CRÉDIT LOGEMENT
response to the
Joint Forum consultative document

29 April 2013

Subject:	**Joint Forum consultation on Mortgage Insurance**
From:	**CRÉDIT LOGEMENT**
To:	**JOINT FORUM**

In response to the Joint Forum consultative document of February 2013 entitled "Mortgage insurance: market structure, underwriting cycle and policy implications", Crédit Logement wishes to state its position on the practice of mortgage insurance for residential property loans in France and on the recommendations set out in the consultative document.

Introduction: CRÉDIT LOGEMENT AND THE FRENCH MARKET FOR PROPERTY LOANS GUARANTEED BY A FINANCIAL OR INSURANCE COMPANY

Crédit Logement, a financial company founded in 1975, is the French market leader for property loans guaranteed by a financial or insurance company.

As at 31/12/2012, outstanding residential property loans guaranteed by Crédit Logement in favour of the main French banks totalled €233 billion, representing more than 50% of all guaranteed property loans and approximately 25% of all French residential property loans.

Crédit Logement is regulated by the French prudential supervisory authority, the ACP (Autorité de Contrôle Prudentiel). As at 31/12/2012, it had capital (T1 + T2) of € 8,200 million, of which more than €3,700 million has been deposited in a mutual guarantee fund as protection against its guarantee portfolio credit risk.

Crédit Logement is rated AA- by Standard and Poor's[1] and Aa3 by Moody's[2], and has played a key role in developing an extremely secure residential property loan market in France.

The market for residential property loans guaranteed by a financial or insurance company developed in France under the impetus of Crédit Logement, which offered banks an alternative solution to mortgage insurance that is both less expensive and easier for borrowers to use. It is also a secure solution for lenders, as in addition to the fact that the amount of the guarantee is based on the value of the property being financed, it is provided by an institution that is an acknowledged expert in the management of this type of credit risk.

[1] With a negative forecast due essentially to tensions on French sovereign debt and doubts as to the strength of the French banking industry.

[2] With a stable forecast despite French macroeconomic forecasts that are likely to adversely affect the quality of the credit risk, and based on the agency's opinion on its strong loss-absorption capacity.

Under this system, the borrower pays a premium or a contribution to the mutual guarantee fund. Under the Crédit Logement system, part of the contribution to the Mutual Guarantee Fund may be paid back to the borrower at loan maturity if the borrower has not defaulted, subject to anticipated losses on the portfolio as a whole, according to the system whereby risks are pooled between all borrowers, all lenders and all generations. The lender benefits from a guarantee that the outstanding loan will be repaid in full if the borrower defaults. The guarantee provider is subrogated to the lender's rights, and is entitled to recover the amounts paid to the lender from the defaulting borrower against the borrower's entire assets.

The guarantee provider's activity is frequently regarded as equivalent to "mortgage insurance"[3]. The difference with a traditional "mortgage insurance" activity is that, on the French market, each application is analysed by the guarantee provider before being approved.

Firstly, it should be noted that the market is not limited to borrowers unable to get onto the property ladder without external assistance, or to high LTV transactions. On the contrary, guarantee providers have always been keen to propose an offer based on the pooling of risks and on maximum diversification of the customer base, avoiding any adverse selection and any concentration other than structural concentration, in order to improve the solidity of the guarantee mechanism.

The traditional approach to risk in France is based on a two-fold analysis: an initial analysis of the borrower's capacity to repay the loan, followed by an analysis of the capacity of the financed property to provide sufficient funds to repay the loan in the event the borrower defaults. This means the guarantee provider double checks the application, providing a second opinion as a credit risk management specialist.

As a result, the number of claims relating to guaranteed residential property loans in France is statistically lower than the number of claims relating to property loans secured by a mortgage, even though the French banks maintain tight control over them.

Furthermore, losses in the event of a default are also significantly reduced because, in addition to the property being financed, against which a mortgage can be registered in the event of a default[4], under French law a borrower can be compelled to draw on his/her entire assets to repay a loan. This also protects both the lender and the guarantee provider, who is subrogated to the lender's rights, against the "negative equity" phenomenon common in countries in which action for recovery of a defaulted property loan can only be brought against the value of the property financed by the loan.

The French system has operated successfully for 40 years and is a key contributing factor to the very low risk levels on the French residential property loan market.

[3] Cf . The rating methodology applied by Moody's to French market operators.

[4] When a loan is guaranteed by a financial or insurance company, the borrower agrees in the loan agreement to grant a promise of a mortgage in favour of the lender/originator or the guarantee provider and undertakes not to dispose of the underlying property or mortgage it without the consent of the lender or guarantee provider. The registration of this mortgage will only be effective if the borrower defaults under the guaranteed loan.

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.	On the French market, the interests of lenders/originators and guarantee providers are aligned primarily through the extensive use of guaranteed loans, ensuring large-scale pooling of risks and avoiding concentration on loan segments that are intrinsically high-risk. Furthermore, the rights and obligations of lenders/originators and guarantee providers are recorded in an agreement under which the originator undertakes: - to implement a policy of selection and management of guaranteed loans that is at least equivalent to mortgage loans and, in any event, will not harm the interests of the guarantee providers, - if the borrower defaults, to produce the documents that will enable the guarantee provider to check that the risk information supplied when the guarantee was provided was used as the basis of the decision to grant the loan. Lastly, the guarantee provider acts independently when deciding whether to provide a guarantee, and may refuse to pay the lender if it fails to perform its obligations.

Joint Forum recommendation	Comment
2. Regulators should ensure that originators and insurers of mortgage loans apply strong underwriting standards.	On the French market, the high underwriting standards applied to loans by lenders and guarantee providers are regularly checked by: - The banking regulator, which insists particularly 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 guarantee provider (verification of double-checking principle). - The supervisor, as part of compliance of the insurers' governance system with Pillar 2 of Solvency II. - The specific supervisor, acting on behalf of the holders of bonds issued by French 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 that is sufficient (at least A) to remain eligible as a supplier of protection under Basel regulations. To enable the supervisory authorities to monitor for possible deviations, originators and guarantee providers should communicate indicators on the underwriting quality of all new customers: - breakdown by probability of default and of loss in the event of default, - default probability rates at one year, or aggregate per loan generation, - loss rates in the event of default, aggregate and per loan generation, - anticipated loss rates calculated over the average portfolio duration according to premiums or mutual guarantee fund contributions received.

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 guarantee providers underwrite and manage risks themselves. In France, other than with specialist credit institutions, property loans are a promotional offering to draw in new banking customers and enable banks to make a margin out of providing customers 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. To avoid behavioural deviations, the supervisory authorities should be aware of certain practices: - payment of commission to credit brokers when the guarantee provider provides a guarantee, - payment of commission to the lender/originator when the guarantee provider provides a guarantee, - payment of commission or target-based remuneration to employees of the lender/originator when the guarantee provider provides a guarantee.

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.	Supervisors of guarantee providers should require them to carry out stress tests along the lines of those required by the banking regulators, such as: - sensitivity tests to measure the deterioration of risk parameters or macroeconomic variables impacting the level of risk parameters, - global stress tests modelling all the consequences of the deterioration of macroeconomic data on the institution's business model, - tests to measure the institution's capacity to deal with crises on a scale similar to those observed in a number of countries since 2007 (USA, Spain, etc.). The guarantee providers' business models must be sufficient for them to ride out any such crisis.

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.	One way of enabling supervisors to mitigate regulatory arbitrage between types of guarantee and business sectors is to ensure that the capital requirements applying to the lender/originator and the guarantee provider, when considered in conjunction, are - equivalent, - indexed to the actual risk level observed by them, and not dependent on the type of guarantee used by the originator or on the business sector. Supervisors should also ensure that capital requirements included in future regulations currently under discussion are based on an identical quantile of the loss distribution in each business sector (e.g., 99.9% for banks).

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 guarantee providers already meets these requirements of good risk underwriting practices: - Selection on the basis of 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 agreement committing his/her entire assets, - French guarantee providers carry only the insolvency risk, as 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, linked to the quality and control of data on which decisions to provide a guarantee are based, 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 guarantee, the guarantee provider checks the original application and information. - The guarantee covers the lender's full claim, which allows the guarantee provider to diversify its portfolio to include high-quality loans such as loans without any minimum LTV. These practices prevent adverse risk selection.