Guidance Note on Reserving for Mortgage Guarantee Business

Introduction

Under the Insurance Companies Ordinance (Cap. 41) (Ordinance), the Insurance Authority (IA) has the primary responsibility of ensuring that an insurer is able to meet its liabilities or fulfil the reasonable expectations of policy holders. Adequacy of the technical reserves set aside by an insurer for payment of future claims is an important factor affecting the insurer's ability to meet such obligations. As part of his routine monitoring, the IA assesses the adequacy of technical reserves of an insurer when examining its solvency position under the Ordinance.

Mortgage Guarantee Business

2. Since early 1999, mortgage guarantee insurance has emerged as a new line of business in Hong Kong. Under its present form, mortgage guarantee insurance protects the lending bank against the risk of loss arising from default in payment by a mortgagor in respect of that portion of mortgage loan which exceeds 70% or other pre-determined ratio of the value of the property.

3. Mortgage guarantee insurance is generally of a long tail nature which distinguishes it from other classes of general insurance business. The risk it covers is also unique in that defaults by mortgagors are influenced both by events affecting an individual mortgagor's income as well as by general economic downturns. It is a type of insurance which in times of severe economic downturn could give rise to accumulated or catastrophic losses to an insurer.

4. In view of its long tail nature and the potential accumulation of risks, the IA expects that an insurer writing mortgage guarantee business shall adhere to the following guidelines in setting aside technical reserves in respect of this line of business.

Application of this Guidance Note

5. This Guidance Note applies to an insurer as well as a reinsurer in respect of its mortgage guarantee business carried on in or from Hong Kong.

Adequacy of Technical Reserves

6. The IA is not likely to be satisfied that the technical reserves set aside by an insurer in respect of mortgage guarantee business are adequate unless the insurer has established and maintained an Unearned Premium Reserve, a Provision for Claims Outstanding [including claims incurred but not reported (IBNR)] and a Contingency Reserve in the manner set out in paragraphs 7 to 11 below respectively.

Unearned Premium Reserve (UPR)

7. Since the risk exposure period of mortgage guarantee business normally straddles more than one year, the total written premiums should be accounted for immediately upon inception of insurance and that portion which does not relate to the current accounting period should be set aside as UPR. An insurer should provide for an UPR in the following manner or in a manner considered to be not less prudent (e.g. apportioning the single premium on a basis reflecting the expected claims incidence) than the following : -

(a) <u>Annual Premium Basis</u>

The annual premium shall be recognized on a straight-line basis over the period of insurance with the remaining balance as UPR.

(b) <u>Single Premium Basis</u>

The single premium shall be apportioned equally over the "effective period of risks".

8. The "effective period of risks" refers to the period commencing from the loan drawdown date to the date when the loan-to-value ratio reduces to 70% or other pre-determined ratio.

Provision for claims outstanding (including IBNR)

9. An insurer should set aside an adequate amount of provision to meet outstanding claims, including claims the amounts of which have not been determined and claims arising out of incidents that have not been notified to the insurer (IBNR) and related expenses for settling such claims.

10. For the purpose of this Guidance Note, outstanding claims do not imply total risks, but rather identifiable and probable claims. In computing the amount of the provisions for reported claims and IBNR, an insurer is expected to take into account, among others, the length of the default period, the outstanding principal balance covered by insurance, the current market value of the collateral and the available historical claims data reflecting the frequency and severity of the losses. In particular, an insurer should set up a provision for outstanding claims as soon as a mortgage loan which is delinquent for over 90 days is identified.

Contingency Reserve (CR)

11. An insurer should set aside a provision in the form of a CR in the following manner: -

(I) In respect of its mortgage guarantee business which is entered into before 1 January 2011:

(a) An amount equals to 50% of the net earned premium income derived from mortgage guarantee business in each year of account shall be assigned to the CR;

(b) The amount assigned to the CR in respect of a year of account shall be maintained for a period of 7 years. Withdrawals may be made by the insurer where the claims incurred in any year of account exceeds 35% of the net earned premium income in that year of account for the purpose of meeting those excess liabilities. Any such withdrawals shall only be made on a first-in-first-out basis; and

(c) At the end of the 7th year, the amount assigned to the CR in respect of a year of account may, to the extent it has not already been depleted by prior withdrawals under (b) above, be released and available for the general purposes of the insurer.

(II) In respect of its mortgage guarantee business which is entered into on or after 1 January 2011:

(a) Except for direct non-standard mortgage guarantee business as defined in (e) below, an amount equals to 50% of the net earned premium income derived from mortgage guarantee business in each year of account shall be assigned to the CR;

(b) For direct non-standard mortgage guarantee business as defined in (e) below, an amount equals to 75% of the net earned premium income derived from mortgage guarantee business in each year of account shall be assigned to the CR;

(c) The amount assigned to the CR in respect of a year of account shall be maintained for a period of 10 years. Withdrawals may be made by the insurer where the claims incurred in any year of account exceeds 35% of the net earned premium income in that year of account for the purpose of meeting those excess liabilities. Any such withdrawals shall only be made on a first-in-first-out basis;

(d) At the end of the 10th year, the amount assigned to the CR in respect of a year of account may, to the extent it has not already been depleted by prior withdrawals under (c) above, be released and available for the general purposes of the insurer; and

(e) For the purpose of this Guidance Note, direct non-standard mortgage guarantee business of an insurer includes any of the following in relation to a loan secured by a property, which is insured by the insurer as its direct mortgage guarantee business : -

(i) the loan-to-value ratio exceeds 85% as at the date of origination of the loan;

(ii) the borrower's debt-to-income ratio exceeds 50% as at the date of origination of the loan; or

(iii) the underlying collateral is not used as the borrower's own and sole residence.

12. An insurer should notify the IA within 14 days of any withdrawal made from the CR.

13. The maintenance of a CR recognizes the need to provide for the contingency of accumulation of risks in times of severe economic downturn. This practice is generally in line with those applicable to insurers writing mortgage guarantee business in the United States and Australia.

Reinsurance Arrangements

14. An insurer carrying on mortgage guarantee business, as required by section 8(3)(c) of the Ordinance, shall have adequate reinsurance arrangements in force at all times in respect of such business, having regard to its own circumstances. An insurer will be required to justify its case if no such arrangements are in force.

Responsibility of an Insurer

15. This Guidance Note sets out the *minimum* standard expected of an insurer in setting aside technical reserves in respect of mortgage guarantee business for the purposes of ensuring its ability to meet liabilities or fulfil the reasonable expectations of policy holders. It shall be the sole responsibility of the insurers concerned to have due regard to all relevant factors, including the quality of their business portfolio and risk exposure, in determining whether a higher level of technical reserves should be maintained.

Reporting of CR

16. For monitoring purposes, an insurer is required to report separately the amount of CR set aside by it, including any amount of withdrawal made from the CR during the year either in the Hong Kong General Business Returns or by way of a note to the Returns which are submitted to the IA annually. In addition, the basis of the calculation of the reserve and whether it has been consistently applied in each accounting period should be disclosed in the Balance Sheet.

17. For the clarification of doubt, the CR is not regarded as part of the "liabilities" for the purposes of the local asset requirement under section 25A of the Ordinance.

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