RESPONSE TO FEEDBACK RECEIVED - CONSULTATION PAPER ON THE PROPOSED REGULATORY FRAMEWORK FOR MORTGAGE INSURANCE BUSINESS

1 INTRODUCTION

1.1 On 12 October 2006, MAS released a consultation paper inviting comments on the proposed regulatory framework for mortgage insurance business and the proposed treatment of mortgage insurance in the calculation of the capital requirements for locally incorporated banks.

1.2 The consultation period closed on 15 November 2006. Various parties commented on the consultation paper and MAS would like to thank all respondents for their contributions. The respondents are listed in Appendix A.

1.3 We have carefully considered the comments received and incorporated the relevant feedback into the final regulatory framework. Comments that are of wider interest, together with MAS' responses, are set out below. The finalised regulatory framework can be found in Appendix B.

2 SCOPE OF OPERATIONS

2.1 Mono-line requirement

2.1.1 While some respondents supported the requirement for mortgage insurers to operate as mono-line insurers, other respondents commented that given the size of the Singapore mortgage loan market, this requirement may restrict the number of mortgage insurers in the market. Banks would in turn face with having a limited choice of insurers and potentially higher insurance costs, making it unattractive for banks to take up mortgage insurance.

MAS’ Response

2.1.2 We believe that the mono-line requirement is necessary as it helps to focus managements’ attention and expertise and prevents contagion risks of

peak mortgage insurance losses from affecting the interest of non-mortgage insurance policyholders.

2.1.3 We further note that most of the world's leading mortgage insurers are already set up as mono-line insurers due to the requirement in established markets such as the United States, Canada and Australia. Therefore, the mono-line requirement should not be a factor that limits the number of mortgage insurers setting up operations in Singapore if there is sufficient demand for this product.

3 PRUDENTIAL RULES

3.1 Capital

3.1.1 In the consultation paper, we had proposed that mortgage insurers be required to maintain a contingency reserve. The contingency reserve requirement was calibrated according to the treatment in the US such that mortgage insurers are to contribute 50% of the earned premiums each year to the contingency reserve. Each year's contribution must be maintained for 10 years and are released thereafter if there are no claims during this 10-year period. Before the end of the 10 years, these reserves can only be drawn down if the loss ratio from mortgage insurance business in a particular year exceeds 35%.

3.1.2 One respondent asked MAS to consider adopting two other features in the US contingency reserve requirement: (i) to treat contingency reserve as a form of capital that can be used to meet regulatory capital requirement; and (ii) to impose a cap on the contingency reserve required based on the amount of insured risks in force.

MAS' Response

3.1.3 In addition to considering the capital requirements that insurance regulators in other jurisdictions impose on mortgage insurers, we have to also consider our current regulatory treatment of credit-related insurance business.

3.1.4 Therefore, two features in our treatment of contingency reserves maintained by trade credit insurers will be adopted in the mortgage insurance regulatory framework[1]. First, up to 50% of the C1 (insurance risk) risk requirements to be maintained by insurers in respect of a particular insurance fund under the risk-based capital framework can be met using no more than 50% of the contingency reserves set aside in that fund. Next, annual contribution to the contingency reserves need not be made if those reserves exceed 400% of the highest amount of net written premiums in respect of mortgage insurance in the current and previous two years.

3.1.5 As mortgage insurance is new to Singapore, MAS may fine-tune the rules relating to contingency reserves in future as we gain experience in implementing the rules and assess the development of mortgage insurance in Singapore. MAS will also give itself the flexibility to consider appropriate exemptions relating to the contingency reserve requirements under special circumstances.

4 CONDUCT OF BUSINESS RULES

4.1 Effects of mortgage insurance on borrowers

4.1.1 A couple of respondents were concerned that banks may pass on the cost of mortgage insurance to borrowers resulting in an increase in the cost of borrowing. These respondents also requested that banks be required to disclose the amount of mortgage insurance premiums passed on to the borrowers, pass on to borrowers any discount or rebate that banks may receive from mortgage insurers, and allow borrowers to opt out of the mortgage insurance coverage arranged by the banks.

MAS' Response

[1] See "Proposed Modifications to Regulatory Requirements for Trade Credit & Political Risk Insurance Business" (MAS, November 2006).

4.1.2 Currently, banks are required to set aside higher amounts of capital for mortgage loans with a loan-to-value ("LTV") in excess of 80%. To compensate for this higher cost of capital, banks generally charge higher interest rates for such loans.

4.1.3 With the introduction of mortgage insurance, banks may choose to purchase mortgage insurance to reduce the amount of capital they have to set aside for loans with LTV in excess of 80%. It is up to the individual bank to decide whether and what proportion of the cost of mortgage insurance should be passed on to the borrowers. The bank may also decide whether to recover the cost of mortgage insurance through charging the borrower the cost of the insurance or through a higher interest rate for the loan. A borrower who wishes to obtain a mortgage loan with LTV in excess of 80% is free to ask the banks if they are taking up mortgage insurance and the borrower may factor that information into his decision of which bank to borrow from.

5 CAPITAL REQUIREMENTS FOR BANKS USING MORTGAGE INSURANCE

5.1 Requirement for sufficient legal review

5.1.1 One respondent asked if it was necessary for a legal counsel to review all loan documentation and give an opinion on the legal enforceability in all relevant jurisdictions. Another respondent sought clarification on how often MAS expects the periodic reviews of continuing enforceability to be performed.

MAS' Response

5.1.2 MAS expects a bank to ensure that all of its mortgage insurance documentation is subject to proper legal review. In practice, we note that there is usually one master policy for all loans insured by a particular mortgage insurer, in which case, review of that master policy will suffice for loans covered by that policy provided that there are no separate riders or exceptions to the master policy.

5.1.3 A bank is expected to review its legal documentation at least once every 12 months, but in any case no later than 15 months from the previous review.

5.2 Requirement for mortgage insurance contract to be irrevocable

5.2.1 Two respondents highlighted that mortgage insurers typically exclude risks that do not relate to a borrower's credit default risk, or are related to circumstances that are peculiarly within the control of the bank or are directly covered by other types of insurance. In view of this, they proposed that several valid exclusions be allowed.

MAS' Response

5.2.2 We agree that certain non-credit related policy exclusions could be allowed and will modify the requirement as set out in paragraph 2(b) of Appendix B.

5.3 Requirement for the bank to be able to seek repayment from the mortgage insurer in a timely manner

5.3.1 A few respondents sought clarification on what would constitute "timely repayment", particularly in cases where a mortgage insurer is expected to pay claims only after enforcement of collateral has taken place.

MAS' Response

5.3.2 Where a mortgage insurer is expected to pay claims only after enforcement of collateral has taken place, the mortgage insurer should pay claims promptly once the collateral has been realised and the loss has been established. However, if this is not completed before 24 months, the bank must have the right to receive such payments regardless of the status of realising the collateral. In this case, the claim payment will be based on the estimated value of the collateral and a final settlement will occur upon realising the collateral.

5.4 Effects of mortgage insurance

5.4.1 Two respondents asked if it is necessary for a bank to take into account the credit strength of the mortgage insurer when applying the proposed treatment under MAS Notice 637 and the Basel II Standardised Approach.

MAS' Response

5.4.2 For consistency with the Basel requirement for eligible guarantors to have a credit rating of at least A- by Standard and Poor's, A3 by Moody's Investors Service or A- by Fitch Ratings, MAS will require that MI providers to have a credit rating of at least A- by Standard and Poor's, Moody's Investors Service or Fitch Ratings at the inception of the mortgage insurance contract for a loan to qualify for the concessionary treatment under MAS Notice 637 and the Basel II Standardised Approach. Thereafter, the bank can continue to recognise the credit risk mitigation effects of mortgage insurance so long as the MI provider is rated no lower than BBB- by Standard and Poor's, Baa3 by Moody's Investors Service or BBB- by Fitch Ratings.

6 OTHER FEEDBACK

6.1 The rights of mortgage insurers

6.1.1 One respondent requested that regulations be put in place to specifically protect mortgage insurers' right to determine the criteria on which it would provide mortgage insurance products to lenders. The respondent felt that this would enable mortgage insurers to undertake and provide their own rating for each lender and borrower with whom they do business, and create their specific risk profiles in light of the nature of the business.

6.1.2 Another respondent asked if mortgage insurers will have a right to refuse to underwrite the risk of a particular loan.

MAS' Response

6.1.3 We do not feel a need to have regulations to govern insurers' rights vis-à-vis lenders. These matters are best left to the lenders and insurers to deal with when they negotiate the terms of the insurance contract.

6.2 Disclosure to mortgage insurers

6.2.1 One respondent asked about the extent to which a bank's disclosure to the mortgage insurers is allowed taking into consideration Section 47 of the Banking Act on Banking Secrecy.

MAS' Response

6.2.2 In disclosing information on borrowers to the mortgage insurers, banks would have to abide by all the requirements stipulated under Section 47 of the Banking Act and the relevant Schedule, such as the need to obtain the borrower's written consent.

6.3 90% LTV limit

6.3.1 Several respondents requested that MAS allow mortgage insurers to finance the MI premium into the original loan amount and permit the combined LTV to exceed 90% LTV.

MAS' Response

6.3.2 Under MAS' housing loan rules, banks are allowed to disburse housing loans only after borrowers have made the minimum 10% downpayment out of his personal finances. This downpayment serves to deter over-borrowing by purchasers, and reduces potential losses to banks or mortgage insurers in the event of a borrower default.

6.3.3 To preserve the social and prudential objectives of this requirement, financing of the mortgage insurance premium as part of the original loan amount will not be allowed where the aggregate of the insurance premium and the loan amount exceeds the maximum amount of financing permitted under MAS' housing loan rules.

Appendix A

List of Respondents to the Consultation Paper on the Proposed Regulatory Framework for Mortgage Insurance Business

1. Mr. Chia Lee Yen
2. DBS Bank
3. Ernst & Young
4. Genworth Financial
5. NTUC Income
6. OCBC Bank
7. Standard Chartered Bank Singapore
8. The PMI Group
9. United Overseas Bank

Appendix B

Finalised Regulatory Framework for Mortgage Insurance Business

1 MAS will be regulating mortgage insurance business based on the insurance regulatory framework applicable to general direct insurers with additional regulatory requirements to address risks specific to mortgage insurance business. These additional requirements include:

- Mortgage insurers will be required to operate as mono-line insurers;
- The certification of mortgage insurers' policy liabilities will have to be carried out by actuaries approved by the Authority.
- In valuing mortgage insurance liabilities, approved actuaries will be required to make explicit allowance for, and disclose in their valuation reports, key risk drivers such as probability of default by LTV, loss given default and seasoning;
- Mortgage insurers will be subjected to the insurance risk-based capital requirements under the Insurance (Valuation and Capital) Regulations 2004 with mortgage insurance being treated as a business with medium volatility;
- Mortgage insurers will be subjected to a contingency reserves requirement such that they will be required to contribute 50% of the earned premiums each year to contingency reserves (except when the total contingency reserves accumulated exceeds 400% of the highest amount of net written premiums in respect of mortgage insurance in the current and previous two years). Each year's contribution to contingency reserves must be maintained for 10 years and are released thereafter if there are no claims during the 10 year-period. Before the end of the 10 years, the reserves can only be drawn down if the loss ratio from mortgage insurance business in a particular year exceeds 35%;
- In determining the financial resources available to a mortgage insurer, up to 50% of the C1 (insurance risk) risk requirements to be maintained by mortgage insurers in respect of a particular insurance fund under

the risk-based capital framework can be met using no more than 50% of the contingency reserves set aside in that fund;

- Mortgage insurers will not be allowed to deal directly with borrowers in the loan origination process. This prohibition includes, but is not limited to, solicitation of business from and entering into contracts with borrowers; and
- Where a mortgage insurance arrangement creates any obligation on the borrower or confers the mortgage insurer any right against the borrower, the bank is required to disclose to the borrower the following before the commencement of the arrangement: (a) the nature of mortgage insurance; (b) the name of the mortgage insurer; (c) the borrower's rights and responsibilities under the mortgage insurance contract, if any; and (d) any subrogated rights that the mortgage insurer may acquire in the event of the borrower's default and its effects on the borrower.

2 A Singapore-incorporated bank will be allowed to recognise the credit risk mitigation effects of mortgage insurance for a mortgage loan with an LTV of more than 80% but not more than 90% if the following requirements are met.

- The coverage must be provided by an insurer that is registered to carry on mortgage insurance business in Singapore and that is not a related corporation of the bank;
- For banks that calculate their capital requirements based on MAS Notice 637 or the Standardised Approach for Credit Risk under Basel II, the mortgage insurer must have a credit rating of at least A- by Standard and Poor's, A3 by Moody's Investors Service or A- by Fitch Ratings at the inception of the mortgage insurance coverage for a mortgage loan and a credit rating of at least BBB- by Standard and Poor's, Baa3 by Moody's Investors Service or BBB- by Fitch Ratings on an ongoing basis;
- The bank must employ robust procedures and processes to control residual risks such as legal, operational, liquidity and market risks;

- The bank must conduct sufficient legal review to verify and have a well founded legal basis to ensure that all documentation used in documenting the mortgage insurance is binding on all parties and legally enforceable in all relevant jurisdictions, and undertake such further review as necessary to ensure continuing enforceability;
- The bank must ensure that the mortgage insurance coverage complies with the following:
  (a) it represents a direct claim on the mortgage insurer and is explicitly referenced to specific exposures, so that the extent of cover is clearly defined and incontrovertible;
  (b) it is irrevocable[2], i.e. there must be no clause in the contract that would allow the mortgage insurer unilaterally to cancel the coverage or that would increase the effective cost of the coverage as a result of deteriorating credit quality of the housing loan;
  (c) it is unconditional, i.e. there should be no clause in the mortgage insurance contract outside the direct control of the bank that could prevent the mortgage insurer from being obliged to pay out in a timely manner in the event that the borrower fails to make the payments due;
  (d) the definition of a qualifying default/non-payment of the borrower in the mortgage insurance contract should be aligned with that used by the bank;
  (e) the documentation governing the transaction allows the bank to seek repayment from the mortgage insurer for any money outstanding on the qualifying default/non-payment of the borrower in a timely manner. The bank must have the right to receive such payments without first having to take legal action against the

[2] The Authority will not normally regard exclusions relating to the non-payment by the bank of money due in respect of the mortgage insurance contract, and clearly defined non-credit-related events (e.g., exclusions relating to bank negligence and fraud, title defects, physical damage to the collateral, acts of war or rebellion, and claims contrary to law) as a failure to meet this condition.

borrower for repayment of the mortgage loan[3];

(f) it is an explicitly documented obligation assumed by the mortgage insurer; and

(g) it covers all types of payments that the borrower is expected to make under the documentation governing the housing loan; and

- For banks that calculate their capital requirements based on MAS Notice 637 or the Standardised Approach for Credit Risk under Basel II, the mortgage insurance must cover at least the portion of each mortgage loan in excess of 80% LTV at inception of the loan.

3 A bank that meets the requirements may apply a 50% risk weight to these loans under MAS Notice 637. When Basel II is implemented, a bank that meets the requirements may apply a 35% risk weight to these loans under the Standardised Approach for Credit Risk or recognise the credit risk-mitigation effects of mortgage insurance by adjusting PD or LGD estimates of these loans as appropriate under the Internal Ratings-Based Approach.

[3] Where a mortgage insurer is expected to pay claims only after the enforcement of collateral has taken place, the mortgage insurer should pay claims promptly once the collateral has been realised and the loss has been established,. However, if this is not completed before 24 months, the bank must have the right to receive such payments regardless of the status of realising the collateral. In this case, the claim payment will be based on the estimated value of the collateral and a final settlement will occur upon realising the collateral.