

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

7. Foremost Guaranty Insurance, no title or date
for speech

Foremost Guaranty Insurance

- I. Unique characteristics of real estate investment decisions
 - A. Yield must be determined by assumptions about the real estate and the real estate owner.
 - B. Converting space time to money time
 - C. Real estate investment is the purchase of a set of assumptions
 - D. Investment risk is the difference between assumptions or proforma statements and realizations.
- II. A mortgage commitment is a form of investment which requires the underwriter to infer or to assume that the capacity and will to pay of the borrower and the collateral of the property will lead to recovery of the capital and an interest return on investment net of a given administrative cost.
 - A. A variance between this assumption or realization occurs because of:
 1. External contingencies which may undermine scheduled repayment, administrative cost, or capital recovery and therefore reduce net effective yield.
 2. Errors in the entrepreneurial skills of extending credit
 - B. Risk management is concerned with the identification, measurement, and control of potential significant variance in assumptions
 1. The objective is to conserve existing assets and secondly to realize income expectations
 2. The methods available for controlling risk include:
 - a. Avoid
 - b. Combine for statistical prediction
 - c. Shift by contract
 - d. Shift to insurance
 - e. Limit maximum loss
 - f. Reduce frequency and severity
 - g. Hedge
 3. The mortgage loan process is a risk management process
 - C. The mortgage lender is extending credit while the mortgage guarantor is insuring against the consequences of mistaken assumptions or errors in judgment in the process of credit judgment.
 1. External risk have always been insured by the lender
 - a. Title insurance or bonded opinion
 - b. A bonded surveyor
 - c. Property and casualty coverage
 - d. Priority of recording date
 - e. Errors of omission - bankers blandet bond of faithful performance
 - f. Earthquake insurance

2. The capacity or will to pay is also protected in part by:
 - a. Life insurance
 - b. Accident and health insurance
 - c. Other assets for liquidity of borrower (pleasure, pain and bailout)
 - d. Unemployment insurance or guaranteed income eligibility
 - e. Credit reports
 3. Note that the critical assumptions of appraised value of collateral and credit history are vulnerable to error or suddenly changed conditions and no insurance program is available for the consequences.
 - D. Entrepreneurial judgment at the point where the lender is interviewing or analyzing his data can be biased by interaction by credit officer and borrower, credit officer and the production or loss prevention attitudes of his superiors, or credit officer and general public optimism or depression. All of these can lead to loss of good business by the lender or acceptance of poor business more often than is normally expected.
- III. Mortgage guaranty insurance insures against loss as a result of an error in appraisal or omissions in the credit report. In addition, the use of mortgage loan insurance protects the lender against the excessive opportunity costs of too conservative a loan policy or too generous a loan officer.
- A. Note the difference between extension of credit and guaranty against the consequences of the assumptions which led to extension of credit.
 - B. The original lender may take an hour or more to analyze the loan, FHLDMC takes 11 minutes, and a mortgage guarantor 5 or 6.
 - C. It stabilizes the financial expectations of the lender in respect to:
 1. Yield on an individual loan
 2. Loss reserves which are set by tax law rather than alternative risk from investment assets
 3. Sharp reduction of earnings due to defaulted property as inadmissible asset
 4. Maintenance and ability to pay top dividends
 5. Feedback to the lender on reliability of credit report, appraisers, and loan officers based on spot checks of transaction before aggregate bias becomes too damaging.
 6. Stabilization of lender against local or regional economic cycles which are more typical of real estate trends than national cycles.
- IV. National market for private guaranty is both favorable and unfavorable to guaranty concept:
- A. New surge of new young families means growing demand for home
 - B. Higher prices would mean lower downpayment and longer payment term
 - C. Competition between intermediaries for yield means acceptance of higher risk loans.

- D. Trend toward multi-family townhouses as rentals postpones purchase
- E. Trend toward condominium townhouse creates too great a concentration of risk.
- F. Trend toward indirect government control with private guarantor through GMA collateral trust regulations Freddie-Mac regulations, and HUD proposal to provide reinsurance.
- G. Tendency for regional small scale guarantors rather than large scale national operation.