitable for mortgage-backed debt by making high LTV loans eligible
- Could provide capital relief on high LTV loans that carry MI
- Most importantly, MI shares credit risk

Default Risk Relative to 80% LTV (80% = 1.0)

Data Source: Genworth	80% LTV	85% LTV	90% LTV	95% LTV
US Mortgage Info. Corp.	1.0	2.53	2.30	4.38
Canada: GE Mortgage Insurance	1.0	n.a.	4.08	10.63
Australia: GE Mortgage Insurance	1.0	1.92	2.34	10.63
UK: GE Mortgage Insurance	1.0	1.30	2.02	10.07
Canada: Mortgage Insurance Corporation	1.0	1.99	3.45	7.69

MI Benefits to Mortgage Market Development

- Helps standardization of underwriting and documentation
- Supports better delinquency management
- Requires effective foreclosure procedures
- Encourages improved appraisal
- Support development of MBS market

MI Structure

Issues in MI Structure in Emerging Markets

- Public or private
- Level of coverage
- Regulatory structure

MI in Emerging Markets

Country	**Year**	**Sponsor**	**Coverage**
Lithuania	1999	Public	25%
Hong Kong	1999	Public	10 – 25%
Kazakhstan	2004	Public	20 – 50%
S. Africa	1989	NGO/public	20%
Mexico	2004	Public	20 – 30%
Algeria	2000	Public	90%
Columbia	2004	Public	70% of loss
Estonia	2001	Public	24%

Other MI Efforts

Country	**Year**	**Sponsor**	**Coverage**
India	In progress	PPP	commercial
Thailand	In progress	PPP	commercial
Romania	Assessment 2006	n.a.	n.a.
Ukraine	Assessment 2005	n.a.	commercial
Kenya	Assessment 2006	n.a.	commercial
Russia	Assessment 2004	n.a.	commercial

Prerequisites for MI in Emerging Markets (1)

- Effective regulatory structure for Banks
- Effective regulatory structure for Insurance Companies
  - Specialized mortgage default insurance regulation
  - Conservative rules for capital and reserves
- Competitive banking sector
- Functional Primary Mortgage lending market
  - Benchmark LTV
  - Preferably some common loan standards

Prerequisites for MI in Emerging Markets (2)

Functional primary mortgage market traits:

- Reasonable economic, and political stability
- Established legal framework
  - Contract enforceability (“rule of law”)
  - Timely foreclosure procedure (tested)
- Functional system for transferring and recording ownership
  - real estate property titles and
  - Liens (reliable and cost effective)

Prerequisites for MI in Emerging Markets (3)

Functional primary mortgage market traits:

- Dependable Appraisal – property evaluations
- Data availability (mortgage, credit, and property)
- Lender competence in loan underwriting and administration
- Functional home resale and rental housing markets

Factors Mitigating Against MI in EU Candidate Countries and other Emerging Markets?

Factors Mitigating Against MI in EU Candidate Countries

- House price increases assumed to continue; foreclosures sold into rising market
- Low credit risk environment?
- Other traditional forms of credit enhancement

- Not likely- credit cycles not going away: “irrational exuberance”?
- Won’t continue;Spain, US, and UK already bracing
- Personal guarantees, top-up loans

Factors Mitigating against MI

- MI requires considerable capital
- MI not familiar to EU & other regulators.
- Is MI valid as a CRM tool (credit risk mitigation)?
- Securitization a less familiar form of capital market funding?

- True – required to truly share risk!
- This situation may change. UK' FSA may have set a precedent for MI
- Impact of MI would be realized via the LGD (loss given default)
- Perhaps an issue, since MI can be an important credit enhancement in MBS

Conclusions

Why is MI Expanding Worldwide?

- Developed Markets:
  - Credit enhancement to assist cost-effective funding in capital markets; more loans become eligible for mortgage bond cover or for MBS
  - Regulatory device to reduce capital charges on higher LTV loans
  - Good way to assist moderate income groups
- Emerging Markets: all of the above, PLUS:
  - help share risks and standardize growing markets
  - Combine with government subsidy programs to promote affordable housing in a ”market-friendly” manner

Recommendations for Emerging Markets

- Mortgage market legal framework crucial (foreclosure)
- Regulatory framework crucial, esp. capitalization
- Promote private or PPP sponsorship if possible
  - If not, public MI should have private structure
  - Partial insurance only: never 100% guarantee
  - must minimize moral hazard
- Coordinate with development of risk weight policy for residential loans and mortgage-backed debt

Summary of Key Risks to MI Operations

RISK TYPE	SYSTEMIC RISK	INDIVIDUAL BORROWER
Regulatory & Operations Risk	Insufficient capital; moral hazard of 100% coverage	Insufficient funds to honor claims
Political Risk for Government sponsored MI	Unbudgeted subsidies, large contingent liabilities	Arbitrary eligibility and/or selection for MI

Benefits and Risks

- In sum, MI can be a useful form of credit enhancement in emerging markets
- If not properly regulated, can lead to serious long-run problems

Annex

MI Helps Pursue a “New Equilibrium”

- **“Static”** analysis of MI in emerging markets might suggest that MI just increases costs for borrowers
- A **“dynamic”** analysis shows a new, higher equilibrium can be reached:
  - Banks have more borrowers
  - More modest income families have homes
  - Defaults may be higher but total revenues have risen
  - Construction and home furnishing sales increase
  - Banks can reduce interest rates and extend terms

Government MI Companies

North America	Western Europe	Emerging Markets
U.S.	France	Hong Kong
Canada	Sweden	Kazakhstan
Mexico (under development)	Belgium	Baltics
	Finland	Slovenia
	Netherlands	

Public versus Private MI Coverage

Country	Type of MI	Typical Coverage
USA - FHA and VA	Public	100%
USA - 7 Private MI's	Private	17% to 25%
Canada - CMHC	Public	100%
Canada Private MI	Private	100%
Australia - 1	Public	100%
Australia - 2	Private	100%
New Zealand - 3	Private	20% to 30%
United Kingdom	Private	less than 100%
France	Public	100%
Italy	Private	20% to 40%
Spain	Private	20% to 40%
Netherlands	Public	100%
Sweden	Public	less than 100%
Sweden	Private	20% to 40%
South Africa - HGLC	NGO	20%
Hong Kong	Public/Private	30% or less
Israel	Private	20% to 30%
Lithuania	Public	25%
Kazakhstan	Public	30%

Private and Public/Private MI

North America/Pacific	**Europe**	**Emerging Markets**
U.S.	United Kingdom	South Africa (NGO, public)
Canada	Spain	India (public, private, IFC)
Australia	Italy	Thailand (public, private)
New Zealand	Portugal	
	Ireland	
	Netherlands	

Banking Regulation

Bank Regulators' recognition of need for MI on high LTV ratio loans

- Reduced Risk Weight is incentive for banks to use MI, or
- ***Mandate*** the use of MI on high LTV loans

deters "adverse risk selection" by insured lenders

Insurance Regulation

Specialized MI Insurance Regulation is needed

- “Monoline charter or Segregation of capital and reserves from any other insurance lines
- Risk-based capital requirements (e.g. 20 to 1)
- Catastrophic loss reserve requirements
- “Conflict of Interest” provisions that assure underwriting independence
- Prohibit premium rebates - kickbacks

Possible Subsidy Elements?

Sponsorship	Capital Contribution	Premium Payment
Government Sponsorship (full or partial)	“indirect” subsidy	Possibly subsidized
Private Sponsorship	None – unless inadequate capital leads to bailout	Not likely

MI can be a Good Partner for Housing Subsidy Programs

- Commercial MI is not a direct subsidy program
- If Government sponsored, is an indirect subsidy
- MI can be combined with “market friendly” subsidy programs - for example:
  - Down payment assistance
- Specific households can be be targeted for MI
  - lower income
  - first time buyers
  - young households

In sum, MI Serves the Common Interests of Borrowers & Lenders

- Borrowers wanting high LTV can obtain loans and will enter the housing market sooner, stimulating construction and the economy
- Lenders wanting to expand their market share can protect their increased risk position with MI
- Bank regulators allow lower capital charge on high LTV loans that carry qualified MI
- Insurance regulators ensure that the capital adequacy positions of MI companies will support the long term market risks that they insure