

The MI Industry's Transformation

Key Structural Changes Will Help Prevent a Repeat of the Financial Crisis

By Arch Mortgage Insurance



As COVID-19 spread throughout the U.S. in early 2020, the housing market felt the impact almost immediately. Not only were buyers staying home to comply with shelter-in-place or lockdown orders, many current homeowners lost their jobs or were put on furlough.

In this altered environment, private mortgage insurance (MI) providers attracted special scrutiny. It's well-known that the 2008 housing crisis claimed three of seven mortgage insurance companies operating at the time as mortgage delinquencies, and lenders' MI claims skyrocketed.

MI companies paid out more than \$50 billion in claims over several years.¹ At the same time, many insured loans were discovered to have severe defects in the original underwriting or were otherwise subject to rescission.

Recalling how the housing collapse

played out over a decade ago and watching job losses mount, credit unions are asking: Will this time be different?

SWEEPING CHANGES FOR MI INDUSTRY

Mortgage insurance is an integral com-

ponent of the U.S. housing market. Over the past year, it helped more than 1.4 million Americans purchase or refinance a home, according to the public filings of the six major mortgage insurers.

As vital as MI is to mortgage lending, the changes mortgage insurers have undergone over the past decade have largely escaped the spotlight. Since 2008, the Federal Housing Finance Agency (FHFA) and the MI industry itself imposed transformative changes consisting of three main elements:

- Established significantly higher capital standards with the 2015 Private Mortgage Insurer Eligibility Requirements (PMIERs).
- Required more rigorous and sophisticated underwriting, which is producing measurably higher loan quality.



■ Introduced advanced reinsurance management practices, including effective credit risk transfer (CRT) tools such as MI-linked notes (MILNs) that shift risk to investors.

“Since the financial crisis, mortgage insurers have embraced change in ways that strengthen the MI industry as a whole and provide added protection for our lender partners,” said Arch MI President and CEO Michael Schmeiser. “In addition to higher capital standards, it is difficult to overstate how drastically improved credit quality and underwriting quality are today.”

AMPLEY CAPITALIZED

The collective impact of these changes was summed up in the headline “Better Prepared: Mortgage Insurers Ampley Capitalized to Weather Crisis,” which

appeared in the Asset Securitization Report in April.²

The centerpiece of the article was an analysis by investment bank Keefe, Bruyette & Woods (KBW) of how COVID-19 could affect MI companies.

The KBW report says, “This time is different than (the 2008 housing crisis for MI companies) because of stronger mortgage underwriting quality, more enhanced risk distribution methods and robust retained capital buffers.”

The year 2020 differs from 2008 in a number of other important ways. In contrast to the overbuilt market of a decade ago, there’s now a shortage of homes for sale. According to the National Association of Realtors® (NAR), a lack of inventory was a key factor in home prices increasing during the first quarter of 2020 despite the ongoing coronavirus pandemic, USA Today reported on May 18.³

NAR Chief Economist Lawrence Yun said median single-family home prices in the first quarter were up year-over-year in 96% of U.S. markets, according to the May 18 report. “Supply is extremely limited, and there are simply not as many homes for sale to meet the demand among potential buyers.”

NAR reported that all regional median single-family sales prices rose in the first quarter when compared to 2019: Northeast (9.7%), Midwest (7.5%), South (7.5%) and West (7.5%). Even with the recent increases, home prices nationwide are largely in line with fundamentals in contrast with the pre-crisis market when homes were overvalued by more than 30%, according to Arch MI research.

PRIVATE MORTGAGE INSURER ELIGIBILITY REQUIREMENTS

During the recessionary period after 2008, mortgage insur-



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ers were regulated largely at the state level by the departments of insurance in the 50 states, Puerto Rico and the District of Columbia. Typically, each jurisdiction imposes capital requirements for MI companies, but shrinking capital buffers during the housing crisis pushed some mortgage insurers out of compliance.

To prevent a repeat of the 2008 crisis, the Federal Housing Finance Agency (FHFA) and the MI industry worked together with Fannie Mae and Freddie Mac (Government Sponsored Enterprises, or GSEs) over several years to enact new Private Mortgage Insurer Eligibility Requirement (PMIER) rules that require MIs to hold significantly more capital relative to the amounts they insure to meet claim obligations in a downturn.

PMIERs complement state regulations and provide additional protections for lenders, the GSEs and secondary mortgage market investors. PMIER standards must be met for an MI company to be an approved insurer for the GSEs.

The debut of new MI companies in the post-crisis period was another sign of the MI industry’s growing strength. Backed by hundreds of millions of dollars in investor capital, two new industry entrants received approval to launch their operations in part because regulators recognized that a significantly strengthened and reformed MI industry was essential to a healthy U.S. housing market.



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REPORTING AND UNDERWRITING REQUIREMENTS

Today’s far stricter capital standards, which were tightened in 2018 by the Federal Housing Finance Agency (FHFA) and the GSEs, include reporting requirements to ensure MI companies remain compliant.

MI companies must also adhere to a set of rules on managing and measuring

counterparty risk, as well as providing continual updates to the GSEs on insured loans and capital levels.

Additionally, PMIERS enacted quality control requirements on underwriting, eligibility guidelines, data accuracy and fraud prevention.

A set of PMIERS provisions prevents MI companies from rescinding coverage when certain conditions are met. This includes loans on which borrowers have made the first 36 monthly payments. In some cases, rescission relief may be available to the lender after just 12 months under master policies updated as a result of PMIERS.



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MI borrowers tend to have higher credit scores than VA and FHA borrowers, and MI borrowers have the lowest LTV and debt-to-income (DTI) ratios among the three types of borrowers.

Mortgage insurers have seen their share of insured loans rise from about 15.8% of the market in 2009 to 36.3% this year.⁵

ADVANCED REINSURANCE MANAGEMENT

Over the last several years, MI companies have shifted from a strategy of simply holding credit risk to adopting sophisticated reinsurance management

practices that strengthen MIs and their lender partners. Arch MI introduced the first Mortgage Insurance-Linked Note (MILN) in 2015 and the rest of the industry has embraced this form of credit risk management over the past five years. With MILNs, mortgage insurance risk is securitized and sold to investors in a way that's similar to a mortgage-backed security structure.

MILN structures provide excess of loss protection to MI companies. In a typical MILN structure, MI companies retain expected losses and investors assume excess losses due to an economic stress event. The MI retains first loss on the MILN, which ensures it will maintain the highest level of underwriting.

MI Facts

- Nearly 60% of borrowers using MI are first-time homebuyers.
- Mortgages and refinances secured by MI accounted for \$418 billion in insurance coverage written during the 12 months prior to March 2020.
- MIs have nearly \$1.3 trillion in insurance in force on 5.4 million mortgages as of March 31, 2020.

Sources: U.S. Mortgage Insurers and quarterly reports of six MI companies.

Footnotes

- 1 U.S. Mortgage Insurers Fact Sheet. Q1 2020. www.usmi.org/pmi-by-numbers/
- 2 *Asset Securitization Report*: "Better Prepared: Mortgage Insurers Amply Prepared to Weather Crisis," April 3. asreport.americanbanker.com/news/better-prepared-mortgage-insurers-viewed-as-amply-capitalized-toweather-an-expected-jump-in-loan-delinquencies
- 3 *USA Today*: "Despite Coronavirus, Home Prices Increase in the First Quarter," May 18. www.usatoday.com/story/money/2020/05/18/coronavirus-home-prices-first-quarterincrease/111702900/
- 4 The Urban Institute: "Sixty Years of Private Mortgage Insurance in the U.S.," Aug. 22, 2017.
- 5 U.S. Mortgage Insurers Fact Sheet. Q1 2020. www.usmi.org/pmi-by-numbers/
- 6 U.S. Mortgage Insurers. "Private Mortgage Insurers Transfer Nearly \$34 Billion in Risk on Nearly \$1.3 Trillion of Insurance-in-Force from 2015-2019."
- 7 *Reinsurance News*: "Moody's Increasingly Positive on Mortgage Insurers as Reinsurance Use Grows," Dec. 2, 2019. www.reinsurancenc.com/moodys-increasingly-positive-on-mortgage-insurers-as-reinsurance-usegrows/



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As of May 2020, MI companies transferred about \$35 billion in risk on nearly \$1.3 trillion of insurance in force from 2015 to now using reinsurance and other Credit Risk Transfer (CRT) tools.⁶

In a December *Reinsurance News* article titled "Moody's Increasingly Positive on Mortgage Insurers as Reinsurance Use Grows," the magazine wrote "the U.S. mortgage insurance sector has reported broad-based improvements to its credit profile over recent years, with strong net income and improved capital adequacy."⁷

"Fundamental pieces of the private mortgage insurance industry look very different from a decade ago," Arch MI's Michael Schmeiser said. "I'm confident the changes have positioned the industry for success to navigate inevitable future cycles as they arise."

Arch MI is a leading provider of mortgage insurance in the United States. Backed by a solid capital base, Arch MI offers expert risk management and financial services to help mortgage lenders protect their investments and expand their origination opportunities. The combination of a risk-focused underwriting platform and extensive loan performance data means Arch MI can offer solutions backed by superior analytics to support customer needs.