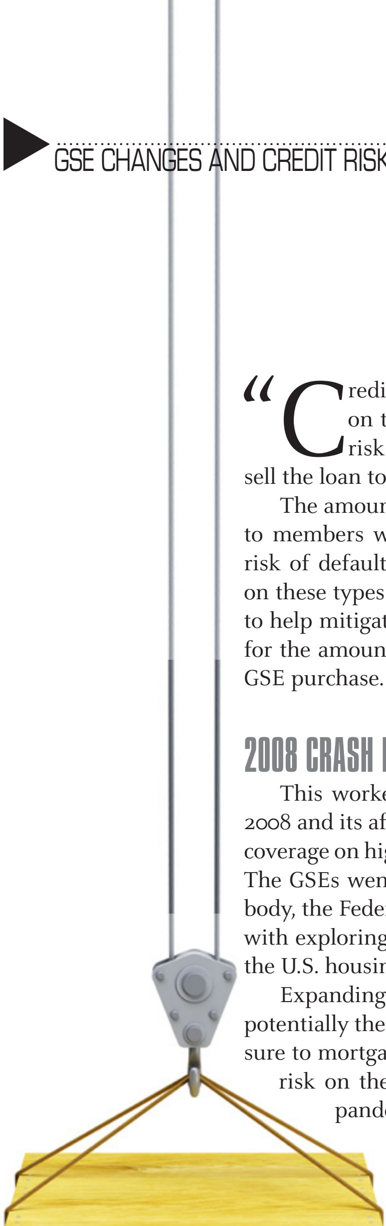

CREDIT
RISK

Coming in 2017: Expanded Credit Risk

Deeper MI Coverages May Help Reduce G-Fees and Member Payments

By Arch Mortgage Insurance Company

One of the most sobering consequences of the Great Recession was the revelation of critical weaknesses in the nation's mortgage finance system. ■ In particular, the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, came under fire as the full extent of the credit risk in their portfolios came to light. Delinquencies mounted and, with insufficient capital available to cover the losses, U.S. taxpayers were eventually stuck with the bill. ■ Subsequent industry proposals for the GSEs' reform have all recognized that reducing their exposure to credit risk would be crucial in restoring the health of U.S. housing.



"Credit risk" is the risk that a member may default on their mortgage debt. Credit unions incur that risk when the loan is originated. But when they sell the loan to the GSEs, the credit risk is transferred.

The amount of risk involved varies. Because loans made to members who put down less than 20% carry a higher risk of default, the GSEs require mortgage insurance (MI) on these types of loans before they purchase them, in order to help mitigate the risk. The GSEs set minimum standards for the amount of mortgage insurance on loans eligible for GSE purchase.

2008 CRASH EXPOSED RISKS

This worked well until it didn't. The housing crash of 2008 and its aftermath demonstrated that the amount of MI coverage on higher-risk loans was in many cases insufficient. The GSEs went into conservatorship, with a new oversight body, the Federal Housing Finance Agency (FHFA), charged with exploring ways to reform the agencies and strengthen the U.S. housing system for the future.

Expanding Credit Risk Transfer (CRT) has emerged as potentially the best mechanism for reducing the GSEs' exposure to mortgage default, estimated at $200 billion of credit risk on their $4.5 trillion book of mortgages. Such expanded CRT options include deep-coverage mortgage insurance, as well as other methods of shifting additional credit risk away from the GSEs, whether on a large scale or loan-by-loan basis.

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Proponents hope to not only "de-risk" the GSEs but also attract more private capital to the system to share in and absorb credit risk. By allowing private mortgage insurers to insure deeper coverages and inviting private capital to participate as well, expanded CRT promises a more stable U.S. mortgage finance system, lower costs for homebuyers, protection for taxpayers and profitable opportunities for investors.

Opportunities for CRT are available at both the front end—defined as "transactions in which the arrangement of the risk transfer occurs prior to, or simultaneous with, the acquisition of residential mortgage loans by [the GSEs]"—and on the back end—defined as "transactions in which the arrangement of the risk transfer occurs after the acquisition of residential mortgage loans by the [GSEs]" (FHFA, *Single-Family Credit Risk Transfer Request for Input*, June 2016).

In designing an expanded CRT program, the FHFA established 10 key principles to govern transactions, guide participation and ensure the continuing strength of the housing system:

- Reduce taxpayer risk
- Economically sensible
- Continuity of core business
- Repeatable
- Scalable
- Counterparty strength
- Broad investor base
- Stability through economic and housing cycles
- Transparency
- Level playing field

INTRODUCING 'DEEP MI'

The GSEs have been practicing a form of CRT since they were founded, by requiring loan-level mortgage insurance on loans with loan-to-value (LTV) ratios greater than 80%.

With private mortgage insurance already established as a reliable means of reducing GSE risk exposure, the simplest, easiest and most transparent way to expand CRT is to work with the MI companies to deepen mortgage insurance coverage on loans–both those with an LTV greater than 80% and those with lower LTVs.

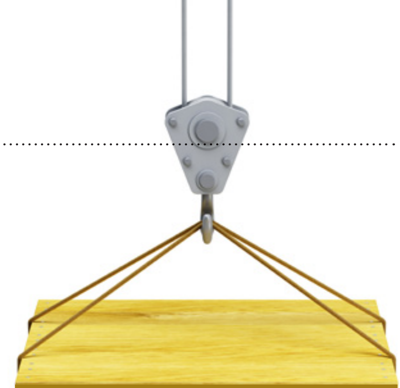
With "Deep MI," a private mortgage insurer has the opportunity to provide larger coverages for either a single mortgage loan up-front (front end) at origination or on existing pools of loans in the GSEs' portfolio (back end). For example, an MI company would insure 50% of a mortgage loan up-front, which should be enough to compensate investors in the event of member default, even in periods of severe home declines.

In return, MI premium payments for that loan would be higher to offset the higher cover percentage purchased. However, these additional premiums paid typically would still be cheaper than the GSEs' Loan Level Price Adjustment (LLPA) fees, currently levied on members through higher interest rates. And because their credit risk would now be greatly decreased, the GSEs would have to either reduce or even abolish LLPA fees for loans with "Deep MI" coverage.

To offer such a "Deep MI" structure, the private mortgage insurer would have to meet certain standards, including capital reserves and liquidity that meet the Private Mortgage Insurance Eligibility Requirements (PMIERs) established by the GSEs in 2015, overseen by rigorous risk management.

BRINGING IN PRIVATE CAPITAL

CRT proposals for the GSEs also include a call for bringing private capital into the mortgage finance system. CRT is an attractive investment opportunity: The market for expanded CRT has grown since the first such transaction in 2013, crossing the $1 trillion reference collateral threshold in 2016. And private capital is an attractive partner, helping



to ensure that loss protection is available through the entire credit cycle.

By sharing in the risk, private capital investors stand to earn higher returns. Wall Street is one possibility. Other possibilities include reinsurance firms, which represent a deep, high-quality pool of private capital, and have a track record of staying in markets throughout the business cycle. Participating in CRT would be a good fit for reinsurers also because its mortgage insurance underwriting results are largely uncorrelated with the underwriting results of other lines of business, thereby helping to diversify their portfolios.

For both private mortgage insurers and private capital, CRT represents a tremendous opportunity. However, both look to the GSEs to provide clear, transparent risk-adjusted capital rules on CRT that will facilitate their participation.

WHO WINS?

The benefits of expanded CRT for U.S. taxpayers are obvious: they're less likely to suffer a repeat of the Treasury-funded bailouts of the GSEs when another housing recession hits.

For homebuyers, CRT appears to reduce the costs associated with taking out a mortgage. According to one study, it cuts costs by an average $8/month, or $2,300 over the life of the loan (Milliman Inc., *Analysis of Deep Coverage Mortgage Insurance*, Oct. 15, 2015). Homebuyers also benefit from the greater stability of the housing system and increased access to mortgage financing.

For credit unions, there are real benefits associated with CRT, specifically the reduction of LLPA fees and lower costs for their homebuying members.

Some credit unions are concerned, however, about their ability to participate in CRT transactions as compared to other financial institutions. The key principles of CRT specify "economically sensible" transactions, which are those in which "the cost to [the GSEs] for transferring the credit risk does not meaningfully exceed the cost ... of self-insuring the credit risk being transferred. This cost analysis should consider administrative costs, projected credit losses from member defaults over the life of the loans, and the cost of holding capital to protect against projected credit losses during stressful macroeconomic conditions."

Credit unions might find it financially onerous to participate, as they would be required to meet capital requirements and incur the costs of posting collateral and setting up special-purpose vehicles to handle collateralized recourse transactions (defined by FHFA as "front-end credit risk transfer transactions in which a lender or special purpose vehicle ... agrees to reimburse the [GSEs] for a certain percentage of credit losses on loans sold to the [GSEs]"). However, the FHFA is also committed to a "level playing field," requiring CRT transactions to reflect only the cost of transferring credit risk:

> As required by FHFA, the volume of mortgage loans sold by seller/servicers to the GSEs will not be a consideration in determining any guarantee fee concessions offered as part of a credit risk transfer transaction. As a result, these guarantee fee concessions will not favor large mortgage originators over small ones. *(FHFA, Single-Family Credit Risk Transfer Request for Input,* June 2016)

However, for credit unions, a "Deep MI" strategy on the front end may work best. They have in place the systems and processes to order MI for loans at the point of origination, so expanded coverage options would work well within the existing framework. Expanded CRT also provides for greater transparency, so credit unions would be able to more accurately assess transactions and understand the tradeoff between guarantee fees and deeper MI coverage in terms of both their own loan portfolios and their members' monthly payments.

Andrew Rippert, CEO-Global Mortgage Group for Arch Capital Group Limited (parent of Arch MI), notes that both Deep Cover MI selected by lenders and reinsurance options selected by the Enterprises will work for smaller lenders:

> "Small lenders have systems and processes in place to order private mortgage insurance at loan origination," Rippert says. "Moreover, full transparency will permit smaller lenders to accurately assess transactions and to understand how guarantee fees are affected by particular transactions ... Deep Cover MI and the reinsurance structures ... are lower-cost and more efficient sources of CRT that can be made available for small lenders with relative ease, utilizing existing delivery infrastructures."

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CRT: A POSITIVE CHANGE

As 2017 begins, the housing industry is coping with rising interest rates and declining affordability, as well as uncertainty over the direction of GSE reform and housing policy under President Trump. However, the expansion of CRT appears to be a positive development for the industry, helping to safeguard taxpayers against future "housing bubbles" while lowering payments for homebuyers and strengthening the system of mortgage finance.

By transferring the risk on their books through the strategies of "Deep MI" and private capital participation, the GSEs—and the U.S. economy—can avoid a repeat of the debacle of 2008.

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