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FFSA Response to the Joint Forum consultative document on Mortgage Insurance

29 April 2013

Subject:	**Joint Forum consultation on Mortgage Insurance**
From:	French Federation of Insurance Companies (FFSA)
To:	The Joint Forum

1. Introduction: Surety insurance ("Assurance caution") belongs to the "mortgage loan insurance" class of business

In response to the Joint Forum consultative document of February 2013 entitled "Mortgage insurance: market structure, underwriting cycle and policy implications", the French Federation of Insurance Companies (FFSA), whose membership includes insurance companies carrying on surety business (in particular CEGC, Crédit Logement, CNP Caution and CAMCA) wishes to state its position, firstly on the transaction of mortgage insurance (or "*assurance caution*") in France, and secondly on the 6 recommendations set out in the consultative document.

Mortgage loan insurance provides protection to **lenders** against losses arising from borrowers defaulting on reimbursement of their loan. The borrower pays the insurance premium but the lender is the policy beneficiary. The insurance most often covers part of the difference between the proceeds from sale of the foreclosed property and the outstanding balance of the loan.

The annex to the report devoted to France describes the practices of the French property loan industry as being efficient. These practices help minimise risk, especially through the widespread use of guaranteed loans ("*prêts cautionnés*"). This practice enables a pooling of risks on a very broad basis and avoids a concentration of guaranteed loans on segments of production with inherently the greatest risk, such as can be observed in other markets (with a concentration on high LTV transactions or socially disadvantaged borrowers). It also relies on the principle of double checking, the lender/originator and the guarantor each operate an autonomous selection policy. In its risk selection the surety insurer focuses on the borrower's repayment capacity, fixed-rate type loans and supplementary insurance to cover borrowers in the event of death, illness, etc.

In this document, the French system of guaranteed loans is rightly regarded as equivalent to "Mortgage Insurance".

However, we have observed that a poor understanding of the system of surety on loans continues, including amongst credit rating agencies who convey the idea that a mortgage would be a better guarantee than a surety. That is why it is necessary to clarify the scope and operation of the surety system on property loans in France, in order to confirm it belongs to the "mortgage insurance" class of business.

The French surety system is based on the fact that the **insurer, after making payment and being subrogated to the totality of lender's rights and remedies, is entitled to recover such payment against the borrower's entire wealth up to the value of its claim.** This recovery is based firstly on amicable measures involving postponement of the debt repayments and, when there is no other viable solution, on sale of the asset being financed, in the same manner as a lender with a mortgage guarantee.

With a guaranteed loan the borrower grants a promise of **a mortgage in favour of the lender/originator or the guarantor and undertakes not to dispose of the underlying property nor mortgage it without the agreement of the lender or guarantor.** The registration of this mortgage will only be effective if the borrower defaults under a guaranteed loan, whereas with mortgage loans, registration always occurs, at the time of granting the loan.

In the event of default, the risk of loss of the property or that a third party may have a privileged claim, which is sometimes stressed, is included in the insurance premium. The occurrence of such an event is also very rare, as evidenced by market statistics. The marginal case of resale of the property prior to effecting the mortgage or organised insolvency of the borrower in default, is an operational risk and not a credit risk.

As indicated above, **in the absence of the asset being financed, the insurer of the property loan remains creditor of the debtor on the whole of his/her wealth and income.**

The surety is **a guarantee which aggregates with the mortgage guarantee** effected in the event of default. The lender is covered firstly, by the guarantor's technical and free reserves and, secondly, in the event of failure of the guarantor, by its ability to recover the asset being financed and the rest of the borrower's wealth. This system has a good track record going back 40 years and helps to maintain a very low level of risk on the French property loan market. Economically it is the same as the activity carried on by mortgage insurers (see box on the Exposure of mortgage insurers and surety insurers to underwriting risk).

Exposure of mortgage insurers and surety insurers to underwriting risk

There are two facets to the underwriting risk on property loans: firstly, the default frequency or probability (PD) and secondly the severity or loss on default (LGD or PCD).
The protection provided by the mortgage insurer as well as the surety insurer, aims to cover the bank's LGD by guaranteeing it a 100% recovery of the sum owed by the debtor. Indeed, the Bank adjusts its LGD accordingly in its calculation of weighted assets or RWA ("Risk Weighted Assets") In addition, the principle of double-checking means that guaranteed loans have a lower probability of default than that observed on mortgage loans.

The risk for the insurer (MI or guarantee) relates to that part of the exposure that is not covered by the first surety, ie that provided by the asset underlying the property loan (ensured either by a mortgage registered on granting the loan or at the time of default). In both cases, the share of the exposure at risk is that part that cannot be recovered after sale of the asset.

The level of exposure of the surety at the time of default, ie Exposure At Default (EAD), is identical to that of the mortgage insurer, who covers loans with an LTV (Loan To Value) above 80 %, in return for a premium (P). Therefore, the traditional insurer claims-cost ratio C/P is expressed by: (PD x LGD x EAD) / P.
EAD is minimised in different ways depending on whether the mortgage registration is done on granting the property loan or at the time of default:

- by capping the claim settlement by the MI insurer (generally the portion above 80% LTV);
- by diversifying the surety insurer's loan portfolio where the LTV is less than 80%, which minimises or even eliminates part of the exposure in the event of default.

2. Comments on the Joint Forum recommendations

Joint Forum recommendation	Comment
1. Regulators should examine how to align the interests of originators and those of mortgage loan insurers.	Traditionally, French banks require proof that a down payment comes from own funds. The providers of surety exclude from their agreements cases where the down payment cannot be proven to have come from the borrower's own funds. This practice forces lenders to systematically check that the down payment comes from own funds when taking out insolvency insurance. The providers of surety are autonomous in their decision-making and select on the basis of an homogeneous population. The surety (or MI) does not require a mortgage registration and relates to the whole of the loan, regardless of the level of LTV. Its cost is comparable, or even lower than a mortgage registration and this avoids anti-selection. The surety insurer relieves the bank of the totality of the claim and, by subrogation to the rights of the lender, takes over the loan and recovers amounts owing on its own account. Any commissions paid to the lender by the insurer could be replaced by a system of profit-sharing calculated on the claims cost (C/P) or the combined ratio, which would have the effect of better combining the interests of the bank and the insurer and would limit the potential incentive of overstating the commissions paid.

Joint Forum recommendation	Comment
2. Regulators should ensure that originators and insurers of mortgage loans apply strong underwriting standards.	The high underwriting standards of French insurers are regularly checked by: - the banking regulator, which particularly insists on the quality of standards for selection and management of loans and verifies that the lender/originator implements a policy of selection and management of loans that is independent of the surety providers (verification of double-checking) - the supervisor, as part of compliance of insurers' governance system with Pillar 2 of Solvency 2. - the specific supervisor acting on behalf of the holders of bonds issued by residential housing financing companies, part of whose assets (loans for residential housing) are bonded. - credit rating agencies, in particular so as to continue to deliver a quality of signature sufficient (at least A) to remain eligible as a supplier of protection under Basel regulations. In addition, the risk strategy of a surety insurer is to minimise the probability of default (PD). The surety insurer focuses therefore on the long-term solvency of the borrower. It has a vested interest in maintaining high standards so as to accept the best customers. The new European standards for calculating solvency capital requirements are based on a risk volatility approach. This approach enables high underwriting standards to be maintained so as to stay solvent and profitable. The underwriting process is based on a second reading of loan applications, on the basis of specific criteria and totally independent of the lender. Autonomy of decision-making is the primary criterion verified by the specific supervisor and imposed by French legislation in order for the sureties to be eligible for inclusion in the SFH residential-housing finance scheme ("Société de Financement de l'Habitat"). The refusal rate of surety applications averages between 10% and 20% of loans previously accepted by lending institutions, which demonstrates insurers' ability to select risks so as to eliminate the higher risks. Therefore it is the best customers who benefit from surety insurance.

Joint Forum recommendation	Comment
3. Supervisors should be alert to, and where necessary correct, any deterioration in underwriting standards stemming from behavioural incentives influencing originators and insurers.	In almost all cases, French bankers and insurers underwrite and manage the risks themselves. In France, other than with specialist credit institutions, property loans are a promotional offering to draw in new banking customers and which enable banks to make a margin out of providing the customer with multiple products. Of course, this margin on other banking products is earned with the best customers. There is, therefore, no value in granting loans (with a low margin) if the anticipated customer value is insufficient. In order to enable the supervisory authorities to monitor for possible deviations, insurers should publish indicators on the underwriting quality of customers recruited into the portfolio (type of loan, purpose of the loan, sector of professional activity, borrowers' socio-economic classification etc.).

Joint Forum recommendation	Comment
4. Supervisors should require mortgage insurers to build capital buffers and reserves in order to deal with fluctuations of the underwriting cycle and so cover losses during periods of crisis.	The regulatory regime under which French insurers operate already provides for several levels of cover for liabilities over time and takes cyclic effects into account: -The French insurance code does not allow the margin to be booked before the end of the insured liability. It requires the adequate technical reserves to cover risks for the duration of their liability. -The European Solvency 2 directive imposes new solvency capital requirements, on the basis of a 99.5% quantile corresponding to bankruptcy every 200 years. This quantile is calculated throughout the cycle, which automatically means a buffer is created. The Joint Forum recommendations should not lead to the introduction of additional rules for a sub-class of insurance that would aggregate with the new Solvency II rules, which already meet the objective sought by these recommendations. In order to avoid the contagion of insurers by a major risk on residential housing loans, the carrying on of loan surety business should remain isolated from the rest of their insurance business, including life. The "surety provider" can still diversify its risks in terms of duration (long, short), in terms of counterparty (corporate, retail) and in terms of risk (loan sureties, market sureties, regulated sureties, performance guarantees etc.). This practice allows the insurer to show specialisation in loan sureties while still being very diversified.

Joint Forum recommendation	Comment
5. Supervisors should review 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 the credit risk between banks and insurers.	The expected losses on French surety insurers' healthy portfolios of outstanding loans, are covered by premium reserves for the whole residual life of those loans. It seems coherent to align the approach of banks with that of insurers in the absence of surety insurance on the loan, ie to compel the lender to take out an insurance for what is today deemed to be a statutory reserve. With regard to the required solvency margin, there can be no arbitration overall. The capital available to the lender and the insurer to provide for an unexpected loss are cumulative, even if the lender can adjust its risk parameters in order to take account of the additional protection. Economically, the insured loan is covered by the insurer's capital and technical reserves and the lender's capital whilst uninsured loans are covered only by the lender's capital, in a proportion that depends on the type of surety on those loans. The adjustment of capital mobilised by banks in order to take account of insurance is based on the quality of the insurer's credit rating (Basel 2 requires at least A- to be eligible as a provider of protection which is above the 99.5% requirement which corresponds to BBB).

	The difference in the required levels, ie 99.5% for insurance and 99.9% for the banks, reflects the tolerance of the public authorities and regulators with regard to risk of bankruptcy of insurers and banks. The decision as to whether to carry on surety business as a bank or as insurance is a commercial decision and/or one of eligibility strategy (for example, no need to be rated to be eligible as a provider of protection if a bank *vs* rating requirement if an insurer).

Joint Forum recommendation	Comment
6. Supervisors should apply the FSB Principles for Sound Residential Mortgage Underwriting Practices (“FSB Principles”) to insurers noting that their implementation necessitates both insurance and banking expertise.	The selection criteria used by French banks and insurers already meet these requirements of good risk underwriting practices: - Selection on the basis of the sustainability of the borrower's level of creditworthiness - Protection of the consumer particularly by the rules relating to usury that limit the interest burden, - Obligations of the borrower under the loan committing his/her entire wealth - French insurers carry only the insolvency risk, death and disability cover is provided by another insurer with adequate credit rating. - The agreement between the lender and the insurer which defines compensation for the lender, transfers the operational risk, linked to the quality and control of decision-making data, onto the lender. It is in the interest of the lender to check this information in order to be compensated in the event of default. When the lender calls on the surety, the insurer inspects the original loan application and accompanying information. - The surety covers the lender's full claim, which allows the insurer to diversify its portfolio on loans of high quality, for example, without any minimum LTV. These practices prevent risk anti-selection.