Annex : FBF Response to Joint Forum consultation on mortgage insurance

I – Introduction: Residential loans secured by an insurance guarantee belong to the mortgage insurance category

The French Banking Federation–FBF wishes to express its position on the six recommendations contained in the Joint Forum consultative document, dated February 2013 and titled "Mortgage Insurance: market structure, underwriting cycle and policy implications", and provide further information on guarantee insurance practices in France that complement Annex B of the Joint Forum document.

FBF notes with satisfaction that the annex of the consultation devoted to France rightly highlights the effectiveness of French financial services practices in relation to property lending.

These practices contribute to mitigating risks along 3 main lines:

- Selection of borrowers according to their ability to repay the loans;
- Widespread fixed rate on housing loans with regular installments; and
- Additional insurance covering borrowers in the event of death, sickness, etc...

Therefore, there is a fair balance between the interest of the borrower, the lender and the insurer resulting in an extremely low yearly cost of risk (< 0.1 %[1]) and thereby minimizing systemic risk.

The French system of residential loans secured by an insurance guarantee exhibits the same characteristics as the definition adopted by the Joint Forum for "Mortgage Insurance " : property loan insurance protects lenders against losses when loans default – i.e. when outstanding debt exceeds the foreclosure proceeds. The borrower pays the insurance premium, but the lender is the policy beneficiary, and the amount of loss coverage is usually capped as a proportion of lost loan principal".

However, there continues to be a misunderstanding of the guarantee system provided by guarantee insurance in France, as well as the idea that mortgage would be a better or more secured guarantee than guarantee insurance.
This is why we consider it useful to clarify the scope and functioning of the residential loan guarantee system in France, in order to confirm that it belongs to the "Mortgage Insurance" category.

The French guarantee system is based on the fact that **the insurer, subrogated after payment in all the rights of the lender, exercises its full recourse on the entire assets of the borrower** until the extinction of the debt. This recourse is based firstly on amicable measures and, when there is no other solution, on recourse to the sale of the financed property in similar conditions to those of a lender having a mortgage guarantee.

In the case of a guaranteed loan, the borrower agrees in its lending contract to a **mortgage promise in favour of the guarantor. The registration of this mortgage** shall be effective in the event of the borrower defaulting. On the other hand, registration is systematic, at the time of the loan approval, in the case of a mortgage loan.

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[1] According to « enquête annuelle sur le financement de l'habitat en 2011 » by the French Supervisor – Autorité de contrôle prudentiel -ACP (July 2012)

In the event of default, risk of property encumbrance or pre-emption by another creditor on the asset (example: registration of a first-ranking third party), is incorporated in the insurance premium. The occurrence of this event is very low as highlighted by French market statistics. The unlikely event of the property resale before the mortgage is executed, , represents an operational risk and not a credit risk.

As mentioned previously, **in the absence of the financed property, the insurer of the property loan remains the creditor of the debtor in respect of all its assets and its income.**

For the lender, the insurance guarantee **is added to the mortgage guarantee** taken in the event of default. The lender is covered firstly by the guarantor's technical reserves and capital, and secondly, in the event of the guarantor's bankruptcy, by its ability to seize the financed property and the rest of the borrower's assets. This system has proven itself for 40 years and helps maintain a very low level of risk in the French property loan market. From an economic viewpoint, it is similar to the activity of mortgage insurers.

II- Comments on the Joint Forum's recommendations

1. Policymakers should consider requiring that mortgage originators and mortgage insurers align their interests.

Traditionally, French banks require the justification of the personal contribution by own funds (Equity). This is because guarantee organizations exclude from their compensation agreement contribution cases not justified by the borrower's own funds. This practice forces lenders to systematically justify the personal contribution by own funds when taking out an insolvency insurance policy.

The guarantee organizations or "guarantee insurers" are autonomous in their decision-making and select their risks based on a uniform population. The guarantee does not require mortgage registration at the outset but requires the borrower to make a contractual mortgage registration promise at its own cost in the event of default. The guarantee covers the entire loan, whatever the Loan to value (LTV) level. Its cost is comparable, or even lower than the mortgage registration, which prevents anti-selection.

In case of default, the guarantee insurer pays off the bank in respect of the entire debt and, through the principle of subrogation in the rights of the lender, becomes the owner and makes recourse on its own behalf.

Through the second analysis of the loan by the guarantee insurer, interests of the latter and the originator are closely aligned.

2. Supervisors should ensure that mortgage loan originators and insurers maintain strong underwriting standards.

The supervision of lending banks like the supervision of loan insurers already has a high requirement level in France, with the convergence of control methods for both sectors under the control of a single supervisor (ACP - Autorité de contrôle prudentiel). The selection of borrowers is subject to rigorous rules monitored by the supervisor with respect to the solvency ratio, by rating agencies as well as by the specific controller when loans are refinanced by a "Société de Financement à l'Habitat" (French home financing company issuing covered bonds).

Similarly, French guarantee insurers are insurance companies supervised by the French bank and insurance supervisor. They already apply high standards when underwriting a contract. These standards are regularly checked by:

- The supervisor, regarding compliance of the governance system for insurers with pillar 2 of Solvency 2;
- A specific controller imposed by the French law and acting on behalf of the holders of covered bonds issued by "Sociétés de Financement à l'Habitat" and where part of the assets (housing loans) are guaranteed;
- Rating agencies, notably in order to continue to deliver an adequate rating (at least A) to remain eligible as a protection provider under the Basel regulations.

Moreover, a guarantee insurer's risk policy aims to reduce the probability of default (PD), as in banking terms. The lending bank like the guarantee insurer therefore focuses on the borrower's long-term ability to repay the loan. It is in the guarantee insurer's interests to maintain high standards in order to cover the most solvent clients.

The new European standards for calculating the solvency margin ("Solvency 2") are based on a "risk volatility" approach. This approach makes it possible to maintain high underwriting standards in order to ensure solvency and profitability.

The underwriting process is based on a second review of loan applications by the insurer, which is added to the selection already made by the lending bank, based on its own criteria and completely independently from the lender. Decision-making autonomy is the first criterion checked by the specific controller, imposed by the French law in order to recognize the eligibility of loans secured by an insurance guarantee for the issuance of covered bonds by "Sociétés de Financement de l'Habitat".

3. Supervisors should be alert to - and correct for - deterioration in underwriting standards stemming from behavioral incentives influencing mortgage originators and mortgage insurers.

In nearly all cases, French bankers and guarantee insurers underwrite and manage the risks themselves. They keep the risk on their books until final repayment.

To enable the supervisory authorities to monitor any deterioration in underwriting standards, lenders like guarantee insurers should inform their supervisors on the underwriting quality of new clients entering their portfolio, with the level of granularity still to be defined (loan type, purpose of the financing, professional business sector, socio-professional category of borrowers, etc.).

4. Supervisors should require mortgage insurers to build long-term capital buffers and reserves during the valleys of the underwriting cycle to cover claims during its peaks.

The regulatory regime under which French insurers operate already provides for several levels of cover for commitments over their duration and takes account of cycle effects:

- The French insurance code does not allow the anticipated acquisition of the margin before the end of the insured commitment. It imposes the constitution of a non-acquired premium, with amortization in proportion to the maturity of the commitment.
- The European Directive, Solvency 2, imposes new solvency capital requirements, based on a 99.5% quantile, corresponding to a bankruptcy every 200 years. This quantile is calculated through the cycle, which automatically results in the constitution of a buffer.

In order to avoid the contagion of insurers by a major home loan risk, the guaranteed loan activity should remain isolated from the rest of the insurance activity, notably life insurance.

The guarantee insurer can always diversify its risks in terms of duration (long, short), in terms of type of counterparty (corporate, retail) and in terms of risk (loan guarantee, contract guarantee, regulated guarantees, performance guarantee, etc.).

5. Supervisors should be aware of and mitigate cross-sectoral arbitrage which could arise from differences in the accounting between insurers' technical reserves and banks' loan loss provisions and from differences in the capital requirements for credit risk between banks and insurers.

The expected loss on portfolios of performing loans in respect of French guarantee insurers is covered by the provisions for premiums, over the entire residual life of the loans.

Concerning the solvency margin requirement, there cannot be any arbitrage at the overall level. The capital posted by the lender and by the guarantee insurer to deal with unexpected loss is additive, even if the lender is able to adjust its risk parameters in order to take account of the additional protection.

Economically, the insured loan is covered by technical reserves, the capital of the guarantee insurer and the capital of the lender whereas non-insured loans are covered solely by the capital of the lender, proportionately to the type of guarantee of these loans.

The adjustment of capital posted by the banks in order to take account of the insurance is based on the rating quality of the guarantee insurer ("Basel 2" requirement of at least A- in order to be eligible as a protection provider, which is above the 99.5% requirement, which corresponds to BBB in "Solvency 2").

Concerning the difference in the level of requirement, 99.5% for insurance and 99.9% for the banks, it reflects the tolerance of the public authorities and regulators with regard to the risk of bankruptcy of insurers and banks.

The arbitrage in terms of exercising the activity of guarantee insurer as a bank or as an insurance company is a commercial arbitrage and/or eligibility strategy arbitrage (for example, no need to be rated in order to be eligible as a protection provider in the case of a bank vs. rating requirement for an insurer).

6. Supervisors should apply the FSB Principles for Sound Residential Mortgage Underwriting Practices to mortgage insurers noting that proper supervisory implementation necessitates both insurance and banking expertise.

The selection criteria of French banks and insurers already meet these best practices requirements in respect of risk underwriting:

- Selection based on the continuity of the borrower's solvency level;
- Consumer protection notably through usury rules limiting the interest charge;
- Borrower's obligations in respect of its loan committing all its assets ("full recourse");
- French guarantee insurers only incur the insolvency risk, with death-invalidity cover being delivered by another insurer with adequate rating quality;
- Agreements between the lender and the guarantee insurer which define the lender's compensation transfer the operational risk related to the quality and control of data to the lender. It is in the lender's interests to check the information in order to receive compensation in the event of default. The insurer checks the original application file and information in the case of guarantee calls by the lender.

The guarantee covers the lender's entire debt, which enables the guarantee insurer to diversify its portfolio on high quality loans. These practices prevent the anti-selection risk.