JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

f. "Risk Management Functions of Mortgage Guaranty Insurance", no date

RISK MANAGEMENT FUNCTIONS OF MORTGAGE GUARANTY INSURANCE

I. The residential mortgage lender is uncertain about the frequency or severity of losses due to foreclosure, particularly where loans exceed 80% of appraised property value for several reasons:'

   A. Frequency is vulnerable to increase when the economy experiences reverses in the business cycle with greater frequency, when social patterns are increasing the frequency of domestic upset, and de-personalization of social relationships is reducing pride of performance, community loyalty, and faith in long term plan.

   B. The severity of loss is increasing because total claim rises to reflect higher interest rates, higher real estate taxes, and higher vandalism rates, while at the same time local area real estate prices can reverse sharply as a result of one or two events.

   C. The consequences of aggregate foreclosure losses on net investment income have multiplier impact on institutional liquidity or ability to compete for capital.

   D. Institutional lenders do not wish to regard themselves as risk takers, only retailers of money under arrangements which are self liquidating.

   E. Most real estate finance arrangements today are patchwork modifications on institutional ideas which grew out of the Depression, either its cause or its effect.

II. The origins of the mortgage guaranty idea began about 1900 when mortgage bankers began to sell small denomination certificates of participation in large mortgages and portfolios of mortgages, typically to small individual savers and estates for widows and orphans.

   A. The mortgage banker guaranteed the on time payment of interest and eventual repayment of capital as part of a servicing contract. Loan ratios of 50%, plus the local image of the banker, were presumed to make this possible.

   B. Most states provided minimal regulation under their banking laws, while some defined it as title insurance and required $25,000 of policy holder's surplus.

   C. By 1925 the guaranteed mortgaged certificate was regarded as gilt-edged and mortgage bankers used it as an advertising term to float mortgage bonds and certificates. Generally the appraisals were exaggerated, there were no loss reserves, and the contingent liability of the guarantor greatly exceeded their assets. While it only promised on time service it was understood to mean as unconditional guaranty.

   D. During the beginning of the depression investors continued to receive interest payments from the guarantor eventhough underlying loans were in default, with guarantor raising cash from bank loans, the sale of good mortgages, arbitrage and their own securities, etc.

   E. In 1934 the state of New York shut them all down with losses to investors approaching $2.5 billion . New York passed a law prohibiting such

guarantys that wasn't modified until 1974.

F. The Alger Report, a New York state investigation, however, recommended the need for high ratio, single family house loans, advertised over long term to protect the buyer and guaranteed by government to protect the lender.

III. In 1934 the federal government began such aprogram with the creation of The Federal Housing Administration to insure lenders against losses due to residential mortgage foreclosure.

A. The FHA was really a device to reform the residential mortgage process in the US by:

1. Standardizing the mortgage form as a monthly advertised loan including taxes and interest.

2. Fitting the loan terms to the monthly income of the borrower.

3. Federal rating of borrower capacity to pay.

4. Federal appraisal by FHA staff.

5. Contoolled interest rate to reflect reduced risk for lender.

6. Creation of actuarial reserves for losses based on an economic model assuming disaster of 1931 proportions.

B. Beginning with 80% loan ratios, a prohibition on secondary financing and a premium of 1/2% the anniversary balance of the loan outstanding, the program created:

1. The Mutual Mortgage Insurance Fund designed to refund excess premiums when all losses to a given batch of loans were known.

2. An elaborate actuarial reserve system based on mortgage cells defined by month of origination, location quality, borrower and structure rating and loan ratio. Premiums and losses per cell eventually became basis for dividends.

3. In event of default lender would foreclose and in exchange for title would receive bonds in the amount of the claim at a nominal government interest rate which could be called once the property was sold.

4. Lender originated application, dispersed funds, and service loan while the government made all the decisions and guaranteed the results

5. FHA soon discovered it could set subdivision and building standards, penalize builders for quality, and more recently push environmental or social objectives of federal policy by its standards of eligibility.

C. By the early 1950's the lenders had come to resent:

1. FHA red tape and delays.

2. Surrender of credit and property evaluation functions.

3, Control on interest rates and the resulting point system.

4. Payment in nonliquid bonds.

5. By 1957 FHA had collected 2.2 Billion in premiu ms but had incured net losses of only $3 million because of housing shortages, rising prices, and conservative loan practices.

6. Congress began to use the guaranty to stimulate public objectives in public housing, college housing, and moderate income housing which were not run as insurance operations.

D. In the meantime the Veterans Administration began a guaranty plan, covering the first $7500 of loss of buying the loan for deserving vets in financial difficulty. There were no insurance reserves and losses were part of the annual VA budget.

1. Lenders like the the cash guaranty on the top $7500.

2. Real estate brokers were unhappy with VA supervision of the transaction which was only completed at the price set by the VA.

E. Savings and loans sought congressional approval for the Home Loan Bank to own and operate a guarantor agency which would insure the top 20% of a residential loan up to 90% of value, for ten years with payment in cash, no interest ceiling, and only spot-check control of appraisals and borrower analysis by the lender.

1. Notice that only federally regulated lenders are eligible.

2. The lender is insured, not the saver (who has FSLDIC).

3. The banks prevented passage in Congress with an amendment for interest ceilings, [illegible] continuation of point system.

IV. While the Congressional battle was still being fought the Mortgage Guaranty Insurance Corporation of Milwaukee was formed. by Max Karl, [illegible] chairman of the Board

A. The Policy offered was essentially what the S & L's proposed. Insurance of the top 20% for a one time appraisal fee plus 1/2% the first year and 1/4% thereafter in the event of a claim guarantor pays 20% in cash or 100% and later resells the property.

B. The 20% option was an afterthought but has become the standard modus operandi. California ultimately required a policy holder surplus to be no less than 4% of the face of the mortgage, i.e. ~~mortgages~~ [illegible] insured could exceed 25 times ~~maximum liability~~ surplus + contingency reserve

C. Carefully reading the Alger Report, insurance regulators made it a single line company, increasing capital requirements to 2.5 million and more recently Freddie Mack has raised eligible requirements to 5 million -- more than is required of any other insurance line.

IV. D. Mortgage Guaranty Insurance violated a basic requirement of an insurable risk, i.e. namely that each insured risk should be independent of the others to avoid catastrophe losses.

1. Domestic random upset and resutting foreclosure was an independent risk.
2. However, what about frequence and severity attributable to a downturn of the economic cycle at the local, regional, or national level? What about a negative social response to a neighborhood or housing type? To a project?

E. Since the business cycle cannot be forecast, regulators chose the European concept of developing financial mass, huge resources to absorb shock losses. To achieve that the financial plan not only required a large block of capital for entry but also:

1. 50% of earned income to be labelled a contingency reserve to be utilized only when losses exceeded 200% of annual premium or when the state commissioner would permit them.
2. Deferral of the federal income tax for 10 years on the 50%, a device borrowed from long term cycle losses of earthquake insurance.
3. This huge build-up in reserve always lagged the addtion of new liabilities which was held in check by the 25 times ratio.

F. About 1959 Max Karl executed a brillant tactical marketing move. He made seven former presidents of the U.S. Savings and Loan League the controlling block of directors, unlocking his primary market of S&L's and opening the door to unprecedented expansion. Only New York refused to recognize Mortgage Guaranty Insurance until last year.

G. Competitive companies initially copied the MGIC program, even to the typographical errors in the rate manual but the emphasis was always on finding a marketing edge and the personnel were almost always from mortgage lending rather than insurance:

1. Regional groups of S&L's mavericks
2. Appeals to the commercial banks (which are not permitted to have an interest in guaranty companies, even in one bank holding companies since interlocking directorships were a major souce of trouble in the 1920's in the Alger report).
3. Introduction of multiple premium planns to provide coverage only until the loan reached 80% of value.
4. A test of risk dispersion among institutions represented on the board of directors as in the case of MGIC.
5. No commissions are paid to lenders or anyone affiliated with lenders to eliminate competition by rebate.
6. Competition by service in terms of speed of underwriting, secondary mortgage market and seminars etc.
7. There are now 11 companies providing residential mortgage loan insurance with MGIC providing about 55% of the total volume, CMI second but IMI and FMI and PMI gaining at a faster rate of growth on a smaller base.

H. Since the private guarantor insures the top 20% of the claim which is about 25% of the face of the loan, the guaranty puts the lender in the same position as he would have been with a 75% loan ratio (95% less 25%)(.95) The effective risk of 25% is higher than the statutory definition of 20% of the mortgage, a discrepancy which has led to small differences in some states as indicated by CMI premium plan on brocbure.

1. The cushion protects the lender against claims exceeding appraised value, against a fall in appraised values, or bias by lending loan officers relative to favorable neighborhoods, borrowers, etc.
2. The guaranty makes it possible for banks and others to compete for high ratio loans when regulations require a public or private guaranty and still avoid the mess at FHA.
3. The private guaranty can qualify the loan for sale in the secondary market so that the lender can continue to make loans even though none of his own funds are available to cover it.
4. If the lender has made a bad loan where the loss exceeds 20% the lender still loses some money.
5. If the lender cannot obtain marketable title of the property in good repair, he cannot collect the guaranty either.
6. Thus the severity of loss is reduced but not eliminated as in FHA, the frequency of loss probably increases with high ratio loans and so does the servicing costs which are not covered.
7. The borrower pays the premium but by contract and by law is no longer subject to deficiency judgment. Since the insurance covers losses only on foreclosure, the lender is reluctant to pursue specific performance or damages. In short, the guarnaty reduces significantly the pain incentive in the form of down-payment or remedies for default but increases the cash bailout potential for the lender.

V. This rapid growth in the industry does not occur without some mistakes for which the industry has been paying in 1973 and 1974. Most of the mistakes were in diversification and investment while residential loans continues to make as inflation covers appraisal mistakes or eliminates necessity for foreclosure.

A. Diversification of insurance lines led to some coverages which at least taught us more about what they are doing right in thr residential area.

1. The insurance of mobile homes depended on a network of mobile home acceptance companies as well as established banking intermediaries. Severe losses could be attributed to the business practices of the acceptance company, proving that their first line of underwriting defense is careful selection of qualified lender.

B. Two companies introduced commercial mortgage and lease insurance for both multi-family and other types of investment real estate. Unlike residential insurance, the property was the primary security and if it was too specialized as well as leveraged, the result was disaster. The best purpose of the insurance was not to raise the loan ratio but rather to raise the credit quality of the loan or lease so as to improve the loan interest rate.

3. For municipal bonds or industrial development bonds secured by real estate with difficult liquidation potentials or special industrial real estate, the guaranty was useful in reducing investment banking costs of marketing the issue. The guaranty improves the liquidity of the collateral by providing, in part, an alternative cash bailout.

B. The most serious mistakes were in investment policies where they did not follow the traditional insurance philosophy making investments which have a variance-covariance relationship to earned premium income and foreclosure losses. If interest rates rise the number of new mortgages insured will fall. So will the price of long term bond and common stock. As inflation increases foreclosure losses should drop, just the opposite of the casualty insurance company whose losses increase as replacement costs rise unless prepaid premiums are invested in equities which will rise with inflation.

1. The private guarantors investing in the early '60's invested in common stocks, insured savings accounts (low yield high reciprocity) and long term bonds.
2. Inflation killed the stocks and sent the interest rate soaring and disintermediation made it undesirable to increase that by withdrawing from savings accounts.
3. A better policy would be to invest in short term governments when interest rates are low and premium value is high and then reinvest when interest rates are high so that increased investment income would offset decreasing premium income and stabalize earnings per share.
4. Worse, the guarnty holding company set up their own mortgage companies financed with short term bank credit. When interest rates flip flopped MGIC faced negative leverage of more than 2% on some of its mortgage portfolio.
5. As a result common stock prices have roller coasted with MGIC dropping from 100 to 2 1/2 or 3 in a year and now moving back up.

C. Despite the tremendous growth in volume, assets, and net worth the industry has been badly hurt by current economic trends and is now making some overdue adjustments.

1. Accounting, statistics, and portfolio analysis is being organized according to insurance management rather than marketing management principles.
2. Most commercial mortgage and lease business has been suspended, with the exception of multi-family loans.
3. Investment policies are being gradually adjusted but portfolios are locked in by huge devaluation losses.
4. Smaller companies are beginning to consider mergers to achieve national diversification and sufficient financial mass.
5. A national association has been organized called Mica which may become a base for upgrading and sharing statistical data about mortgage foreclosure frequency and severity as it relates to different borrower or property attributes.