

Mortgage Insurance: Enhancing Credit Risk Management in a Global Financial Center

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Japanese banks appear finally to have recovered from the collapse of the bubble economy and, after a long period of retrenchment and restructuring, are seeking to make new loans and add assets to their books. In the absence of significant demand from corporate borrowers, most banks have turned to residential mortgage lending to generate revenues. The withdrawal of the Government Housing Loan Corporation from direct lending has created opportunities for banks and encouraged this trend.

Historically, the credit risk associated with residential mortgage loans has been regarded by Japanese banks as extremely low, and this has led in recent years to looser underwriting standards and more aggressive lending practices.

Residential mortgage lending, however, is not without its risks, and some bank analysts at rating agencies have begun to express concern with the aggressive lending practices of Japanese banks. In the United States, similar lending practices contributed, for example, to the real estate collapse in California in the early 1990s. A major factor in limiting losses to mortgage lenders as a result of defaulted loans then was mortgage insurance.

In the increasingly competitive mortgage loan market in Japan, mortgage insurance affords Japanese lenders a credit risk management tool that is widely used in other developed financial markets. As described below, mortgage insurance can contribute in many ways to enhancing the competitiveness of Tokyo as a global financial center.

Mortgage Insurance is New to Japan:

Mortgage insurance is new to Japan and has been available only since August 2005. It does not yet have regulatory support in Japan, and – partly as a consequence of this – it is not yet widely accepted in the lending market.

However, in many developed financial markets around the world, it is regarded as a useful, if not essential, credit risk mitigation instrument for mortgage lenders.

What is Mortgage Insurance?

Mortgage insurance provides protection to the mortgage lender in the event that a borrower defaults on a mortgage loan.

After a default has occurred and the lender has repossessed and liquidated the mortgaged property, there will often be a shortfall between the outstanding amount of the loan (plus unpaid interest and expenses associated with the sale) and the sale proceeds realized from the repossessed property. If there is such a shortfall, the mortgage insurer will pay an amount equal to such shortfall to the lender, subject to the limits of coverage set forth in the insurance policy. In this manner, mortgage insurance either eliminates or greatly reduces the loss suffered by the lender in the event of a default on an insured mortgage loan.

Mortgage insurance does not provide protection to the borrower. In the event of a default, the insurer has the right to pursue the borrower for the reimbursement of any amounts paid to the lender.

Mortgage Insurance in Developed Economies:

Many developed economies of the world have an established mortgage insurance market. Where a mortgage insurance market exists, mortgage insurance is often required by lenders for loans with high loan-to-value (LTV) ratios, because high LTV loans tend to have a higher risk of default.

Loans with high LTV ratios allow borrowers to purchase housing with a smaller down payment, thus encouraging purchases to younger buyers and a higher overall rate of home ownership. The higher default risk associated with high LTV loans is absorbed not by the lender but by the mortgage insurer.

Table 1 - Comparison of mortgage insurance markets and home ownership in selected advanced economies

Country	Mortgage Insurance Market	Home ownership %
USA	Established	67%
Japan	New	60%
Germany	Small	40%
United Kingdom	Established	67%
France	Small	55%
Canada	Established	66%
Australia	Established	70%

Sources: Canada – 2001 Census Data

Australia – Australian Bureau of Statistics

Others – Japan Ministry of Land Infrastructure and Transport

Distinguishing Features of the Japanese Market:

Japan's housing and mortgage loan market is similar in most respects to that of other countries. However, there are differences. The following factors would suggest the Japanese mortgage loan market may be relatively risky in international terms:

- Large proportion of high LTV lending in the current highly competitive mortgage loan market
- Improvements depreciate, leading to an effective increase in LTV
- High proportion of variable rate lending, resulting in greater sensitivity to interest rate movements
- Likelihood of interest rate hikes in the near future

- Demographic factors (such as an aging and decreasing population) that may lead to reduced demand for land and property, resulting in downward pressure on housing prices

On the other hand, there are some mitigating factors. Default rates in Japan have been low despite the long recession, although this can probably be attributed in large part to declining interest rates which lowered monthly mortgage payments for most borrowers. Also, unemployment remains low by international standards, and divorce rates are also low. Unemployment and divorce are two common triggers of default.

Benefits of Mortgage Insurance:

1. Mortgage Insurance Reduces Lender Credit Risk

As noted above, mortgage insurance provides protection to mortgage lenders against losses associated with defaults on mortgage loans. Mortgage lenders most often purchase, or require borrowers to purchase, mortgage insurance for high LTV loans because high LTV loans tend to be associated with a higher rate of default.

Mortgage insurance differs from the guaranties that Japanese banks typically require borrowers to purchase to guaranty the repayment of mortgage loans. First, mortgage insurance results in the transfer of credit risk to an independent third party insurance company. Mortgage loan guaranties, on the other hand, are usually issued by subsidiaries or affiliates of the lending bank, thus retaining the risk within the bank group. Second, mortgage insurance companies are typically rated AA or A by rating agencies, whereas bank-affiliated guaranty companies are usually unrated. Thus, mortgage insurance can confer benefits to the lender in securitization transactions and under the risk-weighted capital rules of Basel II.

2. Mortgage Insurance Increases Availability

In many countries, the introduction of mortgage insurance has led to an expansion in the availability of mortgage loans to consumers, in particular those without substantial savings and those with lower credit scores.

Partly as a result of this, the average age of the first-time homebuyer in countries with mortgage insurance tends to be lower than in countries without mortgage insurance. The average age of the first-time homebuyer in the United States, for example, is in the late 20's. The average age of the first-time homebuyer in Japan is in the upper 30's.

While high LTV loans are currently being made in Japan, this is due in large part to the refinancing of mortgage loans originally made during the "bubble" economy. As a result of falling property values for the last 15 years, the LTV ratios of such refinancing loans can be surprisingly high, often exceeding 200%.

3. Mortgage Insurance Increases Choice

Mortgage insurance also allows smaller lenders to compete on a level playing field with larger financial institutions. Smaller lenders are less well equipped to assess the credit risk of an individual, and in a market without mortgage insurance, this puts them at a significant competitive disadvantage.

The presence of smaller lenders in the mortgage market increases choice for consumers and improves its overall competitiveness. It also means that 'niche' lenders can serve the needs of particular community groups without putting them at a disadvantage.

4. Mortgage Insurance Reduces Cost

Mortgage insurance allows for diversification of credit default risk over time, geography, and a large numbers of borrowers. As such it should act to reduce overall capital requirements for mortgage lending. This is an important benefit for lenders, but it also benefits consumers as it should mean that the cost of mortgage loans is generally reduced.

5. Mortgage Insurance Facilitates Securitization

Mortgage insurance facilitates the securitization of high LTV mortgage loans, since it largely removes the credit default risk that is the main source of uncertainty in the underlying cash flows. Securitization is common in countries like the US, UK, Canada, and Australia, where mortgage insurance is the primary means of credit risk mitigation used in the mortgage market.

Securitization benefits consumers because it allows non-bank lenders to access capital and compete in the mortgage loan market, and also because it offers the choice of long-term fixed rate loans that might not otherwise be available. In addition, securitization benefits lenders by removing risk from the balance sheet and freeing up capital.

Mortgage insurance can increase the efficiency of securitization transactions by reducing the size of the equity or lower-rated portions and increasing the amount realized by the issuer/lender.

6. Mortgage Insurance Smooths the Housing Cycle

Mortgage insurance can benefit consumers, lenders and the economy as a whole by helping to smooth out the housing cycle. Lenders become more cautious about making new loans at the bottom of the cycle, which tends to prolong periods of recession. On the other hand, lenders may lend too much at the top of the cycle, which leads to problems like those experienced in Japan as a result of the "bubble" economy.

Mortgage insurance providers have a longer term view. The fluctuations in risk across the cycle are expected, and are an accepted part of the mortgage insurance business. The mortgage insurer has an incentive to write business at the bottom of the cycle, to maintain its premium income – and also because business written after a crash is likely to be profitable. At the top of the cycle, the mortgage insurer has a strong interest in keeping a check on high-risk lending. These effects help to smooth out some of the effects of the housing cycle.

7. Mortgage Insurance Improves Transparency and Scrutiny

Mortgage insurance companies in Japan are subject to regulation by the FSA. The solvency position, financial performance, claims payment processes, management, and every aspect of the business are subject to the full scrutiny of the FSA. This has clear benefits for the FSA in monitoring the safety and soundness of the Japanese mortgage loan market.

The clarity of reporting and results is enhanced when the insurer operates as a monoline provider. In some countries – such as the US and Australia – it is a regulatory requirement that mortgage insurers operate as monoline insurers.

The monoline approach means that the insurer has to focus purely on the performance of the mortgage insurance risk. A multi-line insurer might be tempted to offer mortgage insurance as a loss leader to build a relationship with a lender (e.g., to encourage the lender to distribute the insurer's other products, such as fire insurance).

Mortgage insurers are also externally rated by agencies such as Moody's and Standard & Poor's, which provides further scrutiny and comfort about the ability of the insurer to pay claims.

The mortgage insurer can also act as a check on lenders. This works in a number of ways. The mortgage insurer clearly has a commercial interest in requiring the lender to practice good risk management, and is likely to specify and monitor underwriting requirements to ensure this.

The mortgage insurer also imposes reporting requirements on lenders. This in itself may help to manage risk. Insurers collect data from different lenders, and can therefore obtain a better view of trends in experience and also compare the performance of different lenders.

Furthermore, mortgage insurers sell mortgage insurance as a long-term commercial proposition. The insurer needs to provide an appropriate return on capital to its owners, and so this ensures that, for example, premiums are set at an economically viable level to reflect long-term loss expectations, and that the business is run soundly on a long-term basis.

Conclusion:

Mortgage insurance is new to Japan but it is a widely accepted credit risk management tool in other developed economies. In addition to reducing the risk to mortgage lenders of losses resulting from defaults on mortgage loans in an increasingly competitive mortgage loan market in Japan, mortgage insurance can facilitate the securitization of mortgage loans, help reduce the volatility of the housing cycle, and encourage the more efficient allocation of capital. By doing so, mortgage insurance can contribute to enhancing the competitiveness of Tokyo as a global financial center.