CONSULTATION PAPER

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Proposed Regulatory Framework on Mortgage Insurance Business

MAS
Monetary Authority of Singapore

PREFACE

1 Mortgage insurance protects residential mortgage lenders against losses on mortgage loans arising from default by borrowers. In July 2005, MAS announced an increase in the "loan-to-value" ("LTV") limit for housing loans granted by banks from 80% to 90%. In conjunction with this increase, MAS also announced that it is prepared to consider mortgage insurance as an alternative risk mitigant to higher capital charge on loans with LTVs exceeding 80% and that it would study the appropriate regulatory framework for mortgage insurers. This paper sets out the proposed regulatory framework for mortgage insurance business. The paper also describes how mortgage insurance will be treated in the calculation of the capital requirements for locally incorporated banks.

2 MAS invites interested parties to submit their views and comments on the recommendations set out in this consultation paper. Submissions in electronic form are strongly preferred and should be sent via e-mail to the following address: mg_ins06@mas.gov.sg. Written comments should be submitted to:

Insurance Supervision Department
Monetary Authority of Singapore
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Singapore 079117
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All comments should be submitted to MAS by 15 November 2006.

3 Please note that all submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

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1. BACKGROUND

1.1 Mortgage insurance[1] protects residential mortgage lenders against losses on mortgage loans arising from default by borrowers. It is unlike mortgage life insurance which pays off the outstanding mortgage debt if the borrower, being the life insured under the insurance policy, dies.

1.2 In July 2005, MAS announced an increase in the "loan-to-value" ("LTV") limit for housing loans granted by banks from 80% to 90%. In conjunction with this increase, MAS also announced that it is prepared to consider mortgage insurance as an alternative risk mitigant to higher capital charge on loans with LTVs exceeding 80% and that it would study the appropriate regulatory framework for mortgage insurers.

INTRODUCTION OF MORTGAGE INSURANCE IN SINGAPORE

1.3 The key objective of introducing mortgage insurance in Singapore is to provide banks, being the dominant private sector originator of residential mortgages, with another instrument to manage their credit risk exposures. Mortgage insurance mitigates the insured loans' credit risk from bank's portfolio. This provides banks relief in both economic and regulatory capital which in turn increases banks' capacity to undertake new business and optimises their return on equity.

1.4 Mortgage insurance may also introduce better credit risk management practices in the market. Professional mortgage insurers have specialised expertise in assessing credit risks in mortgage loans. They bring to the market their own credit risk assessment methodologies and models and act as a "second pair of eyes" to banks' assessment of credit risks.

1.5 Furthermore, mortgage insurance facilitates the transfer of credit risks from banks to mortgage insurers and, in some cases, the capital markets. This reduces the concentration of mortgage loan risk in the banking system and is therefore advantageous from the systemic stability standpoint.

1.6 Lastly, mortgage insurance may assist in the development of locally-originated mortgage-backed securities. This adds to the variety of financial products being offered in Singapore and is beneficial to the development of a financial centre.

[1] Also known as mortgage guaranty insurance or lenders mortgage insurance.

2 PROPOSED REGULATORY FRAMEWORK FOR MORTGAGE INSURANCE BUSINESS

2.1 To-date, the bulk of the risks of private sector mortgage loans are concentrated in the banks. As such, the regulatory framework for banks' extension of mortgage loans is well developed. However, with the introduction of mortgage insurance, banks will be passing their mortgage loan risks to mortgage insurers. Hence, there is a need to regulate and supervise mortgage insurers so as to avoid regulatory gaps in the financial system.

2.2 In developed economies with matured mortgage insurance markets such as Australia, Canada, United Kingdom and the United States, mortgage insurance business had traditionally been under the purview of insurance regulators and regulated under insurance regulatory frameworks with additional requirements to address risks specific to mortgage insurance business. MAS intends to adopt a similar approach.

SCOPE OF OPERATIONS

Mono-line requirement

2.3 Mortgage insurance business involves primarily the undertaking of credit risks associated with mortgage loans. Profitability of this business therefore has strong correlation with the performance of the economy. Results tend to be highly cyclical with pronounced peaks and troughs. This gives rise to two distinct sets of problems at different points of the economic cycle.

2.4 In good years when profits are high, insurers underwriting mortgage insurance become more susceptible to market pressure to reduce premium rates. This in turn compromises pricing and underwriting standards. On the other hand, empirical evidence showed that profitability of other lines of non-life insurance business tends to deteriorate along with the downturn in the economic cycle - the same time when mortgage insurance losses peak. This exacerbates the risk of failure of insurers that conduct both mortgage insurance and other non-life insurance business. In fact, major distresses in the mortgage insurance industries during the Great Depression in the United States and the early 1990s in the United Kingdom principally involved insurers underwriting multiple business lines.

2.5 To reduce the risk of insurers underwriting mortgage insurance becoming insolvent, the United States, Canada and Australia require such insurers to operate as

mono-line insurers (i.e. to have mortgage insurance as the only line of business). Firstly, this restriction helps focus managements' attention and expertise. As there is no prospect of using profits from other business lines to subsidise mortgage insurance losses, it creates more disciplines and focus for insurers to concentrate on the long-term sustainability and management of the business. This is particularly important given the cyclical nature of mortgage insurance.

2.6 Furthermore, with limited diversification benefits from other business lines, the mono-line requirement prevents contagion risks of peak mortgage insurance losses from affecting the interest of non-mortgage insurance policyholders. Based on the reasons above, a mono-line requirement is preferred.

MAS recommends that mortgage insurers be required to operate as mono-line insurers.

PRUDENTIAL RULES

2.7 Having sound valuation and capital rules is crucial to improving the probability that mortgage insurers will have sufficient resources to meet their obligations when due.

Actuarial valuation

2.8 Mortgage insurers need to adequately provide for their policy liabilities. Insurers are required to conduct annual actuarial valuation of their liabilities in accordance with MAS Guidelines ID1/04. These Guidelines have been drafted quite broadly and do not make reference to particular business lines. To strengthen the reliability of the valuation of mortgage insurance liabilities, actuaries conducting the valuation should consider key risk drivers such as probability of default by LTV, loss given default and seasoning. This in turn encourages mortgage insurers to collect and analyse data in a manner consistent with proper credit risk management.

MAS recommends that certification of mortgage insurers' policy liabilities be carried out by an actuary approved by the Authority.

In addition, it is recommended that approved actuaries 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.

Capital

2.9 Capital requirement is the other key component to insurers' solvency. Ideally, capital rules should be sensitive to credit risks undertaken through mortgage insurance. The Australian Prudential Regulatory Authority adopted this approach and has recently reformed its capital rules for mortgage insurers to better reflect the probability of default and loss given default for loans of different LTVs, seasoning, underwriting process and type of mortgage insurance structure in a catastrophic loss event. The new formula was developed based on extensive analysis of historical default data.

2.10 Given that Singapore does not yet have sufficient local data on the loss behaviour of high LTV loans, it is not possible to reliably calibrate a similar capital model for mortgage insurers operating in Singapore. Approaches based on simplified calculations may therefore be needed.

2.11 Under the prevailing risk-based capital ("RBC") regime applicable to insurers, mortgage insurance business would be considered a business line of medium volatility, akin to the treatment for credit insurance originating in Singapore. Mortgage insurers would be required to set aside capital for insurance risks as a percentage of policy liabilities according to this volatility classification. Mortgage insurers also need to set aside capital for asset risk in accordance with the profile of their investments.

2.12 Additional safeguards are needed to address problems associated with the cyclical nature of mortgage insurance business. As mentioned earlier, profitability of mortgage insurance business is closely linked to economic conditions and has very pronounced peaks and troughs. There is a danger that insurers dealing in this business prematurely distribute profits during good years and leave themselves with insufficient funds to meet peak losses during economic downturns. To address this risk, several insurance regulators impose a contingency reserve requirement ("CRR") on mortgage insurers in their jurisdictions[2] . CRR often extends to other credit risk related insurance business. For example, MAS has already imposed CRR on insurers underwriting credit insurance and financial guarantee insurance.

2.13 In the United States, mortgage insurers are required to contribute 50% of the earned premiums each year to the contingency reserve. Each year's contribution must be maintained for 10 years. Before the end of the 10 years period, these reserves can only be drawn down if the loss ratio from mortgage insurance business in a particular

[2] The most notable of which are the regulators of the United States and Hong Kong.

year exceeds 35%. In addition to preventing premature release of profits during the good part of the economic cycle, such CRR also addresses the pro-cyclicality[3] problem where mortgage insurers can hold less reserve after a peak loss event has occurred.

2.14 The US CRR calibration appears to be appropriate to Singapore. First, as mortgage insurance is new to Singapore, much uncertainty remains over how the loss experience of this line of business will unfold. It would be prudent to adopt the more conservative calibration among jurisdictions imposing CRRs on mortgage insurers. The requirement to hold a portion of each years' earned premiums for 10 years is reasonable considering that the Singapore private residential property market cycle is estimated to be about 12 years[4]. The CRR calibration would be reviewed in future according to the experience of mortgage insurers' underwriting results in both normal and stress years.

MAS recommends that mortgage insurers 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.

In addition, it is recommended that mortgage insurers be subjected to a contingency reserve requirement 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%.

CONDUCT OF BUSINESS RULES

Insurers' interaction with borrowers

2.15 As mentioned earlier, the key objective of introducing mortgage insurance in Singapore is to provide banks with another instrument to manage their credit risk exposures. It is not intended for mortgage insurance to change the existing business model where banks deal directly with borrowers on the granting of mortgage loans. Therefore, it is preferable for mortgage insurers not to deal directly with borrowers (including soliciting and entering into contract with borrowers) in the loan origination

[3] Capital requirements are meant to ensure firms hold adequate resources so that they will remain solvent after the occurrence of a stress event. However, most capital requirements require firms to maintain similar degree of buffer even when a stress event has actually occurred. This often has the effects of (i) forcing firms to raise additional capital when capital is scarce; or (ii) limiting firms' ability to undertaken new business and earn profits to rebuild their financial strength.

[4] Macroeconomic Review, MAS. [July 2002]

process. It helps to keep loan administration simple for all parties involved and minimises the risk of market misconduct issues arising.

2.16 While borrowers are generally not parties to mortgage insurance contracts, lenders' choice to obtain mortgage insurance protection on their mortgage loans may nevertheless have an impact on borrowers. For example, the mortgage insurance contract may provide that the bank will transfer its rights against the defaulting borrower and the related collaterals to the insurer after the insurer pays the claim. Therefore, there should be adequate disclosure to borrowers when their loans are covered by mortgage insurance. Specifically, if a mortgage insurance arrangement creates any obligation on the borrower or confers the mortgage insurer any right against the borrower, the bank should 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) borrower's rights and responsibilities under the mortgage insurance contract, if any; and (d) any subrogated rights that the insurer may acquire in the event of borrower's default and its effects on the borrower.

MAS recommends that mortgage insurers should 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.

In addition, where a mortgage insurance arrangement creates any obligation on the borrower or confers the mortgage insurer any right against the borrower, it is recommended that the bank be 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.

3 CAPTIAL REQUIREMENTS FOR BANKS USING MORTGAGE INSURANCE

QUALIFYING MORTGAGE INSURANCE

3.1 MAS will allow a Singapore-incorporated bank to recognise the credit risk mitigation effects of mortgage insurance for the purpose of calculating its regulatory capital requirement only if the following criteria are met:

- The coverage must be provided by an insurer registered to carry on mortgage insurance business in Singapore;

- 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) other than non-payment by the bank of money due in respect of the mortgage insurance contract, it is irrevocable, 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 borrower for repayment of the mortgage loan;

(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[5].

EFFECTS OF MORTGAGE INSURANCE

3.2 A bank that meets the criteria set out in paragraph 3.1 above may recognise the credit risk mitigation effects of mortgage insurance in the calculation of its regulatory capital requirement as follows:

- Under the existing capital adequacy framework for banks in MAS Notice 637, the bank may apply a 50% risk weight to mortgage loans with an LTV of more than 80% but not more than 90%;

- Under the Standardised Approach for Credit Risk under Basel II, the bank will be allowed to apply a 35% risk weight to mortgage loans with an LTV of more than 80% but not more than 90%; and

- Under the Internal Ratings-Based Approach under Basel II, the bank will be allowed to recognise the credit risk-mitigation effects of mortgage insurance by adjusting PD or LGD estimates as appropriate.

MAS recommends that a Singapore-incorporated bank be allowed to recognise the credit risk mitigation effects of mortgage insurance for a mortgage loan with an LTV of more

[5] For example, a bank that has granted 2 mortgage loans – one with an 85% LTV and another with a 90% LTV – must ensure that its mortgage insurance would allow it to recover at least 5.88% of the value of the 85% LTV loan (or 5% of the value of the underlying property at origination) and at least 11.11% of the value of the 90% LTV loan (or 10% of the value of the underlying property at origination) should the loans default.

than 80% but not more than 90% if the requirements set out in paragraph 3.1 above are met.

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.

4 SUMMARY OF RECOMMENDATIONS

4.1 MAS proposes to regulate 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 reserve requirement such that they will be required 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 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%;
- 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.

4.2 MAS proposes that a Singapore-incorporated bank 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 requirements set out in paragraph 3.1 above are met. 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.

Monetary Authority of Singapore