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Risk at mortgage insurers

"Until the early 2000s, private mortgage insurers had flourished," *The New York Times* almost reported. "Even when buyers defaulted on their mortgage payments, insurers were rarely stuck because steadily rising house prices meant that homes could usually be sold at a profit."

Every fact but one in the preceding quotation is accurately transcribed. The exception is the decade. The *Times*' article, which was published in 1988, referred to the "early 1980s," not—of course—the "early 2000s." The editorial adjustment is our own, and is offered in the form of a prediction. "Risk at mortgage insurers"—the headline over this essay—assuredly exists, even now. "Upheaval at Mortgage Insurers"—the *Times*' headline from 1988—we expect to materialize in the investable future. *Grant's* is bearish on the private mortgage industry, specifically on Triad Guaranty Inc. (TGIC on the Nasdaq), the most aggressive underwriter we were able to identify.

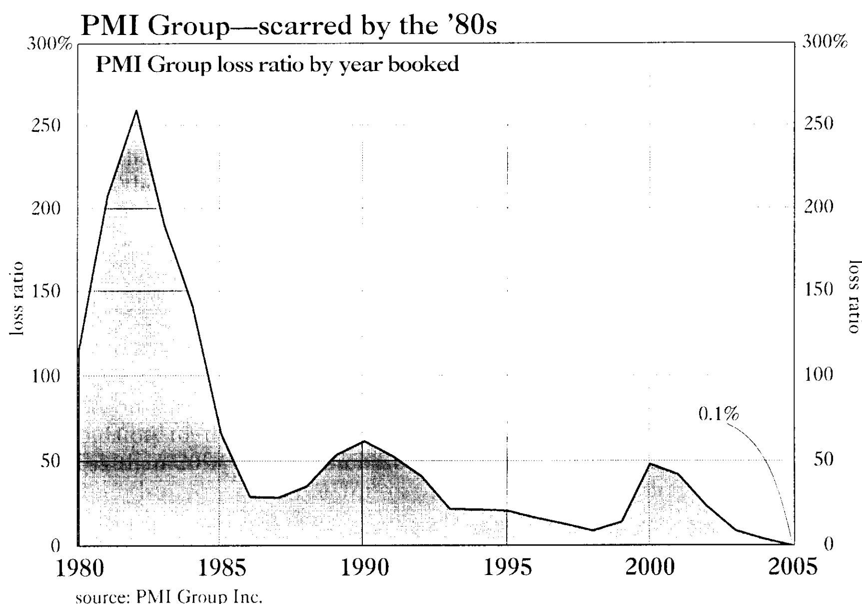
"The mortgage insurance industry is cyclical," observes colleague Dan Gertner, who did the canvassing. "It has suffered downturns in the past. It will certainly suffer them in the future." Just so. The great questions, naturally, are: (1) What form will the next downturn take? (2) Which insurers will be hardest hit? and (3) When will the cycle turn? Best guesses follow.

Private mortgage insurance exists to protect a creditor against a defaulting debtor. Insurance typically covers the first 20% or 30% of loss; damage above the insured portion is borne by the mortgagee. After discharging its obligation to its policyholder, an insurer may pay down the mortgage and sell the property in the open market. In a bull real-estate market, never mind a bubble, that is the very thing it would do—unless, as might be expected, a hard-pressed homeowner chose to sell before he defaulted.

In the 50 states, there was $623.7 billion of mortgage insurance in force at last report, in April. Insurance is typically mandatory for the buyer who puts down less than 20% of the purchase price of a house. The reason is grounded in hard experience. A low down payment is positively correlated with the propensity to drop one's house keys in the mailbox when the going gets tough. In this, the Age of Leverage, you might expect the mortgage insurers to be in clover. They are not, however. A big reason is the very weight of the leverage.

Because just about anyone can qualify to buy a home, the rate of home ownership in the United States has soared: to 68.5% of households in the first quarter of 2006 from 63.7% 13 years before. And over that span, the number of households grew by 12.6%. However, of late, the market for mortgage insurance has failed to keep up with the blistering pace of home buying. One reason is that lenders have been making inroads on the insurers. Not that banks are writing PMI. Rather, they are facilitating the borrowing that cosmetically allows a stretched home buyer to produce enough cash to slip under the bar of a 20% down payment.

The "piggyback loan," also known as



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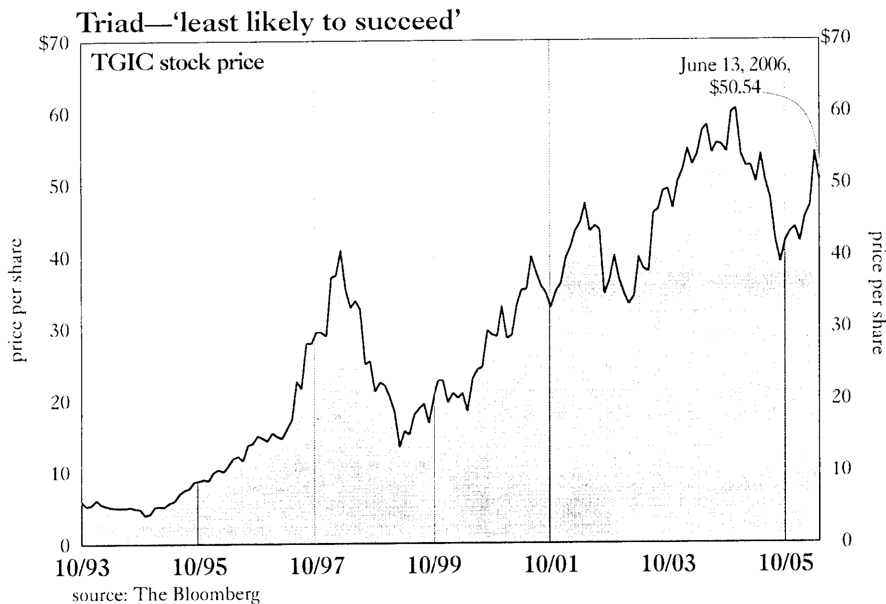

the "80-10-10 loan," is a popular alternative to mortgage insurance. The applicant borrows 80% of the purchase price in a first mortgage, produces 10% for a down payment and borrows another 10% in a junior lien, adding those proceeds to his or her own. No small advantage of the 80-10-10 financing technique is that the interest expense on a home-equity line of credit is tax-deductible, whereas PMI is not. Lobbyists for the insurance interests are busily working to rectify this injustice, but no relief is in sight. A not insignificant problem for the insurers is that the better credits are the ones who can qualify for a junior lien. It's the shakier class of borrower who, in general, turns to mortgage insurance.

To the mortgage insurers, every phase of the credit cycle has its good and bad points. The advantages of low interest rates and E-Z borrowing terms are clear enough: They boost mortgage originations and impart a welcome lift to house prices. Rising prices, in turn, forestall defaults and flatter the insurers' operating results. But there are consolations in a more difficult borrowing environment, too. Rising short-term interest rates tilt the balance of affordability in favor of mortgage insurance, as opposed to 80-10-10 borrowing. And the paucity of refi opportunities in a time of rising interest rates means a lower rate of churn for the mortgage insurers. "Persistency" rises, as they say in the trade. "So at the end of the day, a slower market could be good for MGIC," Sal Miosi, vice president of marketing at MGIC Investment Corp., the biggest U.S. writer of private mortgage insurance, tells Gertner. "The challenge in a big refi market is that more loans fall off the books. When the market slows down, we will write fewer loans, but the loans will stay longer. . . . With short-term rates going up, our core product looks a lot more attractive than it has in the past."

"The past," or at least the era of Ronald Reagan and George H.W. Bush, is a time the mortgage industry will never forget, much as it would like to. Pricing was 40% to 60% lower than it is today. Plunging energy prices caused a wave of foreclosures in the Oil Patch during the 1980s. A contraction of defense spending in the wake of the fall of the Berlin Wall nudged a preposterously overvalued California real estate market over the brink. The PMI Group (PMI on the New York Stock Exchange) participated in both of these formative learning experiences. Business written in the early 1980s provided an especially vivid case study in ill-considered risk taking. The worst of it, in 1982, yielded a ratio of total losses (and loan-adjustment expenses) to premiums earned of no less than 259%. Mark Milner, PMI's chief risk officer, tells Gertner that the root problem was an undiversified book of business. This fact, present-day management has taken to heart, he goes on. The company is diversified with respect to geography, borrower characteristics, lender characteristics and marketing channels. PMI has spread its wings internationally (Australia, Hong Kong, Europe) and functionally (entering the municipal-bond guarantee business through a strategic investment in Financial Guaranty Insurance Corp.). Formerly just a domestic mortgage insurance company, PMI is today, Milner asserts, a "global provider of insurance enhancement."

No doubt, thoughtful managements will not blindly repeat the errors of cycles gone by. They'll make new ones instead. The mortgage insurance industry can hardly help itself, because it's a price taker. The terms and conditions of mortgage lending are the ones it's stuck with (and it's stuck with the loans, too; unlike the auto trade, for instance, do-overs and cancellations are not permitted). And because a mortgage bubble financed the housing bubble, comeuppance, we believe, is almost certain. Industry leader MGIC seems to share these reservations. These days, it is leading by not growing, allowing its insurance in force to shrink by 7.5% since 2001. Last month, at a Bear Stearns conference on mortgage finance and housing, Patrick Sinks, MGIC's president and chief operating officer, talked about the meager prospects for growth in mortgage insurance and related lines. "We've looked at other businesses," said Sinks. "We've looked at the MI industry, the financial guarantee industry, the title industry, all along the mortgage food chain from origination to back-end servicing or holding a loan. There's nothing in that space that is quite fair or fancy, so we've not pulled a trigger on anything there but we continue to look at these opportunities. So we have felt that the best bet to deploy the capital or allow shareholders to redeploy the capital is to buy back shares through share buybacks and dividends."

If, indeed, MGIC is not bullish—as we read the text, it's even a little bearish—on mortgage insurance, it has its reasons. From 2001 to 2005, it disclosed a jump both in losses as a percentage of premiums written (to 44.7% from 15.4%) and in defaulted loans (to 6.6% from 3.5%). This was, of course, in real estate's high-cotton era. The broad problem, Michael J. Zimmerman, the investor-relations vice president for

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MGIC, tells Gertner, is the decline in credit quality. "One of the reasons we grew home ownership in this country to nearly 70% is that we expanded the pie," Zimmerman says. "And we didn't necessarily expand the pie at the 700-plus FICOs [i.e., the higher cut of mortgage borrower]. Typically, it was the lower to mid-credit score ranges. . . . I am hesitant to use the word 'deteriorating,' but the fact of the matter is that it is a different credit pool of borrowers." Coloring these remarks, and results, is that MGIC is one of the industry's more conservative underwriters, with lower-than-average exposure to such vehicles as options ARMs and investor properties, the credit sleeper cells of the next down cycle.

The essential retort to the bearish case is that the crises of the 1980s and early 1990s were the results of bolts from the blue—does anyone really expect the Soviet Union to go out of business again? Employment, not aggressive lending or sagging house prices, is the critical variable in mortgage finance, the argument goes. People with jobs pay their mortgages to stay in their homes. Besides, the bulls point out, rising house prices have served to pad the insurers' effective loan-to-value ratios. On average, they might be as low as 82% to 84% today.

We dispute it. The bolt from the blue this time around will be credit itself, we predict—though nobody will have a right to be surprised when lightning does strike. "The whole issue is credit quality," remarks Peter Brotchie, CEO of Union Trust Mortgage Corp., a Massachusetts-based, privately held regional mortgage banker. "Somebody who would not have even got a loan seven years ago can now get one with no money down and not verify their income. That kind of thing is nationwide. That hasn't been regional. That doesn't just happen in Boston, New York, California or Florida—that's been everywhere." It wouldn't take a collapse in prices to prompt the marginal home buyer (who, don't forget, has hardly any equity at risk) to decide to walk away and rent an apartment.

Of course, that is not how the mortgage insurers see things. "They are betting that their earnings are going to stay the same or go up as the market levels off because they are going to have much higher 'persistency,'" Brotchie goes on. "The loans that are on the books will have lower LTVs and they will continue to get paid on them, because people don't refinance because they've got a 5% fixed-rate mortgage. Even though they've got PMI on it that may cost 50 basis points, it's not worth going to a 6.5%, 30-year fixed-rate to get rid of it. There is definitely truth in that, but what happens if they put that business on in the last two years, from 2003 to 2005, and if a much higher percentage of it goes into default than has gone into default in the past, and if their current volume falls dramatically when the market slows down? That means that new revenues coming in are going to be much slower. So how much does that get offset by higher 'persistency'?"

Triad Guaranty is the *Grant's* nominee for the mortgage insurer least likely to succeed in the coming PMI downturn. Whereas MGIC has been shrinking its book of business, Triad has been on a growth tear. It has boosted its exposure to adjustable-rate mortgages and lesser-quality borrowers. Rapid-fire expansion is stamped on the company's relatively high ratio of net risk in force to statutory capital—12.3:1 vs. 7.3:1 for MGIC and 8.1:1 for PMI Group. "And Triad," as Gertner points out, "has the highest risk in combined force exposure of any mortgage insurer to Florida and California. Florida accounts for 9.2% of exposure, California, 10.1%." Nor does Mr. Market seem to mind—for now. Triad trades at 12.7 times earnings (vs. 9.6 and 10.5 for MGIC and PMI, respectively), and at 1.5 times book (vs. 1.3 and 1.2 for MGIC and PMI, respectively).

After the inevitable cyclical slump has run its course, the industry will, of course, compile a new edition of "Lessons Learned." Gertner's prediction for lesson No. 1 rings true: "Don't insure low credit-quality borrowers using innovative mortgages." Sadly, some will be astonished to read it.

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Triad Guaranty Inc.
(in $ thousands, except per-share data)

	12 mos. to 3/31/06	2005	2004	2003
Total revenues	$202,848	$192,046	$161,266	$139,867
Net losses and loss adjustment expense	72,580	66,855	35,864	23,833
Net income	59,606	56,813	58,417	51,091
Diluted earnings per share	4.02	3.84	3.98	3.52
Total assets	785,978	767,503	672,035	575,579
Total liabilities	270,771	268,312	234,692	205,649
Shareholder equity	515,207	499,191	437,343	369,930
Primary loans in default	5,116	5,336	4,203	3,397
Pooled loans in default	1,776	1,827	1,242	845
Total loans in default	6,892	7,163	5,445	4,242
Net risk in force	7,446,926	7,312,697	7,049,102	6,590,222
Risk-to-capital ratio	12.3x	12.5x	14.0x	15.3x
Prime credits	74.9%	76.0%	81.7%	87.1%
Alt-A credits	22.8	18.3	13.6	6.9
A-minus credits	2.0	4.3	4.0	4.4
Subprime credits	0.3	1.3	0.7	1.6
ARMs	32.4	37.4	33.6	19.3
LTV greater than 95%	10.1	12.4	12.7	7.5
Market cap	$749,820			
Share price	50.54			
Price/earnings	12.7x			
Price/book	1.5			

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