JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

F. Miscellaneous Professional Associations

25. CMI Sales Meeting, February 27, no year.
Speech discusses private mortgage insurance

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CMI SALES MEETING

Tuesday, February 27

I. Intro Notes

A. A year ago we had just completed a history of events and conditions which led to the private insurance of home mortgages for loss caused the lender. Just when we got warmed up we were interrupted by lunch and we just now got back from the bar. I have been asked to comment on the Rapkin Study of MGIC done by the Institute for Environmental Studies, University of Pennsylvania. Careful review of the statistics, assuming investment strategy 33, economic assumption set 41, and default chart 19A suggests that mortgage insurance is undoubtedly a rock hard, corporate fraud.and sale of these services is a criminal violation of the Federal Banking Act.

B. Other than that aside, there is very little of interest in the report for anyone but the academic fraternity. Since I read the preliminary report issued before final publication, there may have been some technical editorial changes.

II. Insurance is a social device with which to combine individual events or exposures into groups appropraite for statistical forcasting, for collection of resources from the many for payment of losses to the few, and for the equitable distribution of these costs to the group.

A. The essence of insurance is combination for purposes of loss prediction, either self insurance or institutional insurance. To be insurable any given exposure to a loss must be :

1. Homogeneous and sufficient for statistical manipulation. must be homogeneous in amount, in vulnerability , and yet independent of one another.
2. Loss event must not affect more than a few at one time--freedom from catastrophe.
3. Loss must be significant and measurable in money.
4. Loss msut be accidental and random in so far as the insured is concerned.
5. Administrative cost must be appropriate to loss cost.

B. Mortgages have all the necessary characteristics except that the peril of economic upset has catastropher possibilities which can only be reduced through broad diversification and geogrphic dispersion.

C. It follows that since ther peril is economic the insurance resource must be relatively free of economic exposure to loss. Otherwise the loss causing phoenomenon increased claims as it decreases resources.

D. Therefore the Rapkin model is concerned with the economic cycle as it affects (1) the frequency and severity of loss to insured mortgages and (2) the income and capital value of invested resources available for claim payment.

E. Admittedly the guarantor is protecting from two different types of losses. The first is random upset of the loan due to personal events in the life of the borrower which cause losses solely due to the low equity cushion for foreclosure expense. Nobody doubts the ability of guarantors to pay that kind of loss, assuming a reasonable degree of care in the selection of borrowers/ Instead there is doubt that guarantors could withstadd a general and prolonged period of recession causing increasing enemployment, declining property values, and therefore an inability or an unwillingness to pay by the borrower.

III. The conclusions of the Rapkin Study are best understood by recalling that:

A. The investment staategy becomes more conservative as you move from 1 to 5, with alternative 5 having the worst performance in terms of yield, market value chagne, and default.even though strategies 4 and 5 are conservatively invested in U.S. Governments, bonds, and mortgages.

B. That delinquency rates move from present experience to depression experience in terms of multiples of the current level of experience --each multiple being defined as the product of an "economy"--.

C. Review of Table VIII-6 will permit us to make some statements about capacity of the guarantor to resist increased losses and declining resource power.

1. Remember Economy 2 means foreclosures twice as high as at present and strategy 2 means some investment in stocks and prefereds, with modest market declines.

2. As new business written declines in periods of adversity staying power is increased.

3. Economy 5 presumes a foreclosure rate five times current levelsand the worst of all investment returns and yet even then the company could stagger along for six years before reaching insolvency.

4. More than that it should be recognized that this model does not take into effect the accelerated release of unearned premium into surplus--that is, there would be tremendous capacity to meet additional claims from assets pledged to unearned premium or reserves for expected losses, incurred, anticipated, or unreported but not paid.

IV. These basic tests are highly encouraging but ignore several significant but implicit assumptions:

A. Geographic dispersion representative of MGUC dispersion for the basic loss experience data . Less dispersion would mean higher losses and shorter staying power.

B. Social attitudes regarding debt and home ownership remain constant and geographically diversified in the same distribution as mortgages. Perhaps events in the core in the next few summers will distort property values and social standards for repayment of mortgages. If the guarantor has more mortgages in the core than in the suburbs, his experience will shift significantly . Property values in the subrbs will rise significantly accelerating cancellation while the threat in the core will postpone cancellation, aging portfolios without improving security.

C. There is always the delicate problem of adverse selection in terms of appraisals, borrowers, and risk participation in total lender portfolio.

D. Problems in urban property valuation and foreclosure also imply that the guarantor with a better mix of exposrues among smaller communities may also fare better.as diversification of home owner types is as important as dispersion geographically. A guarantor with good dispersion among the states may be heavily concentrated in big cities, among industrial rather than service populations, or among areas dependent upon attracting further economic investment or contracts.

E. The ~~tst~~ statistical approach is only significant so long as the characteristics of the data remain constant. The statistics of the single family home buyer are becoming more vulnerable to sharp location bias, rapid technological obsolescence, more interdependency among metropolitan areas and their economics, and shifting philosophies of risk management among mortgage lending or investment personnel.