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U.S. Mortgage Insurers' Credit Quality Benefits From Improved Macroeconomic Conditions

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*(**Editor's Note:** We're republishing this article published earlier today for technical reasons. No content has changed.)*

Improved macroeconomic conditions, more capital, and significantly better operating performance during recent fiscal quarters have resulted in higher credit quality for U.S. mortgage insurers (MIs). Although the sector suffered from 2007 to 2013 because of large operating losses and reduced capitalization, recently higher home prices and employment levels have helped prospects. Still, uncertainty remains regarding regulatory reform of lending practices and housing finance.

Table 1

U.S. Mortgage Insurers Ratings As Of June 1, 2014

	Financial strength rating/outlook (as of June 2013)	Current financial strength rating/outlook
United Guaranty Residential Insurance Co. (UGC)	BBB/Stable/--	A-/Stable/--
Mortgage Guaranty Insurance Co. (MGIC)	B/Stable/--	BB/Positive/--
Genworth Mortgage Insurance Corp. (GMICO)	B/Stable/--	BB-/Positive/--
Radian Guaranty Inc. (RDN)	B-/Stable/--	BB-/Positive/--
Arch Mortgage Insurance Co. (Formerly CMG)	BBB-/Negative/--	BBB+/Stable/--
Essent Guaranty Inc.	BBB+/Stable/--	BBB+/Stable/--

Note: Ratings reflect operating company ratings.

The U.S. Economy Is Likely To Continue Its Recovery

Macroeconomic conditions, including the labor market and housing fundamentals, continue to improve. Standard & Poor's Ratings Services' baseline scenario forecasts the unemployment rate decreasing to 6.45% in 2014 and 5.95% in 2015, and year-over-year increases in housing sales and starts. We do not expect any major roadblocks to the current recovery of the U.S. economy.

Table 2

2014-2015 Scenarios For The U.S. Homebuilding Industry

	--FORECAST/SCENARIOS*--						
	--Pessimistic--		--Baseline--		--Optimistic--		
	--March--		--May--		--March--		Actual
	2014	2015	2014	2015	2014	2015	2013
Macroeconomic indicators							
Real GDP (% change)	1.17	1.57	2.46	3.17	3.51	4.07	1.88
Households (mil.)	122.77	124.36	122.28	123.76	123.14	125.02	121.41
Yearly % change	1.12	1.29	1.13	1.21	1.43	1.53	1.18

Table 2

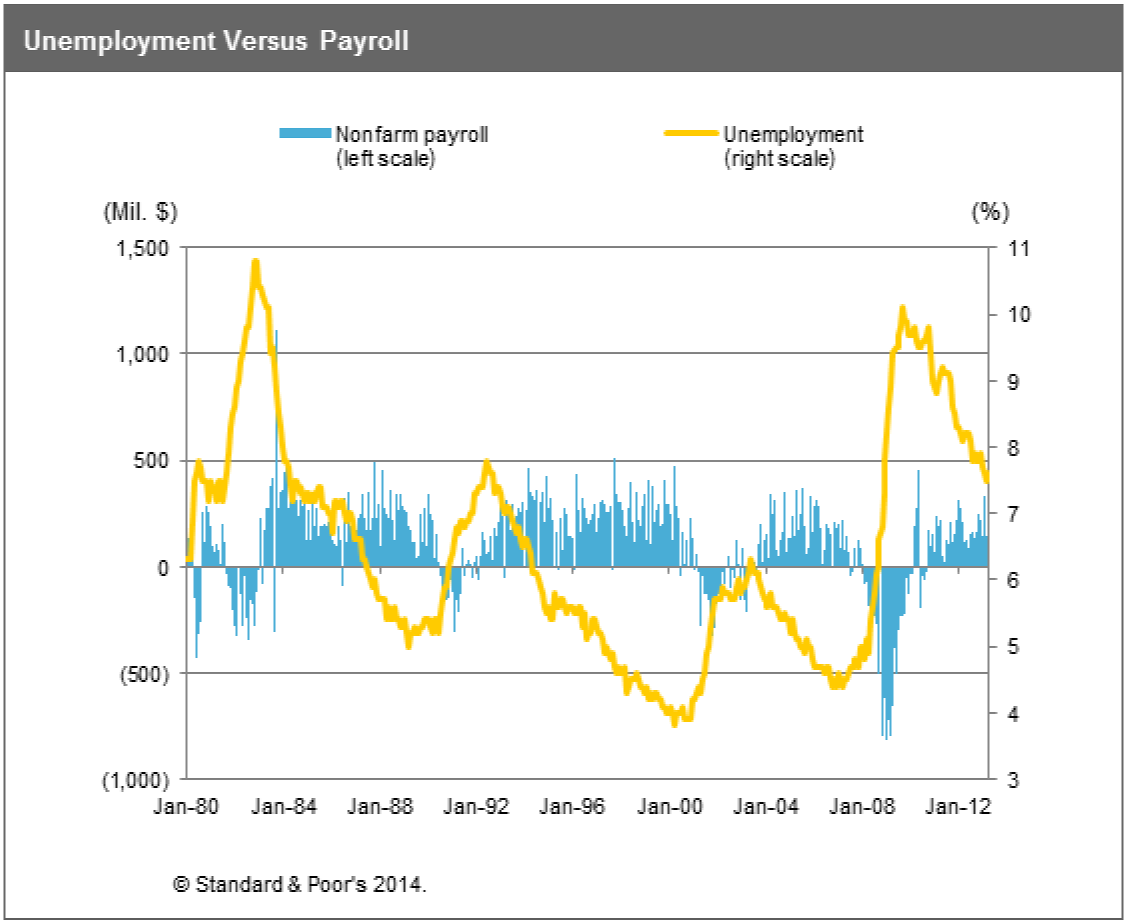
2014-2015 Scenarios For The U.S. Homebuilding Industry (cont.)							
Total nonfarm payrolls (% change)	1.35	1.21	1.82	1.97	2.03	3.06	1.69
Unemployment rate (%)	7	7.06	6.45	5.95	5.83	4.79	7.35
Household net worth, 2005 ($)	76,111.66	76,395.33	76,075.89	77,666.97	78,602.88	79,801.77	74,916.83
Real personal income (% change)	1.5	2.17	2.19	3.92	2.66	5.54	1.7
Consumer sentiment	77.67	78.86	86.03	92.07	87.67	102.03	79.21
30-year fixed mortgage rate (%)	4.38	4.53	4.5	5.01	5.04	6.56	3.98
Existing single-family home sales (mil. units)	4.35	4.71	4.4	4.92	4.56	4.92	4.47
Median single-family existing-home price ($ 000s)	195.09	191.65	198.54	197.94	198.01	197.64	195.93
Total housing starts (mil. units)	0.92	1.04	1.03	1.38	1.13	1.57	0.93
Single-family housing starts (mil. units)	0.59	0.69	0.69	0.93	0.78	1.08	0.62
Multifamily housing starts (mil. units)	0.32	0.35	0.34	0.45	0.36	0.49	0.31
New home sales (mil. units)	0.45	0.56	0.47	0.61	0.53	0.7	0.43
Median new home sale prices ($ 000s)	259.94	256.49	266.78	264.15	263.45	247.36	264.6

*Pessimistic and optimistic forecasts are from "U.S. Risks To The Forecast," published on RatingsDirect. Baseline forecast from the U.S. monthly forecast report. PPI--Producer Price Index. S&P U.S. economic team's forecasts are constructed using the Global Insight model of the U.S. Economy. Industry economic table population process maintained by Quality Data Analytics.

Mortgage Bankers Association projects mortgage originations to drop to $1.05 trillion in 2014 from $1.75 trillion in 2013. This will be partially offset by purchase transactions that we expect to be as high as 60% of the total originations. This should lead to the origination of mortgages with higher loan-to-value ratios (LTVs; more than 80%), providing more new business to private MIs and limiting the impact of lower originations.

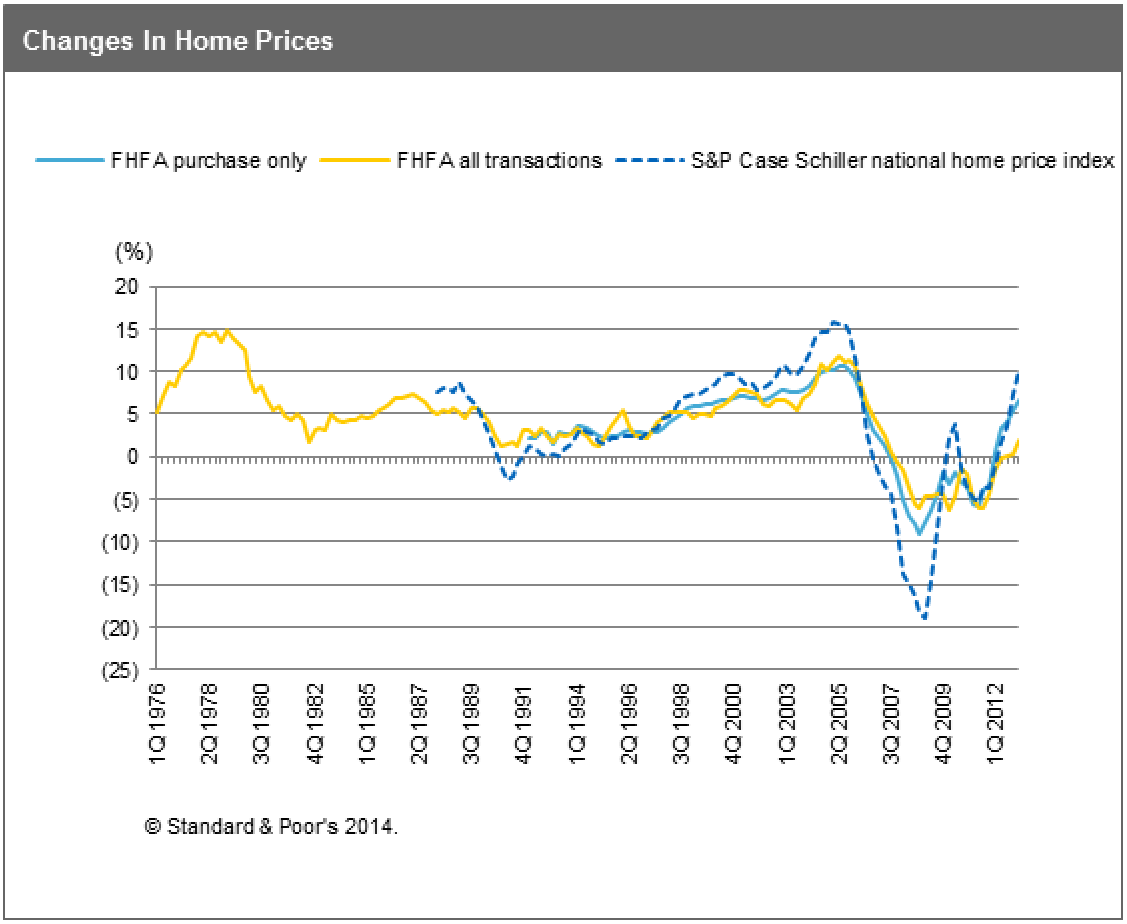
The U.S labor market has improved significantly during the past couple of years. The current unemployment level of 6.3% is the best we have seen since the financial crisis. The growth in payrolls has been significant, too. Lower unemployment rate and higher payrolls not only reduce the probability of default among borrowers but also provide an impetus to new homeowners in the form of larger equity.

Chart 1



The stimulus provided by the labor-market recovery has translated into higher home prices and more home sales. U.S. home prices increased for seven consecutive quarters until fourth-quarter 2013, and the S&P Case-Shiller home price national index grew 11%, aided by higher demand from home buyers and limited inventory. Supplementing the home price gains were the new and existing home sales, which rose by 17% and 9%, respectively.

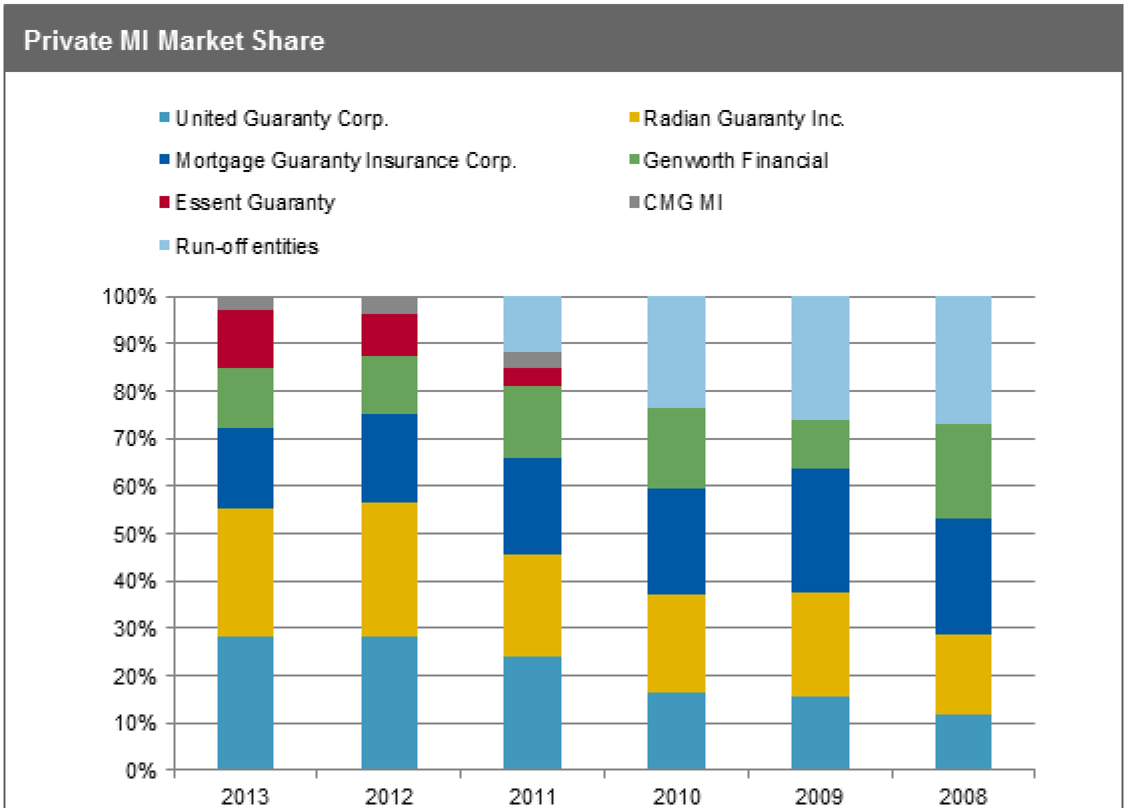
Chart 2



Competition Among Private Mortgage Insurers Remains High

Recently we have seen MIs increase transparency and more closely align terms of coverage via master policy agreements with Fannie Mae and Freddie Mac (the government-sponsored entities [GSEs]). Also, most industry participants followed recent price reductions initiated by a single private MI. More private MIs are also offering lower-priced single-premium policies in addition to the industry's standard monthly payment policies to increase market share with some lenders.

Chart 3



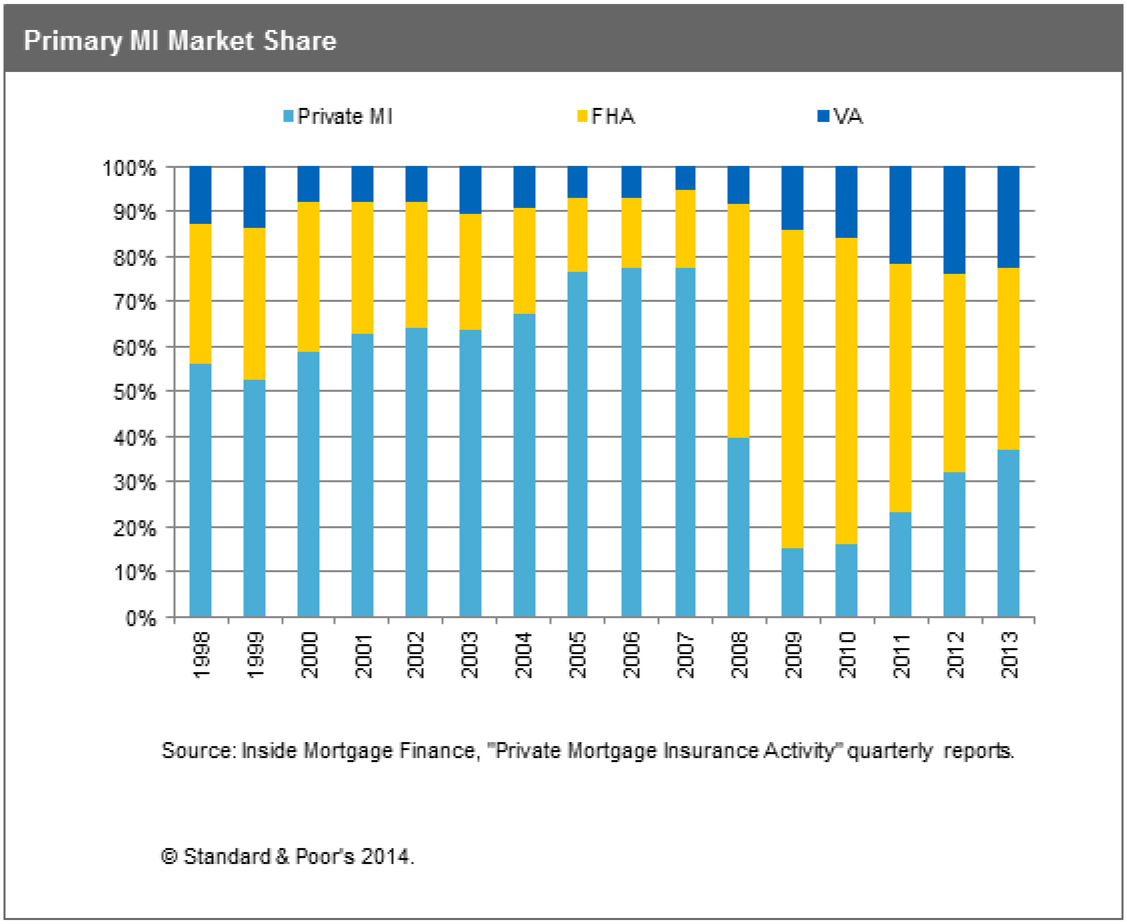
2011 and previous years' data include HARP transactions. Source: Inside Mortgage Finance.

The current origination market is made up of a much narrower credit spectrum by credit score, LTV, and type of loan than before the financial crisis. Higher loan quality is also being driven by the issuance of Qualified Mortgage (QM) rules, which have raised the underwriting standards for extending a loan to a borrower. As a result, differentiation on the basis of pricing and terms and conditions is likely to remain muted for the private MIs in the near future; however, there are still variances in offerings. Therefore, the private MIs will look to differentiate themselves on other factors such as customer service, turnaround time, and general ease of doing business.

Private MIs' market share is on the rise

MIs continue to compete closely with the Federal Housing Authority (FHA) and Veteran Affairs as providers of mortgage insurance. The FHA's market share substantially exceeded private MIs' aggregate participation during the most recent loss cycle. Private MIs' market share of insured mortgages declined to a low of approximately 12% as of year-end 2009 from a high of 77% in 2007 due to the stringent underwriting guidelines the MIs implemented as they attempted to manage exposure and capital. The FHA increased its market share to 75% from 17% during the same period. Recently, private MIs have regained some of the share lost, as the FHA cedes market share via pricing increases and tightened underwriting standards, making private MI product offerings more attractive. The FHA's market share contracted to approximately 40% as of year-end 2013 versus 38% for private MIs. The FHA's pull-back should provide more opportunities for private MIs, but this could reverse if political pressures for the FHA to stimulate affordable housing result in lower premiums.

Chart 4



GSE reform will influence the future of private MIs

In the current origination market, private MIs rely heavily on GSEs for their competitive position. The GSEs currently will not purchase any mortgage that has a LTV of more than 80% without some form of credit enhancement, such as private mortgage insurance. However, GSE reform remains a hot topic in Washington and could have a significant effect on the industry's longer-term business model. It is critical to all MIs' competitive positions that they maintain their ability to insure loans that are sold to the GSEs because GSEs purchase the majority of loans from banks. GSEs have also used other means of transferring mortgage credit risk to private investors, such as structured agency credit risk debt notes.

The GSEs make periodic payments of principal and interest to the investors. Risk-sharing between GSEs and other private capital is also facilitated through agency credit insurance structures; however, the GSEs also are working with non-private MI entities to provide the insurance. In the global property/casualty reinsurance market, capacity is abundant as a result of benign losses and increased capital from institutional investors searching for higher yields and diversification in a low interest rate environment. With non-private MI entities taking on mortgage credit risk, competition in other avenues for the private MIs could increase as well. We are closely monitoring the GSE developments and the qualified residential mortgage and qualified mortgage debate in Washington.

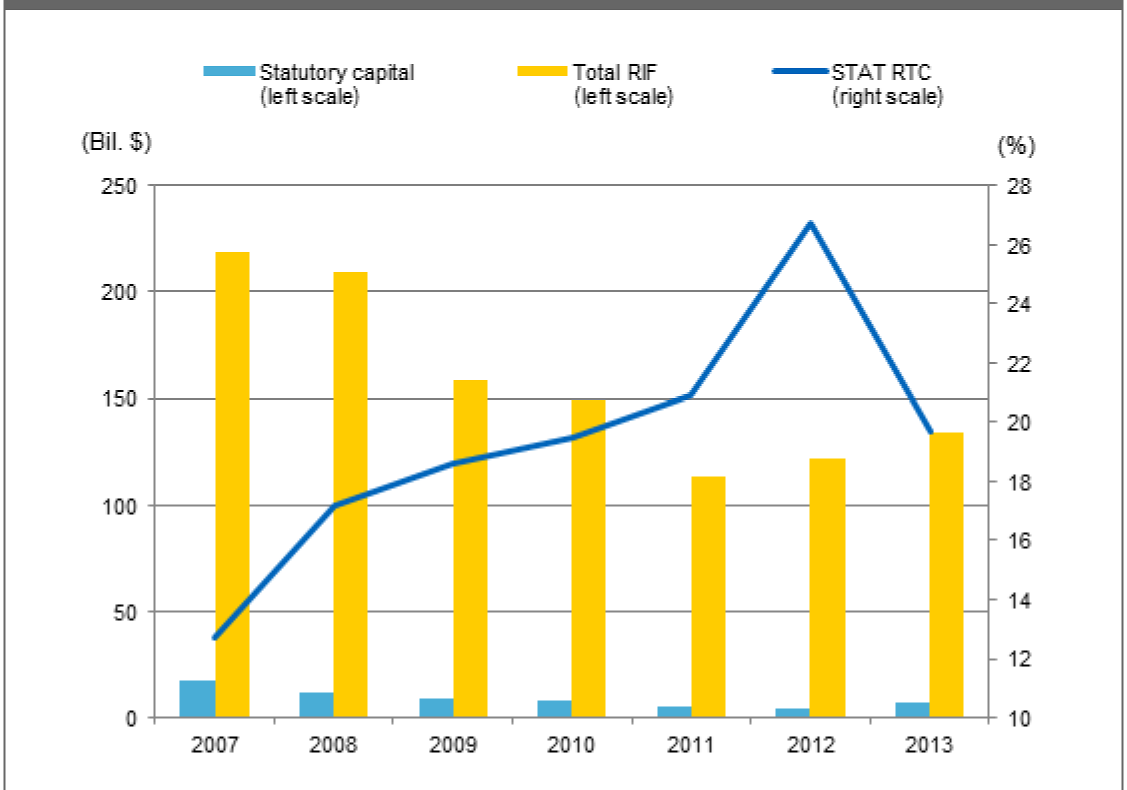
Stricter Capital Requirements Are On The Way

The GSEs and the state regulators are developing stricter capital requirements for the MIs. Various proposals are being considered, including lowering the permissible risk-to-capital (RTC) ratio. We expect final regulations in the second half of 2014, with an initial indication of the regulatory requirements in the upcoming months. If the regulations are unfavorable, MIs could have to lose their competitive position and the possibility of raising external capital to remain in compliance with the new requirements.

Apart from reforms of the capital requirements, the Federal Housing Finance Agency, conservator of the GSEs, plans to wind down the GSEs to facilitate the come-back of private capital in the industry. Therefore, in the near future we could see the reemergence of private-label mortgage-securitization issuances. Therefore, MIs that currently rely heavily on the GSEs will have more opportunities to differentiate their competitive positions. Despite the reemergence of private-label issuances, the regulatory reforms of the underwriting for QM-compliant loans (which predefine a borrowers' ability to repay--could maintain high standards despite the GSEs' diminishing presence.

Chart 5

Industry Risk-To-Capital Ratio Trend Line



As of the end of 2012, the unadjusted industry average RTC ratio was a high 26.7x, as the previous loss cycle led to capital erosion and more risk of regulatory intervention. This excludes the impact of PMI Group, which reported a RTC of 56x prior to being placed into receivership, and Republic Mortgage Insurance Corp., which reported a RTC ratio of 72x before going into runoff in late 2011. Nevertheless, by year-end 2013 the industry average RTC ratio had fallen to 19.7x because of additional capital raises, enhanced reinsurance programs, and positive earnings bolstering capital.

During 2013, while some MIs accessed the capital markets to raise additional funds, another underwent restructuring leading to capital infusions from its parent. Concurrently, the MIs began to lower the risk on their books through higher coverage from private reinsurers. Furthermore, the industry's capital gained strength organically, backed on one hand by fading losses from legacy books and on the other by capital-accretive business written after 2009, which accounted for the majority of the risk portfolio.

Mortgage Insurers Can Expect Strong Short-Term Performance

As the private MI sector continues to adapt to changes in the regulatory and macroeconomic environment, we believe certain aspects of the residential mortgage industry will help MIs' 2014-2015 operating performance.

For legacy private MI players, significantly fewer incurred losses in their portfolios will give a boost to operating performance. As the macroeconomic environment continues to improve, delinquency rates will fall from current levels. In addition, higher cure rates are reducing legacy insurers' default inventory as foreclosures become less prevalent. This, in turn, is reducing late-stage delinquencies, which results in reserve releases on their existing default inventory. We estimate that the ratio of delinquency notices to claims will revert to historical levels, much less than the 20%-25% during the financial crisis.

Private MIs' future revenue and profitability depends on the growth of their in-force book and the absolute earnings generated by their existing in-force portfolio. These factors differentiate de-novo mortgage insurers that depend on new insurance for growth from their legacy counterparts that maintain a significant amount of insurance in force. New-insurance-written (NIW) generation has been lower for the industry as a whole since the end of 2013. In 2014 we expect total mortgage origination to drop to $1.1 trillion from $1.8 trillion in 2013 due to the shift to new-purchase originations from refinancings (which tend to accelerate and occur in a lower-rate environment).

This may limit premium generation for de-novo insurers given their recent start-up characteristic and lower insurance-in-force (IIF) balances. Legacy MI players, however, will benefit from higher persistency rates (i.e., the percentage of insured business that remains on an insurer's books for 12 months) following the shift in mortgage interest rates, which we expect to continue through 2014-2015. Higher persistency will leave older (higher interest rate) insured policies in the insured portfolio longer as borrowers have no incentive to refinance. Although NIW affects an MI's future earnings potential, a 1% increase in persistency would benefit legacy MIs more than de-novo MI entrants because of legacy MIs' significant IIF balances. The retention of in-force policies offsets lower NIW and helps operating performance. This is because of the better loss experience on post-2008 vintages, higher premiums earned in years two-to-four of an insured policy, and higher premium yields on policies written on monthly and single-premium during 2009-2012. Nevertheless, persistency rate gains on established IIF portfolios may overshadow the de-novo players' efforts to acquire market share in a lower mortgage-origination environment.

Despite lower overall mortgage originations due to the shift to more new home purchases in a rising mortgage rate environment, we believe that, overall, the MI sector will benefit. We believe that new-purchase mortgages have higher average loan balances than refinancings, especially given their generally higher LTVs, prompting the need for mortgage insurance. Higher insured mortgage amounts, higher new-purchase LTVs, and the higher home prices can only benefit the MI industry.

The Future Looks Bright

We expect the high-quality NIW and improvement in the U.S. housing market and economy to result in near-term profitability and capital accretion for MIs. As earnings improve, older riskier loans roll off, and capital continues to build, we expect MIs' credit quality to improve. Although we do not foresee a recession in our base-case U.S. economic forecast, if one were to occur, the declining notices-of-default trend could reverse and claim frequency could increase to an extent that would prevent MIs from raising or generating enough capital to continue writing business through the downturn. While the regulatory environment remains uncertain, current proposals call for MIs' future participation in U.S. housing finance. Assuming the private MIs can meet any new capital requirements and continue to operate, the sector should benefit.