Moody's
INVESTORS SERVICE

INDUSTRY OUTLOOK

US Mortgage Insurers: Negative Outlook

Table of Contents:

SUMMARY OPINION 1
OPERATING ENVIRONMENT 2
KEY FINANCIAL PERFORMANCE TRENDS 4
Operating Results Hurt By Protracted Mortgage Losses 4
Limited Recapitalization Opportunities Exacerbate Capital Level Erosion 6
COMPETITIVE ENVIRONMENT AND BUSINESS MODEL SUSTAINABILITY 7
Stronger Players May Benefit From Reduced Competition 7
Business Model Sustainability Remains Uncertain 8
MOODY'S RELATED RESEARCH 9

Analyst Contacts:

NEW YORK 1.212.553.1653

Ilya Serov 1.212.553.2864
Vice President-Senior Credit Officer
ilya.serov@moodys.com

Helen Remeza 1.212.553.2724
Vice President – Senior Analyst
helen.remeza@moodys.com

Ranjini Venkatesan 1.212.553.3686
Assistant Vice President
ranjini.venkatesan@moodys.com

Stanislas Rouyer 1.212.553.3684
Associate Managing Director
stanislas.rouyer@moodys.com

Yazhe Ren 1.212.553.1370
Associate Analyst
yazhe.ren@moodys.com

Moody's has revised its outlook for the US mortgage insurance industry from 'developing' to 'negative'. The outlook change reflects continued weak financial performance of the insurers, their weak economic and regulatory capital position and material uncertainty with regard to the ultimate magnitude of mortgage insurance losses embedded in their portfolios. In addition, given the uncertain evolution of housing finance reform, the long-run sustainability of the companies' business models remains unclear.

Summary Opinion

For US mortgage insurers, 2011 was characterized by protracted mortgage losses, erosion of their capital bases and, in some instances, regulatory takeover. The ongoing weak performance and uncertain future prospects have led us to lower the ratings of four of the six companies in the sector. We have also changed our outlook for the US mortgage insurance industry from developing to negative.

The change in outlook reflects the following economic and regulatory dynamics:

» **Housing market performance continues to disappoint.** Although delinquencies appear to have peaked, the recovery is anemic. We expect home values to be relatively flat with some potential for further decline. As such, in our view, underwater mortgages – and the accompanying risk of elevated defaults - are going to remain a feature of the market for the foreseeable future.

» **Financial performance remains weak.** The mortgage insurers have been unable to mitigate losses from legacy vintages through new production, with volumes declining sharply during the 2007-09 financial crisis and remaining substantially lower than pre-crisis levels since. Capital and liquidity positions remain precarious with some companies breaching regulatory requirements and some under regulatory supervision (leading to a cessation of new business origination and a deferral of part of their claims due).

» **Long-term business model sustainability is unclear**. While solvent MIs enjoy continued regulatory and counterparty forbearance (with better-capitalized firms continuing to write new business), there is limited visibility about the long-term demand for private mortgage insurance. Uncertain dynamics of the mortgage finance market, including the outcome of the government's evaluation of changes to government-sponsored enterprises (GSEs) and the role of mortgage insurers in the mortgage finance market are material long-term concerns.

At the same time, we recognize that, - should the industry successfully navigate its current challenges - there are some longer-term, emergent positives: (a) better -capitalized firms may benefit from limited competition going forward; (b) new business production is more profitable than in the recent past due to higher premium rates, and is of lower risk due to tighter underwriting standards; (c) although the degree of regulatory forbearance in the near term is unclear, the government appears to be in principle supportive of the industry; and (d) housing market conditions may be reaching a bottom with some macro indicators, such as housing affordability, at or better than historical averages.

The negative sector outlook represents our view of the fundamental factors facing mortgage insurers over the next 12 to 18 months and provides a framework against which we consider issuer-specific ratings. We expect that the above dynamics will have an uneven effect on insurers, particularly with respect to companies supported by their parents, and/or enjoying higher capital levels. Larger and better-capitalized companies are better positioned to meet the headwinds facing the sector.

TABLE 1

Mortgage Insurer And Parent Company Ratings

Company	Insurance Financial Strength Rating (Mar 7, 2012)	IFSR Outlook (Mar 7, 2012)
Genworth Mortgage Insurance Corporation	Ba1	Negative
Mortgage Guaranty Insurance Corp. (MGIC)	B1	Negative
PMI Mortgage Insurance Co.	Caa3	Negative
Radian Guaranty Inc.	Ba3	Under Review for Downgrade
Republic Mortgage Insurance Company (RMIC)	Withdrawn	n/a
United Guaranty Residential Insurance Co. (UGRIC) *	Baa1	Stable

*UGRIC's rating reflects the benefit of a net worth maintenance agreement provided by American International Group (AIG, senior unsecured rating Baa1, stable outlook), and inter-company reinsurance agreements.

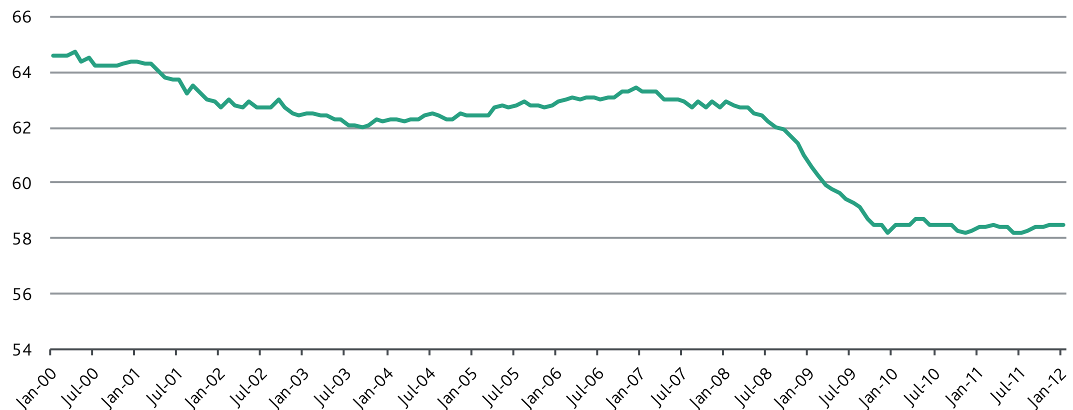
Operating Environment

The tepid macroeconomic recovery, difficult housing market conditions in the US, and material downside risks emanating from the Eurozone crisis continue to present the mortgage insurers with a challenging operating environment.

We expect little movement in overall macroeconomic conditions in 2012, with the GDP growth rate in the 1.5-2.5% range. This compares with a 2011 estimate of 2.5-3.5%. Given these growth dynamics, the recovery in the labor market continues to be anemic. The recent stronger employment reports are yet to establish a pattern and we expect unemployment to remain in the 8-9% range through the year[1]. We also note that with labor participation rates continuing to dwindle, the employment-to-population ratio has been relatively stable over the recent past, and remains at exceptionally low levels (see Figure 1). Consequently, we remain cautious regarding trends in mortgage delinquency and default rates, and expect an only moderate improvement in these through 2012.

[1] See ' Moody's Global Risk Perspectives, Global Macro-Risk Outlook 2012-2013: Further Slowdown in Growth and Increase in Uncertainty, February 2012

FIGURE 1
Employment-to-Population Ratio



Source: Federal Reserve Bank of St. Louis

At the same time, macroeconomic risks remain elevated. Late in 2011, we revised downward our growth estimates for most G-20 economies, including the US[2]. The revision was prompted in part by global financial market turbulence, fiscal consolidation efforts and deleveraging in the banking sectors in the euro area and in the US. In particular, a high risk of further shocks in Europe persists, including economic shocks emanating from a further deterioration in growth, political turmoil arising from opposition to austerity programs, and financial shocks given the fragile confidence in the European banking sector. A recession in the Eurozone may have spillover effects to the US economy. Other impactful downside scenarios include the risk of a hard-landing in China, and a flare up in the Middle East that may result in an oil-related supply-side shock.

However, the central issue faced by the US economy and, most directly, by the rated mortgage insurers is the persistently difficult conditions in the housing market. A weak housing sector through 2012 is likely to continue to be a drag on economic growth. We expect home values to be relatively flat with some potential for further decline (see Figure 2)[3]. Feedback loops between weak housing and the tepid labor market conditions described above restrict housing demand (despite greater affordability and all-time low mortgage rates) and remain a key concern.

FIGURE 2
US Home Prices

Source: National Association of Realtors

2 Moody's Global Risk Perspectives, Global Macro-Risk Outlook 2011-2012: Material Slowdown in Growth, 11 November 2011
3 Ibid

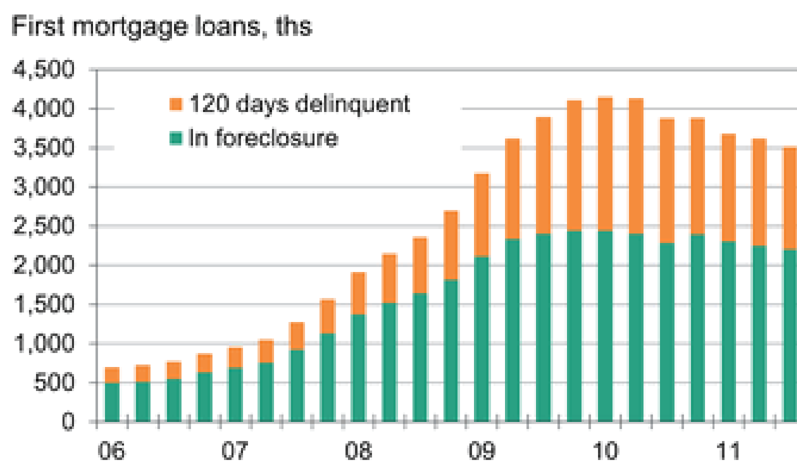
We note in particular:

» Home sales remain stuck near the 5.2 million annualized pace that they have averaged over the last 18-24 months. Homebuilding is also slow with housing starts near record lows.

» The very large proportion of severely underwater borrowers (those more than 20% of negative equity) and a significant backlog of foreclosure properties will delay the return to lower, long-term delinquency rates. Moody's Economy.com estimates that about 3.5 million home are 120 days or more delinquent or already somewhere in the foreclosure process (see Figure 3)[4].

FIGURE 3

Substantial Backlog of Foreclosures



Sources: Equifax, Moody's Analytics

» Past government-sponsored refinancing programs have had spotty success. The renewed focus on these programs in recent weeks (including changes to the Housing Affordable Modification Program or HAMP program and benefits flowing through the State Attorney-Generals' settlement with a number of mortgage servicers) will make available about $20 billion to reduce the principal on distressed home loans. However, given the foreclosure pipeline and the likely implementation period of the refinancing programs, we expect them to have a positive longer-run, but a subdued short-term impact.

Whilst we expect the longer-term outlook for the housing sector to be stronger, with growth in house prices in 2013 and 2014, in the short-term, the conflation of the above factors will continue to constrain US mortgage insurers' rating profiles.

Key Financial Performance Trends

Operating Results Hurt By Protracted Mortgage Losses

Although new delinquency trends appear to have broadly stabilized during the course of 2010 and 2011, this is yet to have translated into materially improved financial performance of the rated mortgage insurers. After a number of years of severe stress, the companies have posted another year of negative net income in 2011, with some firms reporting considerably worse results than in prior years.

[4] U.S. Housing Outlook: A New Dawn Coming?, December 2011

As Figure 4 shows, net incurred mortgage losses[5] for rated mortgage insurers rose from approximately $1.4 billion in 2005 to $11.2 billion in 2008. Equally, net income reached a trough of negative $6.2 billion in 2008. Operating results showed some improvement through 2009-10. However, the $5.5 billion of mortgage losses (incurred up to the end of Q3 2011, and as compared with $6,9 billion for FY 2010), and the $3.3 billion net loss number point to a stalling in the improvement in the housing sector.

FIGURE 4
Rated Mortgage Insurers' Statutory Operating Results

Source: Company reports, Moody's

The greatest part of the worsening results can be attributed to PMI and RMIC, which posted a combined net loss of $2 billion (up to Q3 2011). The remaining four rated mortgage insurers reported net incurred mortgage losses of $3.5 billion and an overall net loss of $1.3 billion, compared with $4.9 billion and $1.8 billion respectively in 2010, an approximately 30% year-on-year improvement.

Underlying the overall trend is the overhang of losses stemming from the insurers' 2005-07 portfolios. For weaker players, such as PMI and RMIC, increased claims incidence and lower profitability metrics reflect the nature of these companies' portfolios (i.e. an excessive exposure to riskier segments of the market such as the Sand States, including Florida, California, Nevada, and Arizona) as well as a significant decline in their investment income, as invested assets fell.

Albeit delinquencies appear to have peaked, we expect incurred losses to remain elevated over the next few quarters due to both new delinquencies and the aging of the current delinquent portfolios. Over the medium term, although the run-off of the legacy risk-in-force will serve to improve the quality of the portfolios, ultimate losses across the industry remain subject to substantial uncertainty due to the volatility in house price trends, uncertainties surrounding the success of loan modification programs, and the continued weakness of the US economy.

In addition, all companies have found it difficult to offset losses via new production. Although new business production is more profitable than in the past (due to tighter underwriting standards and higher premium rates), overall volumes are subdued and remain sharply lower than pre-crisis levels. As Figures 6 and 7 illustrate, private mortgage insurers have seen a severe decline in their overall market share with the FHA now accounting for close to 85% of the sector.

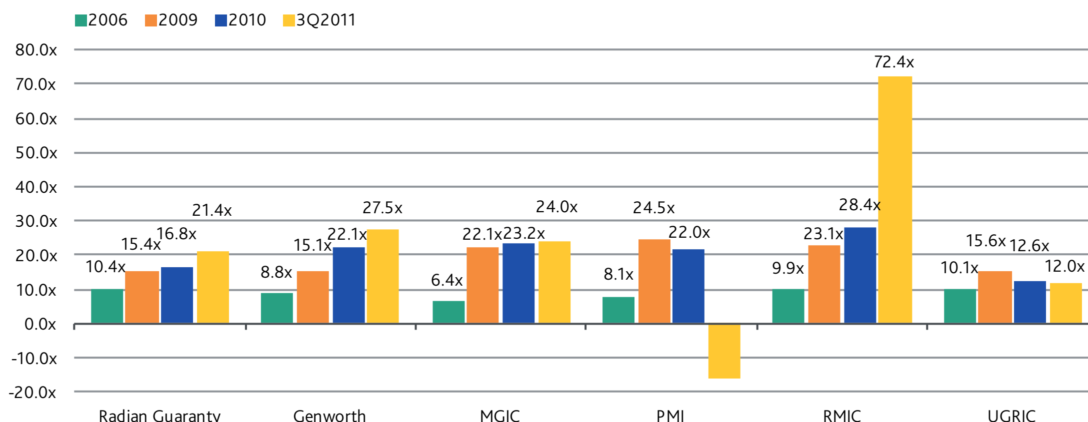
[5] Incurred losses are related to the establishment of reserves for the delinquent inventory using estimated claim rates, claim amounts, and offset by the benefit of captive reinsurance. Reserves are not an accurate measure of remaining losses, as future losses from loans that have not yet gone delinquent are not considered.

Limited Recapitalization Opportunities Exacerbate Capital Level Erosion

Continued losses and limited access to new capital have considerably weakened capital positions. Figure 5 provides the risk-to-capital metric development through 2009-11 for rated mortgage insurers, relative to their pre-crisis positions.

FIGURE 5

Regulatory Risk-to-Capital



Note: UGRIC's risk-to-capital metric is not publicly available. PMI was taken over by the regulator in Q4 2011.
Source: Company reports

In a number of instances, regulatory capital metrics rose to close to or above the minimum required levels (often a risk-to-capital ratio of less than 25:1). Lead regulators, and most other state regulators, have generally tended to exercise forbearance where it is seen as allowing the firms to replenish their capital profile. However, where the insurer's liquidity position is seen as highly stressed due to the mismatch between the front-loaded claims and the future premium income, or when there are additionally concerns about solvency, regulators have taken action.

Notably, PMI and RMIC were put under regulatory supervision by their State regulators in October 2011 and January 2012, respectively, and are now in run-off and deferring a portion of their claims due. Supervisory orders require the two companies to make cash payments for only 50% of presented claims with the remaining portion of the claim covered by deferred payment obligations. This reflects the view that while claims will outpace premium income in the near term, premium income in later years is expected to be sufficient to cover both pending and current claims. While the timing and ultimate recovery under the deferred obligations are unclear due to the lack of clarity about ultimate losses and weak housing market trends, the regulatory action helps the two companies preserve their liquidity in the high claims-payment phase.

In other cases, such as Genworth, which has breached the minimum regulatory ratio, or Radian Guaranty and MGIC, whose capital bases continue to erode (placing the minimum regulatory ratio at risk), the companies essentially rely on forbearance from both their regulators and the GSEs to continue to write new business. They have also received some capital contributions from their parent holding companies.

Given the erosion of their capital levels, a key area of focus in our analysis has been the ability of the rated mortgage insurers to replenish capital. In our view, full re-establishment of credible, long-term credit profiles requires sizeable capital. However, access to capital markets remains problematic. Investors are reluctant to provide new capital in the absence of greater clarity regarding (a) ultimate loss levels; (b) long-term demand for mortgage insurance; and (c) acceptance by the GSEs of the newly-established 'good insurer' entities.

Some companies have established separately capitalized subsidiaries to write new business in States where regulatory waivers have not been granted to the lead insurer. The GSEs have supported such entities if they are subsidiaries of the lead insurer and limit themselves to writing business in states that did not grant the waiver. Insurers' request to write new business out of a sister company of the legacy insurer have not been approved by the GSEs whose main focus appear to be on maintaining access, even if indirect, to the income from the insurer's new production to subsidize the older vintages.

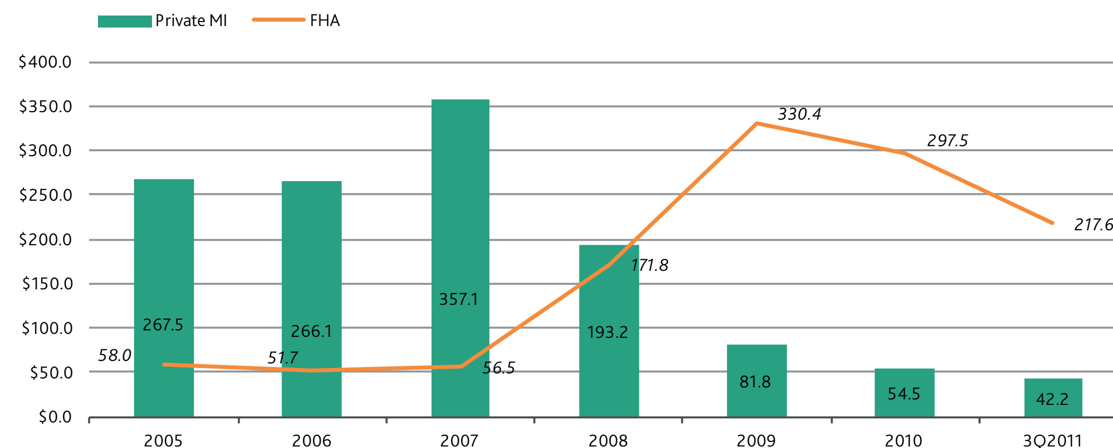
However, GSE's position may get relaxed over time as visibility on ultimate losses and legacy insurers' solvency, improves and as the GSEs shift their focus to the credit enhancement of new production. The capitalization of a sister company of the legacy insurer, in a "good bank-bad bank" structure, while negative for the legacy insurer's counterparties, would be positive for new counterparties as well as holding company shareholders and creditors: such entity could be capitalized a fraction of the capital needed to cover the risks of both new production and legacy portfolios and it would upstream dividends directly to the holding company, bypassing the legacy insurer.

Competitive Environment and Business Model Sustainability

Stronger Players May Benefit From Reduced Competition

The private mortgage insurance sector remains at a competitive disadvantage relative to alternative source of credit enhancement. Given the attrition of capital cushions and uncertainties surrounding the companies' ability to pursue new business, the market remains tilted toward insurance provided by the government-supported Federal Housing Administration (FHA). The FHA's share of the primary mortgage insurance market was approximately 83-84% in 2011, a radically higher share than the approximately 15% pre-crisis (see Figure 6).

FIGURE 6
New Insurance Written (Primary, Forward-Mortgage Insurance)

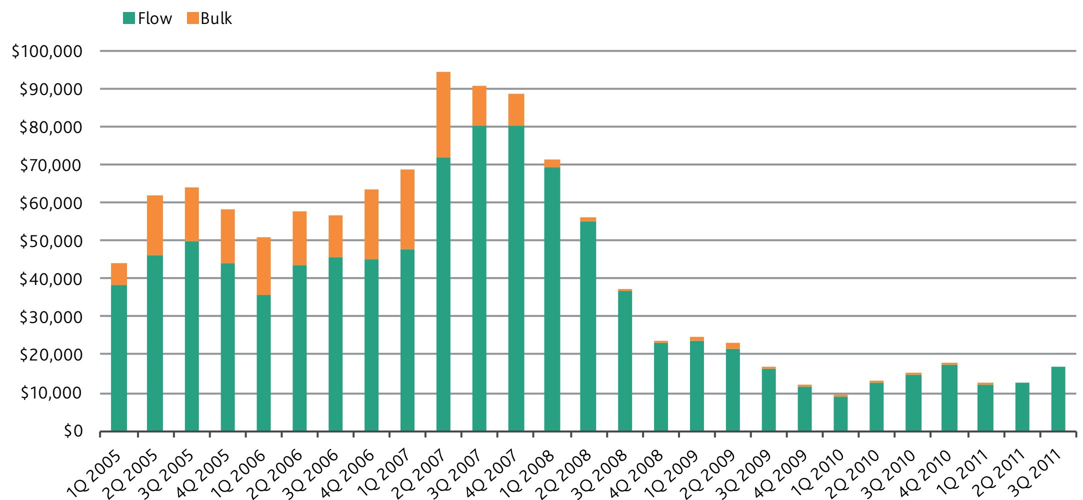


Source: Inside Mortgage Finance, HUD reports

Despite the declining or flat overall volumes, the current market structure presents some opportunity for stronger players, which have more resilient capital cushions and enjoy a higher likelihood of regulator forbearance. Due to the exit of some firms, supply is limited and mortgage insurers with a differentiated financial profile can benefit from current market conditions. This is reflected in both the market share statistics and insurers' ability to write better than average business in terms of credit quality and pricing.

Figure 7 shows overall quarterly trends: a more granular analysis points to market share gains for UGRIC and Radian Guaranty, primarily at the expense of the run-off companies: in effect, individual mortgage insurer penetration rates have been driven by competition for run-off firms' portfolios rather than by aggregate volume increases. In addition, Essent Guaranty Inc. (unrated), a new entrant has been steadily growing market presence.

FIGURE 7
Primary New Insurance Written by Rated Mortgage Insurers - Quarterly Trends



Source: Company reports

Equally, the continued regulatory and GSE forbearance for the remaining mortgage insurers, and the slow pace of GSE reform (if any) allows these companies to retain their status quo positions ,while using this time to gradually re-build their franchises.

Business Model Sustainability Remains Uncertain

Despite the individual mortgage insurers' ability to regain market share, the overall future of private mortgage insurance is unclear. Uncertain dynamics of the mortgage finance market, including the outcome of the government's evaluation of changes to GSEs and the role of mortgage insurers in the mortgage finance market are material long-term concerns. GSE reform and the ultimate structure of the housing market will have a direct, and likely material, impact on future demand for mortgage insurance.

Encouragingly, the mortgage insurance industry ostensibly enjoys material governmental and GSE support. The recent Federal Housing Finance Agency (FHFA) report outlining its plan for the next phase of the conservatorships of Fannie Mae and Freddie Mac emphasizes the importance of shifting credit risk from the GSEs to private investors, including by way of private mortgage insurance. It is also arguable that stronger MIs have demonstrated their ability to absorb high levels of losses.

However, the timing, extent, and specific characteristics of the reform remain uncertain. Perhaps notable in this regard is that we made similar comment at the time of our previous detailed review of the mortgage insurance industry in August 2010. There has been limited additional visibility since. The exact future role of private mortgage insurance is yet to be determined.

Moody's Related Research

Rating Methodology:

» Moody's Global Rating Methodology for the Mortgage Insurance Industry, February 2007 (101822)

Special Comment:

» US Mortgage Insurance: Developing Outlook, August 2010 (127085)Global Macro-Risk Outlook 2012-2013: Further Slowdown in Growth and Increase in Uncertainty, February 2012

Credit Opinions:

» Genworth Mortgage Insurance Corporation

» Mortgage Guaranty Insurance Corp.

» PMI Mortgage Insurance Co.

» Radian Guaranty Inc.

» Republic Mortgage Insurance Company

» United Guaranty Residential Insurance Co.

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 139915

Author
Ilya Serov

Associate Analyst
Yazhe Ren

Senior Production Associate
Judy Torre

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