

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

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PRIVATE MORTGAGE GUARANTY INSURANCE  
AS DISTINGUISHED FROM BANKING AND THE EXTENSION OF CREDIT

STATEMENT OF

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For

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
Hearings on Underwriting Real Estate  
Mortgage Guaranty Insurance

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His first research assistantship in graduate school involved study of the newly formed Mortgage Guaranty Insurance Company in 1958, working first for the Wisconsin Insurance Department and later for MGIC. Working with Prof. Howard Thompson, he built the first computer simulation models of a mortgage insurance firm and provided the first comprehensive analysis of the industry in the academic journals.

He not only holds the professional designation of Chartered Property and Casualty Underwriter with the American College of Property Underwriters but has received the CRE designation from the American Society of Real Estate Counselors and is rated as a Senior Real Property Appraiser by the Society of Real Estate Appraisers. More detailed qualifications are set forth in the appendix.

## I. INTRODUCTION

The Board of Governors of the Federal Reserve System has scheduled a hearing for January 24, 1974, to consider the issue of whether the insuring of real estate mortgage lenders against the consequences of mortgage default (i.e. private mortgage insurance) is an activity considered to be "closely related" to banking and thus an activity which could be a permissible enterprise in which a bank holding company might engage. Real estate mortgage guaranty insurance is insurance which indemnifies mortgage bankers and government supervised mortgage lending institutions for the direct and consequential losses incurred by reason of nonpayment of first mortgage loans, generally restricted to those loans extended to resident-owners of a single family residence, duplex, or a rental property having no more than four residential units.

The purpose of this statement is to set forth the appropriate relationship, theoretical and operational, which may or should exist between the insurance function provided by a private mortgage insurance firm and the credit extension function provided by a bank or other similar lending institution. After a thorough review of the theory and the operations of both private mortgage insurance firms and mortgage lending institutions, one must conclude that the insurance process is a separate and independent function from the extension of credit. This clear dichotomy exists in the theoretical structure and is supported by empirical observation of the industry both in the present and in the past.

This statement begins with a definition of basic mortgage lending investment strategy concepts and a pinpointing of credit functions and credit risk. Then it relates the function of private mortgage insurance as it serves the risk posture of the credit institution. Finally, the statement explores in some detail the theoretical evolution and the operational format which is derived from the theory of a private mortgage insurance company. This process serves to delineate not only the theoretical distinctions between the credit extension and insurance functions but also to demonstrate that the success of the insurance function depends on its independence from the credit function.

## II. MORTGAGE LENDING

### A. Basic concepts

The business of extending credit by making a mortgage loan requires the lender to infer or to assume that the borrower's capacity and will to pay, together with the pledge of certain real estate as collateral, will, despite any event or contingency, lead to the recovery of capital and an incremental interest return at a predetermined administrative cost. These assumptions, if valid, make it possible for the lender to predict a yield appropriate to the cost of loanable funds, to compare this predicted yield against the alternative investment opportunities available, and to determine what policies should be adopted in order to achieve its surplus objectives. Credit risk can be described as the variance between predicted results and the actual results and the actual realization of the loan objectives.

The strategic format of the mortgage loan investment is relatively simple, reflecting a hierarchy of pleasure, pain, and bailout devices for the lender. Maintaining the borrower's will to pay is the primary security for the home loan, and the lender hopes that the borrower's pride of ownership, love of the family, business reputation, and desire for peer group approval will all provide sufficient motivations to assure prompt and complete payment. Should such positive incentives falter, repayment may nevertheless be attained by the borrower's fear of threatened loss of equity, threatened loss of face in the business and social world, and threatened family dislocation and discomfort. If neither pleasure nor pain incentives motivate the borrower, the lender must look to various "bailouts" to recover capital and administrative costs and to achieve the institution's yield objective. These "bailouts" may take the form of: a "voluntary" conveyance of title to the lender (deed in lieu of foreclosure) following which the lender can sell the property; an involuntary liquidation through foreclosure sale; or some other conversion of the note receivable into cash or marketable securities through federal or private mortgage loan default insurance programs.

Prior to making the loan, the lender must attempt to evaluate the borrower's motivation and sensitivity to discomfiture caused by available delinquency remedies. The lender must make this evaluation from direct interviews and credit history. A significant assumption at this point is the degree of reliance placed on the credit report itself, a report which may be of more immediate significance than even the appraisal of the property. The appraisal report on the attributes and value of the property to be mortgaged provides a

basis or benchmark for estimating positive motivations of the buyer to repay in order to advance his own economic self-interest or pride of ownership. In addition, the lender must employ the appraisal report and other indications of value trends to estimate whether property value would be sufficient, in the event of default, to accomplish a "bailout", i.e. recovery of the lender's capital, accrued interest, and costs of collection.

Such a credit evaluation requires use by the credit officer of a variety of assumptions as to existing and future facts and circumstances together with the exercise of judgment. For example, the loan officer must assume, absent some specific facts undermining assumption validity, that the borrower's capacity to repay on schedule will not be terminated by the borrower's death, disability or unemployment, and that the collateral will, in the event of default, probably not have lost value because of fire, excessive wear and tear, defect in title and the like. Judgment is involved in deciding, for example, whether sufficient investigation has been made to warrant making such typical assumptions, whether the borrower has sufficient motivation to meet his obligations and whether the property value will remain sufficient in light of local economic and demographic trends.

A prudent lender, while not knowingly making a bad loan, nevertheless realizes that its expectation of repayment at the time of the loan may vary from actual experience. This possibility of variance from lender expectation is the credit risk, and encompasses all of the possible causes of variance between the loan officer's

beliefs or assumptions as to facts which exist, or will exist, during the term of the loan, and the facts and circumstances as they actually materialize. In a manner of speaking, the decision to invest in a real estate loan or equity position results when the analyst has "bought" a set of assumptions.

The risks that result to the mortgage institution because of these assumptions are of two types:

1. Static risks are those external contingencies which result only in financial losses and thereby undermine scheduled receipt of payments or prevent recovery of capital, accrued interest, and costs from sale proceeds from the collateral after default. Such risks include the borrower's loss of repayment capacity due to death, disability, or loss of employment as well as damage or destruction of the property due to fire and flood or an erosion of collateral value due to undiscovered flaws in the title.
2. Dynamic risks are those contingencies which might cause either unusual loss or profit depending on entrepreneurial judgment and analysis of people in future events. These entrepreneurial judgments are credit skills which involve, in part, rational decision standards and, in part, intuitions as a result of personal knowledge from contacts with the borrower, locale, and background information. For example, the strength of the marriage and the impact of such events as divorce, mental illness, and family cohesiveness will



strengthen or undermine the will of the borrower to pay on schedule. Local demographic and economic trends may accelerate property appreciation or depreciation either enhancing or reducing the will to pay or collateral values. The loan officer must exercise judgment in the selection of an appraiser and credit reporting agency on which to rely. And the loan officer himself may be unconsciously biased towards safety of principal or production of loans, and all of these behavioral factors contain dynamic risk elements.

However, a lending institution, as a quasi-trustee of funds deposited by others to whom it is in a debtor relation, is in the business of seeking compensation from the use by others of its capital and deposited funds for stated periods of time. Thus, safety of principal is paramount and the lending institution is not in the business of seeking speculative compensation for accepting risks that capital lent will not be returned. Therefore, the lender typically seeks to avoid the financial consequences of the static and dynamic contingencies which upset the assumptions on which the loan was made and cause a loss of capital or variance from income expectations. To avoid these financial consequences, the lender may:

1. Avoid, by rejecting a loan application, certain types of property or borrower attributes where the assumptions involve risks unacceptable by internal credit standards.

2. Adjust loan payment schedules to fit some maximum ratio of available income and then provide for servicing procedures and penalties which discourage and control the frequency of repayment delinquencies leading to default.
3. Require a higher ratio of cash investment by the borrower to reduce the ratio of the mortgage loan to expected resale proceeds and thereby reduce the severity of loss in the event of foreclosure.
4. Shift selected static and dynamic risks to third party insurers by means of insurance contracts for such contingencies as fire and windstorm, title flaws, or death of the borrower.
5. Shift to the borrower the financial consequences of unpredictable variance and assumptions as, for example, changes in the cost of loanable funds to the lender requiring a variable interest rate mortgage to maintain revenues equal to or in excess of dividends to depositors, etc.

It should be noted that where the frequency and severity of certain costs can be predicted with highly reliable accuracy, these losses become part of administrative costs and are incorporated in setting the interest rate assumption. These costs may be allocated to a series of accounting periods by means of reserves, but these reserves do not shift any financial consequences of loss from the lender, and the underlying assumptions of these reserves may themselves be subject

to some variance or risk. Thus, reserves for bad debts stabilize financial accounting reports but do not reduce risk-incurred.

B. Role of Insurance

In the event the positive and negative borrower incentives for repayment fail (or in the event borrower repayment capacity is lost by the occurrence of death or disability without life or income replacement insurance), the mortgage lender must look to the property, and to the proceeds from its sale, to recover capital and costs, and to generate the desired interest return. The lender today stabilizes against variance in the assumption of adequate property value through a variety of insurance programs. These programs, generally paid for by the borrower but for the benefit of the lender, include title insurance, property and casualty insurance, and, on occasion, performance or payment bonds to prevent liens by third party contractors. To avoid lapse of any such coverages, the banker's blanket bond provides for umbrella coverage against losses that may not be insured due to administrative oversight. To assure existence of improvements on the property mortgaged, the lender will require a survey by a professional surveyor backed by a bond.

All threats to the existence of the collateral having been shifted to insurance companies with reasonable certainty as to their ability to meet cash commitments, there remains subject to significant variance only the critical question of property value as existing at the time the loan is made and during the term of the loan. The appraiser who provides the opinion of value is neither bonded nor professionally accountable for his opinion except for total negligence bordering on fraud.

Property values, both at the time of the loan commitment and at the time of the foreclosure, are subject to significant variance in terms

probable market price. If the appraisal were accurate as to market value, a loan of 80% of value would imply that the borrower had invested his own cash for 20%, and would, therefore, have a strong incentive to repay. Should the borrower become delinquent, it would be possible for him to sell the home voluntarily and thereby avoid the expense and discomfort of foreclosure. However, as loan ratios approach 95% of estimated market value, with the cost of voluntary sale equaling five or six percent of probable market price, the borrower loses both the motivation to protect his minimal cash equity and the little hope he might otherwise see of liquidating his obligations through voluntary sale of the property. Thus a high ratio loan may increase the frequency of loss relative to the loss frequency with conventional ratio loans, and in addition the slightest error in overestimating probable market price plus the costs of sale eliminates any possibility of recovery of capital by foreclosure on the collateral.

In practical terms there is virtually no possibility, even in the event of a voluntary sale in normal market channels, of meeting all related obligations with a 90% loan that has been delinquent four months or more. The brokerage commission would be at least five percent. Monthly payments (at least one percent of original mortgage balance including principal, interest, insurance, and taxes) would be six months in arrears by the time of closing for a total of six percent. The mortgage lender would be entitled to certain minimum penalties and costs amounting at least to one percent. There would be, therefore, claims against sale proceeds of at least 12% of probable market value, the amount of these claims, exceeding, therefore, the ten percent equity presumed by a 90% loan. Should the borrower choose to retain possession for the six months to a year redemption period

allowed in the foreclosure process, the cumulative payments in arrears would be event greater, as would the legal costs, while the proceeds at a sheriff's foreclosure sale would generally be less than the appraised probable market price.

In either case if the original appraisal made in connection with the 90% or 95% loan overestimated probable market price, or failed to anticipate a trend of value declines in the neighborhood or for the community in general, the maximum loss could be significantly increased. Of course, economic recession in a particular community might not only cost existing mortgage borrowers their jobs and ability to repay the loan, but it would also discourage potential borrowers from considering a home purchase or deny them the credit necessary to make a purchase. The result would be that the effective demand for homes would be sharply reduced at the same time that the supply of homes, voluntarily offered for sale or forced into sale by mortgage default, would significantly increase, sharply reducing liquidating value of the collateral for the short run.

The estimate of probable market price is the source of significant risk of dollar loss to the lender as it affects the lender's evaluation both of the borrower's motivation to repay and of the property's liquidation value in the event of a default. The lender can manage this dynamic risk in these ways:

1. The lender can hold loans to a conservative 65-75% of market value thereby: providing considerable cushion for appraisal error, resale price declines, and accrued payments in default

at the time of foreclosure; and also reinforcing the vested interest of the borrower in repayment to protect his equity.

2. The lender can look to other resources of the borrower, such as savings accounts and securities, and include the power to attach these other assets, with the right to foreclose on the real estate, as a bailout device to recover capital and costs.
3. Since many families, which the nation considers to be entitled to home ownership, have neither the large down payments required by risk approach number 1, or other forms of wealth which may serve as collateral as in approach number 2, lenders have found it necessary to shift to mortgage loan guaranty insurance the consequences of the more unpredictable and likely insufficient salvage values occurring in loans with loan-to-value ratios in excess of the traditionally acceptable 65-75% of value. [The volatility of losses, when the equity cushion is less than 25% and possibly as low as 5%, explains why private mortgage insurance is primarily concerned with, and provides coverage for, the top 20% of the loan. While the normal loan amortization eventually drops the loan-to-value ratio to acceptable conventional ratios, nearly all foreclosures occur within the first six or seven years before borrower equity has undergone sufficient increase to reach these loan-to-value ratios. Hence private mortgage insurance is generally used for the first four to ten years of the loan term. The amount and term of the coverage is specifically tailored to eliminate nearly all uncertainty for the lender of recovering capital, accrued interest and cost in the event of a bailout situation.]

The typical lender, of course, protects itself to a certain extent against inadequacy of security value by the exercise of a pure credit decision, i.e., the rejection or acceptance of particular borrower applications and the negotiation of particular loan terms and conditions. Historically, an important safeguard has been the imposition of a high borrower equity requirement (i.e., low loan-to-value ratios) to assure collateral value sufficient to recover capital, costs and incremental interest in the event of borrower default. But the lender today relies instead on real estate mortgage loan guaranty insurance.

A lender does not use, or rely upon, reserves to stabilize its loan expectation since a typical lender does not base its reserves on forecasts of expected loss frequency and severity. In its reserve computation a lender generally responds, instead, to Internal Revenue Service rulings as to acceptable amounts which may be expensed to a reserve for a general loan type, and hence these reserves are computed on the average loss experienced over the preceding five years of the lender's loan portfolio. This is the maximum deductible reserve irrespective of the investment characteristics of various subcategories of mortgage loans or economic expectations for the next five years. Insurance, then, provides assurance that the lender's mortgage will achieve yield expectations, to the extent those expectations depend on factors other than the lender's cost of loanable funds.

### III. REAL ESTATE MORTGAGE GUARANTY INSURANCE

#### A. Background

Real estate mortgage guaranty insurance is the generic name for insurance which indemnifies mortgage bankers and government supervised

mortgage lending institutions for the direct and consequential losses incurred by reason of nonpayment of first mortgage loans. Real estate mortgage insurance, in other words, protects a lender against loss from the occurrence of default by a borrower whose collateral is inadequate and, hence, against loss from the variety of static and dynamic risks inherent in a mortgage loan except for those risks to the adequacy of collateral value stabilized by title insurance, property and casualty insurance and mechanic's lien bonds. Real estate mortgage guaranty insurance is written by the Federal Housing Administration ("FHA"), the Veterans Administration ("VA"), the Farm Home Administration and a number of privately owned insurance companies, for a variety of property types. When such insurance is written by privately owned insurance companies, it is usually referred to as private mortgage insurance (PMI).

#### 1. Prior History

The geneology of modern mortgage loan insurance can be traced on its paternal side to the extinct mortgage investment guaranty and on its maternal side to the Federal Housing Administration, particularly the Mutual Mortgage Insurance Fund (MMIF). The mortgage investment guaranty consisted of a certificate of interest in a portfolio of mortgages or in a mortgage, held in trust, on large building project. The mortgage banker would guaranty the "on-time" payment of monthly or quarterly interest to the investor and often represented that the guarantor would "attend to payment of taxes and assessments", a legal flourish which many investors mistook for additional guarantees. Security of capital depended upon a conservative loan ratio not to exceed 67% and an 18 month deferral of principal recapture in the event of foreclosure. The guarantor was



not required to maintain any reserves from premiums and, in essence, the guaranty was simply that of prompt and efficient loan servicing. The autopsy on the mortgage investment guaranty was conducted in 1934 by George Alger, and the results of his study are set forth in a report which bears his name.<sup>1</sup> His recommendations became the basis 25 years later for both Wisconsin and California innovative regulations for private mortgage insurers.

The Alger Report was prompted when in 1934 the State of New York found it necessary to take over 47 guaranty firms having a nominal \$184 million in capital and surplus with which to secure \$1.7 billion in liabilities on mortgage and real estate securities for 225,000 individual investors in that state alone. The reasons for the collapse of these guaranty firms, as revealed by the autopsy, were complex and a synopsis of The Alger Report can be found in an article by this author in 1967.<sup>2</sup> However, it is worth noting that the State of New York permitted an investment guarantor to be organized under either the insurance or banking laws of New York, as a favorite guarantor security was a small denomination, participation certificate in a single large mortgage or mortgage portfolio. These mortgages were originated and serviced by the same title companies, mortgage banking companies, and bank trust departments which were issuing the guaranty. Company names in advertising were intentionally a confusion of identities to enhance the appearance of financial integrity.

<sup>1</sup> The Alger Report, an unpublished report in the files of the New York State Insurance Commission, a photostat of which was made available to the author by the Wisconsin Insurance Department.

<sup>2</sup> "Development and Structure of Mortgage Loan Guaranty Insurance In The United States" James A. Graaskamp, The Journal of Risk and Insurance, March, 1967, Vol. XXXIV, No. 1, pages 47-67.

Wisconsin in 1926 defined mortgage guaranty as insurance under both the surety and title insurance provisions of the Wisconsin statutes, and would not recognize guaranteed mortgage bonds as legal investments for Wisconsin Fiduciaries unless the guarantor was in good standing with the Wisconsin Insurance Department. By 1930 none had such approval and losses for Wisconsin investors in this kind of security were minimal.

Significantly, the authors of The Alger Report, who understood the inadequacies of the mortgage investment guaranty as well as anyone, did not advocate the prohibition of such an institution, although the New York legislature chose to enact such a prohibition in response to investigation of the scandal. The Alger Report authors, among other things, urged the establishment of regulatory ground rules for the guaranty of high ratio, amortized residential loans for owner-occupied single family homes. Aside from advocating investment and accounting reforms appropriate to all insurance operations, The Alger Report called for standardized appraisal techniques, prohibition of subsidiary corporations, and full separation of guaranty firms from other real estate service institutions, such as title insurers, mortgage bankers, brokers, and banks.

## 2. FHA insurance programs

As early as the 1930's it appeared to be in the public interest to provide credit to families for the purchase of homes where the down payment would of necessity be low, where alternative resources of the family would be negligible, and where the credit risk inherent in the mortgage loan would, consequently, be higher. Therefore, the federal government provided mortgage loan repayment insurance with the advent of the FHA in 1936.

The Mutual Mortgage Insurance Fund<sup>3</sup> and subsequent programs of the Federal Housing Administration insured the lender, in the event of borrower default, against loss of principal, interest, and specified administrative costs. The FHA program indemnified the lender against such loss by issuing to the lender government debentures in the amount of the insured loss, while FHA would itself take title to the foreclosed property. In theory the government would hold properties until price cycles would permit resale at a price sufficient to redeem the bonds, and failing that, the deficits on resale would be charged against an actuarial reserve. The federal program presumed to set interest rates and mortgage terms, to process and evaluate the credit application of the borrower and also to appraise the property utilizing FHA staff. The FHA objective was to protect lenders from losses due to their participation in new high ratio long term mortgages, while also innovating new credit and appraisal techniques.

### 3. Modern private mortgage insurance

Because lenders wanted cash rather than bonds to stabilize their liquidity risk and because lenders wished to retain authority in the credit decision, private mortgage insurers were encouraged to enter the field in the late 1950's. The private mortgage insurance programs permitted the lender to retain responsibility for the credit function and to receive, in the event of loss, a cash payment. These programs were developed employing rates and reserves established by the insurance departments of the various states where they now do business. (Within

<sup>3</sup> Mutual Mortgage Insurance Fund (MMIF) by Ernest M. Fisher and Chester Rapkin, 1956, Columbia University Press, New York.

the last ten (10) years, the FHA, while retaining the right to pay losses with debentures, has commenced paying claims in cash).

B. Basic insurance concepts

The business of insurance is clearly distinct from that of a banking or lending institution. The insurance function does not involve issuance of deposits, or provision of credit services, and an insurer's business is not concerned with the variance from expectation in a single transaction. The insurance business, rather, involves:

1. The combination of large numbers of similar transactions for the purpose of predicting both frequency and severity of loss;
2. The pooling of funds, derived in the form of premium from each of the many transactions, for the payment of losses arising in a limited number on account of the isolated occurrences of loss causing contingencies; and
3. The provision of risk capital capable of meeting shock losses arising from conditions which make normative predictions from pooling non-operational.

Unlike a lending institution, which is interested in avoiding all losses on all its loans, an insurance institution, including a mortgage insurer, is interested in predicting and funding the normative loss patterns in large aggregations of individual loss exposures, as well as providing standby funding of shock losses beyond the probable and foreseeable. To avoid loss from inability to recover capital, loss of accrued interest, and loss of amounts constituting additional expenses, which losses are more likely to result from high ratio mortgage loan defaults, the credit institution is willing to have the borrower pay the small certain cost

of a specified and fixed premium. The lender thereby avoids losses of unpredictable amounts, both per loan and in the aggregate, from mortgage default and inadequate bailout collateral.

For insurance to be an appropriate and successful mechanism for shifting the financial consequences of uncertainty relative to any given contingency, certain attributes must characterize the cause of loss insured against and define the amount of loss to be indemnified. Such basic attributes, inherent in insurance theory, include:

1. Unbiased sample base of similar exposure units to permit statistical inference of the frequency and severity of a specified contingency.
2. Fortuitous and independent occurrence of loss, requiring that the insured not know in advance the outcome of the event even though the insured's behavior may in fact be a contributing cause of the event.
3. A cause of loss producing a loss definite in time and dollar amount in order to anticipate claims and accurately reflect liabilities which can be verified.
4. An insured contingency of the type that could not affect the majority of exposure simultaneously.
5. Highly unpredictable loss frequency and severity for the insured which, in the aggregate for the insurer, is still a small

percentage of the insurer's exposure so that the required premium is reasonable relative to the risk stabilizing benefit provided the insured.

The insurance institution organizes its marketing, underwriting, and other operations to achieve an insurable risk consistent with these attributes, and in the performance of these functions is regulated by state departments of insurance which oversee all those who sell insurance to others.

The lending institution, or bank, is not regulated by state insurance departments, or laws, but by entirely different sets of state and federal regulatory statutes, agencies and administrative rules concerned with the separate banking and credit extension functions performed by lenders and banks. [It is interesting to note that bank holding companies may provide credit life insurance "in-house" but may not sell such coverage to others, and that credit life insurance reserves are established on the basis of mortality and morbidity tables which have been proven by actuaries and state regulators to have unique forecasting accuracy in terms of the frequency of loss while loan limits, on rapidly amortized consumer finance instruments, define a declining loss consequence. No such commonly accepted loss frequency tables are available in any other line of insurance, and aggregate excess loss coverage is purchased in the reinsurance market by credit life insurers to eliminate the catastrophe hazard and to convert this line into a loss reserve with a highly predictable profit center.]

C. Nature of risk insured against

It should be stressed here that both the federal and the private mortgage insurance programs see the cause of loss as mortgage default and foreclosure, regardless of any contributory negligence by the borrower or the lender, and in the private program the private insurer is barred by conditions of the policy, and by state statute, from asserting a deficiency claim against a borrower who occupied a single family residence which is the loan collateral. Such an insurance approach is analagous to automobile liability insurance which indemnifies for losses arising out of the ownership, operation, or use of an automobile regardless of the degree of negligence attributable to the insured. Implicitly, therefore, the private mortgage insurer has insured the lender for the dynamic risk consequences of mortgage default including:

1. Loss attributable to misjudgment of the property value, to unforeseeable reversals of property value trends, or to misplaced reliance on those making the appraisals of value.
2. Loss due to a sharp and unforeseen decline in real estate prices attributable to local exogenous factors or the economic cycle, a type of loss unique to mortgage loan insurance since other insurance against loss of property value from other causes limits coverage to current market values except under very special conditions. (The insurance of losses attributable to the economic cycle violates a cardinal tenet of avoiding exposures which, due to a common loss-causing factor such as the domino effect of a

fire in a street of old homes, could result in a catastrophic insurer loss experience within a particular time period. This potential explains the high minimum capital requirements for entry into the business, since, as later discussed, a large pool of capital must be available to meet a catastrophic loss experience.)

3. Defaults due to the death, disability or unemployment of the borrower (when these contingencies have not been adequately anticipated by providing, through other insurance programs, income replacement capacity for the debtor or his estate);
4. Defaults attributable to an error by the originating loan officer, in the exercise of his banking skill, in judging, from personal contact or credit information available, the capacity or willingness of the borrower to pay;
5. Defaults due to a change in borrower attitude which make inoperable threats, implicit in a mortgage loan, of loss or shelter, seizure of net worth, or peer group embarrassment, whether such threats become inoperable due to loss of self esteem, loss of family pride due to divorce, despondency, or mental illness, or loss of perceived investment value due to reversal of economic trends.
6. Defaults due to misjudgment by the bank loan servicing personnel in detecting or correcting delinquencies which then ripen into default or destroy property values; and



7. Defaults due to unjustified optimism on account of loan officer or institutional bias.

Just as the individual loan transaction contains some dynamic risks of managerial judgment error, so also does the management of the lenders overall portfolio contain such risks in terms of the aggregate frequency and severity of loss resulting from underlying entrepreneurial assumptions and policies, which risks are also stabilized by mortgage insurance.

First. If the loan officers are assumed to have complete objectivity in their decisions, then errors in judgment should be random, some proving detrimental and others beneficial to the lender's interests. However, the variance, between the actual fact and the assumption of managerial objectivity and random error, can be very real. Some loan officers may avoid profitable loan opportunities because of an unconscious bias toward safety caused by business tradition, social position, or personal insecurity. Such a bias will reduce profitability due to lost opportunities but will not produce unexpected loan foreclosures. By the same token, others may make loans which may entail unjustifiable risk because objectivity is impaired due to aggressive pursuit of every loan, unconscious bias from personal interaction with borrower, or unjustified economic optimism in the business community. It is likely that the institution's own philosophy will be reflected in the type of loan officer selected or trained by it, and in the incentives and pressures influencing loan officer judgment, hence increasing, or assuring, an aggregate institutional, loan officer

bias. For example, the bank president, who is infected with excessive optimism and promotes community growth and development with the zeal of the Chamber of Commerce (of which he may, indeed, be president), will likely infect his staff with an unwarranted enthusiasm and economic myopia. Likewise, an entire community may be suffering from excessive optimism based upon some minor economic spurt or as yet unrealized growth possibility.

Second. More insidious than the "unconscious bias of position", is the lending decision which has an inherent conflict of interest. For example, a lending institution, which has advanced working capital and construction loans to a home builder, will be most interested in assuring rapid sale of the finished product by providing overly generous credit to buyers. In this manner it would generate repayment of the construction loan at the expense of its conventional residential loan portfolio. [The independent mortgage insurance underwriter may curb such lender tendencies in its review of the lender's applications for mortgage loan insurance, while an affiliated mortgage guarantor would likely insure such loans without questioning them. It is significant that many states such as California and Wisconsin prohibit any mortgage guaranty company from being in any other line of insurance (when all other casualty lines are becoming multiple lines) to avoid the use of a guaranty device as a lever to capitalize on the many other opportunities for profit in real estate transactions. It is not just a question of fair trade practices but rather related to the primary insurance need for random, independently evaluated insured exposures].

Third. The occurrence of a number of mortgage defaults or actual foreclosure losses, which reduce expected cash flow and earnings below planned requirements in any given period, is the ultimate risk to the lender. The cost of loanable funds represented by dividends on deposits and earnings on capital shares is regulated and adjusted periodically to current interest rates. Minimum earnings must cover these requirements if the institution is to remain competitive for savings and avoid a withdrawal of deposits or a significant fall in the price of its shares. Assuming constant value dollars, the image of the institution, its competitive power, and ultimately its liquidity, depend on predictability of cash flow. Foreclosure losses, obviously, narrow spread between portfolio net income and net cost of money available for loans. Portfolio yield is a moving average while both costs of foreclosure and the cost of loanable funds are at the margin for institutions like savings and loans and banks so that spread is very sensitive to those short run phenomena for which the institution is unprepared.

The effect of loan delinquencies, defaults or foreclosures on the spread between reported income and costs of loanable funds is accentuated by the accounting treatment of such loan delinquencies and defaults, and those loans in process of foreclosure, as required by the public regulators of the lenders. Such regulations, applicable to a particular lender, may require that delinquent loans, or loans that are in foreclosure, be written off as a bad debt and an inadmissible asset, or that

interest be deemed earned only when collected upon conclusion of the foreclosure process. Such requirements may, within one period, overstate the ultimate economic loss and assign that overstated loss against earnings within that period. In recent years the Internal Revenue Service has created stringent limitations on the anticipation of future losses by means of institutional reserves for bad debts so that this accounting device has only a limited capacity to smooth the curve of reported earnings from one income period to another.

Thus the device of private mortgage insurance not only serves to shift the risk of loss from any one transaction but also provides a mechanism for leveling earnings in the aggregate for certain mortgage portfolios and within specific accounting periods. Moreover when mortgage guaranty insurance is used to cover all the eligible loans within certain high loan-to-value ratio categories, the consequences of institutional bias can be shifted to others who have a vested interest in detecting this bias and alerting the insured to it. An independent review of credit decisions of the lender by the guarantor also has the potential for detecting conflicts of interest as operational procedures of the guarantor, outlined below, serve in many ways as a continuous audit of the lending institution judgments and data sources. The independent insurance underwriter is analagous to the independent CPA whose functions are clearly distinct from, and cannot be replaced by, the internal auditors of a large firm. Since institutional bias is one of the risks of the credit function, it follows that distance and perspective is necessary to detect that bias and take appropriate underwriting actions.

#### D. Operations

The Mortgage Insurer, whether governmentally sponsored or private, is a true insurer and is, therefore, in the business of assuming, for monetary consideration, other persons' risks of loss, which risks are incident to the other persons' primary activities and are too unpredictable in frequency or severity to be retained as a cost of business. In this case the risk accepted is that of loss incurred by a mortgage lender from default by a borrower.

To reiterate, the concept fundamental to this, or any other, insurance is the combination of certain kinds of risk exposure in such quantity that the insurer, (the one accepting them for compensation) can forecast both the maximum (albeit improbable) losses that are likely to occur and the administrative cost necessary to implement the total program. The exposure to loss accepted must be reasonably homogeneous, but at the same time the source of the individual exposures sufficiently heterogeneous that statistical bias can be avoided.

Therefore, it is not sufficient for a fire insurance company, as an example, to accept risks on all single family frame dwellings less than ten years old. It must also be sure that these homes are located in many communities, and are built by many different contractors, employing many different brand products and materials so that its loss experience will not be distorted by the shoddy workmanship of a particular contractor, by the defective nature of a particular brand product, or by a windstorm or fire which devastates one locale. Likewise, a mortgage insurer must not only have specific subsets of similar exposures, (e.g., exposures to borrower-occupant defaults on 90 to 95 percent loan-to-value ratio single family detached residential mortgage loans), but also exposures on

loans originated by many lenders in many different locales which are secured by many different kinds of residences, appraised by many different appraisers, located in many types of neighborhoods, and occupied by a variety of borrower-occupant types holding many varied job positions. By assuring that such heterogeneity of source exists, a potential bias of normal experience is eliminated in the coverages of thousands of exposures from hundreds of insured lenders, no one of which could justify the creation of adequate reserves to meet its maximum potential loss without the mechanism of insurance.

1. FHA model of rates and reserves

When the FHA first began its operations, it attempted to construct from the disastrous mortgage losses of the depression a complex mathematical model to determine rates and reserve.<sup>4</sup> The FHA devised an actuarial equation parallel to the prospective reserve method of life insurance, beginning with a classification of borrowers and properties according to a risk review matrix. An annual premium for its home mortgage program was set at one-half percent of the outstanding loan value at the beginning of each year, payable over the life of the loan. In addition to the requirements of administrative expense, this premium base provided for both a basic insurance reserve and, in the case of MMIF Section 203 loans, a participating reserve account for the payment of terminal dividends on an actuarial share basis to mortgagors at the time the mortgage was fully amortized. The actuarial formulas included detailed assumptions as to real estate price levels, annual foreclosure frequency

<sup>4</sup> Mutual Mortgage Insurance Fund, *ibid.*

and cyclical annual foreclosure loss severity, reflecting depression magnitude losses, and annual group loss experience.

By June 20, 1957, the FHA Mutual Mortgage Insurance Fund had collected \$758 million, 72 percent from premiums, 19 percent from fees, and less than 9 percent from other sources. Administrative expenses of more than \$308 million alone amounted to 41 percent of total income, and 56 percent of premium income. Only \$4 million had been used to meet losses on acquired property.<sup>5</sup>

## 2. Private Mortgage Insurer's Rates And Reserves

### a. Contingency reserves

The financial history of FHA provided a basis for constructing the rating assumptions of the private guarantor by proving what should not be done. The extra high administrative costs, entailed by the FHA's overly exact procedures, exceeded any losses which the use of such procedures might have prevented. Further, the economic expansion and real estate inflation following World War II had proven it was impossible to forecast long term real estate price levels. Further the FHA experience revealed that virtually all losses occurred during the first ten years of the loan term, (indeed within 4 years in most cases), and that net losses on default occurred only in the case of high loan-to-value ratio mortgages. The high administrative costs were directly related to the fact that the FHA usurped the roles of appraisal and credit analysis of the local lender, and the terminal

<sup>5</sup> "The FHA Mortgage Insurance Premium An Analysis and An Alternative," Study of Mortgage Credit. Sub-committee of Banking and Currency, U. S. Senate, First Session, 86th Congress, Government Printing Office, 1959, Washington, D. C., page 324.

dividends paid at the end of the full mortgage term to borrowers represented, in effect, the return of an overcharge.

For purposes of rate making, the private guarantor assumed that great administrative savings could be accomplished, without a corresponding increase in underwriting errors, by not performing, unlike the FHA, the credit underwriting and property review which was the credit function of the lender. In lieu of the elaborate FHA forecast of losses, the private model anticipated there would be a normal, predictable level of annual random domestic upsets causing a modest level of claims and in addition there would be the possibility of some future economic recession requiring massive amounts of money for relatively short periods of time. The projected approximate allocation of earned premiums from private mortgage insurance operation was as follows:

Long term contingency reserves - 50%

Short term random domestic losses - 20%

Administrative costs - 20% - 24%

Underwriting profit - 6% - 10%

To anticipate the need for massive amounts of money in the indefinite future, a contingency reserve for the payment of claims due to adverse economic cycles, was created equal to 50% earned premiums. These premiums would accumulate for 120 months before they might be deemed earned and, therefore, become subject to income tax and



available for distribution by the company.<sup>6</sup> Only when claims exceeded some annual maximum could the mortgage guarantor apply to state regulatory authorities for permission to pay excess losses from this contingency reserve. Such a technique was similar to that used to accumulate reserves for earthquake insurance and other catastrophic coverages with unpredictable long term cycles.

The contingency reserve retained, and retains, 50% of the premium earned both on those policies still in force and on those cancelled (which most are before the end of ten years). Hence, for example, short rate refunds were, and are, charged against premiums written rather than against this reserve so that the reserve retains amounts attributable to premiums earned on cancelled policies, and thus compounds at a rate faster than the total mortgage balance insured, (although the amounts passing to the reserve lag premiums written because only one-half of those premiums written pass into the reserve and then only after these premiums are released from the unearned premium reserve as written premiums are deemed earned).

b. Premium rates

The premium for insurance on a single-family loan is one-half percent of the first year mortgage balance, plus a \$20

<sup>6</sup> The precise definition in the California Code reads: "In addition to the paid-in capital and surplus provided in Section 12640.03, each mortgage guaranty insurer shall establish a contingency reserve out of net premiums remaining (gross premiums less premiums returned to policyholders) after establishment of the unearned premium reserve. To the contingency reserve the insurer shall contribute an amount equal to fifty (50) percent of such remaining premiums. The yearly contributions to the contingency reserve made during each calendar year shall be maintained for a period of 120 months, except that withdrawals may be made by the insurer in any given year in which the actual losses exceed the expected losses. The commissioner shall, by regulation, determine when an insurer may make withdrawals from its contingency reserve." Section 12640.04, Chapter 2A, California Insurance Laws, pages 1069-70.

application fee (refundable if the application is rejected), with a renewal premium equal to one-quarter percent on the unpaid balance for the next nine years. A single premium payment alternative is available from some companies for three to ten year coverage to eliminate penny ante bookkeeping each year. Moreover these intermediate term policies permit the lender to tailor coverage so that it expires when the amortized loan reaches some predetermined loan-to-value ratio, such as 75 to 80 percent. Although the mortgage guarantor cannot cancel coverage unless the premium is not paid, the lender may choose at any time during a year to cancel a policy and receive a short rate refund, or to let the policy expire at the end of a policy year by not renewing it.

c. Capital requirements

Since mortgage default insurance was, and is, insuring to some degree against losses that are the consequence of economic cycles of unpredictable magnitude and timing, it was, and is, important that the contingency reserve accumulate as rapidly as possible without having to meet ordinary random losses, and that there also be initial financial mass in the form of stockholder capital to meet an unexpected economic reverse during the first ten years of the company's existence when premiums written and liabilities incurred generally exceed greatly those premiums earned from which the contingency reserve is accumulated.

In recent years, insurance regulators have been willing to permit some speculation on innovative insurance techniques where actuarial data was incomplete where the underwriter was able to demonstrate massive

financial resources or at least "financial solidity".<sup>7</sup> In this light, California required initial capital for entry and licensing of one million dollars plus no less than one million dollars of surplus, a total capital requirement higher than any other single line of insurance in the fifty states at that time. Following similar logic, the recently promulgated Federal Home Loan Mortgage Corporation requirements for eligibility as a private guarantor insuring loans in the FHLMC portfolio is at least \$5,000,000 of capital surplus.<sup>8</sup> California further required that the maximum potential liability for a mortgage guarantor on its insurance in force could not exceed a ratio of twenty-five times policy holder's surplus, retained earnings, and the contingency reserves. The definition of maximum potential liability suffers some small arbitrary variation from state to state, as some states define it as twenty percent of the insured mortgage balance outstanding, while others as twenty percent of the lender's claim, which would not only include mortgage principal, but also accrued interest and specified foreclosure costs, which could increase the effective liability to twenty-five percent of the outstanding balance of mortgages insured.

<sup>7</sup> "Financial Solidity" is a concept from European regulation which may be a more realistic approach to non-compartmentalized insurance organization, as suggested by Spencer L. Kimball, "Sketches from a Comparative Study of American and European Regulation," The Journal of Insurance, Vol. XXXII, No. 2, (June, 1965), pp. 196-7.

<sup>8</sup> .1 Minimal Capital: Policyholder's surplus must be maintained at not less than \$5 million. Not less than \$3 million shall be represented by fully paid and non-assessable capital stock. Section 130, Financial Requirements, Federal Home Loan Mortgages Corporation Eligibility Requirements for Private Mortgage Insurance, June 11, 1973.

Moreover, the insurance regulators quickly raised the minimum capital required for a license as a mortgage guarantor to levels higher than any other line of insurance, or indeed, higher than the total capital and surplus required of a multiple line insurance company operating in the property and casualty insurance area or in the life-accident field.

Despite the exceptionally high minimum capital requirements imposed by insurance regulators, the required 20 to 1 maximum liability to policyholder surplus ratio, together with the need for a national scale of operation and spread of risk, has made the practical level of minimum capital even higher so that the relatively new companies have initiated operation with impressively large resources. Foremost Guaranty Insurance Company began in 1973 with \$5 million in capital and surplus in Michigan, and PMI began in 1972 with \$20 million in capital and surplus in California, this being also the initial capital with which Investors Mortgage Insurance began business in 1969! Since the Federal Home Loan Mortgage Corporation (FHLMC) requires that mortgage insurers, to be eligible to insure mortgage loans purchased by it, must have a policyholder surplus of at least \$5 million dollars, this requirement imposes, effectively, a floor upon initial capital required of a new mortgage insurer.

Despite these tremendous capital resources required relative to the total risk a private mortgage insurer may accept, a private mortgage guarantor insurance company is not permitted to underwrite any other type of insurance, and this requirement is

unique to a private mortgage insurer. This concern of both insurance regulators and private industry for achieving massive financial reserves or policyholders surplus relative to the insurer's risk reflects their realization that current rate structures have yet to be tested by a true economic recession.

### 3. Methods And Procedures Of Underwriting

#### a. Audit and review function

The rate and reserve structure is not intended to encourage, or to meet losses resulting from, indiscriminate extension of mortgage loan credit. Likewise it assumes that the risk accepted by the insurer will not be distorted by a pattern of overall adverse risk selection against the insurer by its insured lenders, (i.e., submission by lenders to the insurer of only those loans made to marginal borrowers or which deviate substantially from national and regional patterns and distributions and hence entail unusual risk.) Therefore, a mortgage insurer, to be successful, must establish and maintain systems and procedures designed to detect those lenders originating, or submitting, a consistently poor quality of loan, and to provide underwriting standards against which the quality of loans are tested. To this end, a private mortgage insurer must maintain an ongoing review of lenders, credit information sources, appraisers and appraisal practices, and local real estate markets.

The insurance selection process begins by the limitation of eligible lenders to regulated financial institutions having regular banking hours and established mortgage banking companies. Such institutions and mortgage bankers, when they apply for insurance

eligibility with the insurer, are reviewed as to their appraisal, servicing, and lending personnel and procedures, and as to their operating financial record, before the insurer will issue a master policy permitting the lender to submit mortgage loans for insurance coverage on an individual basis. (The importance of this process is underscored by the recent rules for acceptable private guarantors promulgated by the Federal Home Loan Mortgage Corporation (FHLMC) under their audit requirements in Section 125.3 and .5.)<sup>9</sup> Anytime after this preselection process, a master policy issued to a lender can be cancelled by the insurer where, employing continuing review procedures, it finds that a lender's procedures and operations are no longer sound, or its submissions are found to be inconsistent with the utmost good faith required by the insured-insurer relationship.

The individual applications for mortgage loan insurance submitted to the insurer are given a cursory review by the insurer's underwriter to detect a bias in the application or in the originating lender which indicates a non-normative property or credit situation. This process combines a review of the application to determine that all necessary documents are provided and complete, and a search for certain combinations of factors descriptive of the property or the borrower which would lead to rejection of the application. Both the private industry and FHLMC are developing automated computerized underwriting review methods. Even with manual methods the private guarantor underwriter averages only six to eight minutes per loan submission, as

<sup>9</sup> Ibid.

compared to fifteen minutes by the FNMA buyer in a secondary mortgage market.<sup>10</sup> These review times, when compared to one or more man hours of analysis and interviews by the originating lender, underscore the fact that the guarantor is insuring against the bias or error in the lending process of the originating lender, and is not making a credit decision. Obviously the skills required of the mortgage insurance underwriter, and the pattern of his decision making, is substantially different than the skills and decision making pattern of those involved in making and servicing mortgage loans. If a lender's loan officer incurred as many losses on loans reviewed by him as are normally incurred on loans reviewed by an insurance underwriter, the loan officer's credit extension skills would be suspect, and his job in jeopardy.

The twenty dollar initial application fee was instituted to fund the cost of spot checking appraisal and credit reports. Independent appraisers are hired by mortgage insurers to appraise, on a spot check basis, the property already accepted for mortgage loan insurance in order to measure and observe the appraisal skills and abilities of the mortgage lender and its agents. For lenders which have only recently received a master policy, such spot checks may be made on one out of every five submissions to detect a pattern of bias in the appraisal submissions. As confidence is established, such spot checks may be reduced to a random audit selection of one out of twenty for reappraisal by appraisers specially selected by the guarantor and independent of the lending institution involved.

<sup>10</sup> A speech by Russell B. Clifton, Vice President of Mortgage Operations for the Federal National Mortgage Association at The Mortgage Bankers Association of American Convention in New York City, as reported in Appraisal Briefs, p. 2, November 7, 1973; Volume 8, no. 45, The Weekly Newsletter of the Society of Real Estate Appraisers, Chicago, Illinois.

Spot checks of credit reporting agencies are continuously conducted to evaluate the reliability of each local credit bureau, and the care with which the lender obtains credit information. Such spot check evaluations are shared with the lender and the credit agency to promote continual upgrading of credit reporting firms.

Delinquency and default reports are required monthly from insured lenders and reviewed to identify possible contributing causes in terms of the lender's debt servicing policy, its analysis of neighborhoods and property values, or its candor and reliability in submitting information on loans for which it seeks insurance. These reports provide a basis for establishing detailed loss payable reserves as a charge against the insurer's current income in advance of actual claim submission. They also provide additional data for the underwriting evaluation of a lender's applications for insurance on individual loans.

All of the guaranty companies have also noticed a tendency on the part of lenders to use the guarantor as a means for rejecting a mortgage loan request from a favored bank customer, or for exerting additional subtle pressure on a borrower to correct a delinquency.

b. Safeguards against lender abuse

Throughout this process the guarantor depends on the good faith performance of the mortgage lender, and a variety of features in the system are intended to keep the lender from serving its self interest at the expense of the guarantor. Private mortgage



loan insurance is the only insurance with a statutory prohibition against payment of commissions to persons who benefit from the insurance (i.e., the lenders). Since the guarantor may pay a maximum cash award of 25% of a mortgage balance plus allowed costs, in lieu of complete liquidation of the lenders investment in return for property title, the lender may be forced, if the insured selects the 25% payment option, to incur remaining post claim losses as a penalty for what the guarantor believes to be a loss arising from negligent credit and loan analysis or mortgage servicing.

C. Monitoring risk exposure

The mortgage insurance company, like other insurers, should continually monitor its risk exposure to assure that the risks are divided into appropriate groupings each of which meets the insurer's criteria for adequate homogeneity, risk spread and heterogeneity of source. Hence the mortgage insurer should monitor the size of its risk exposure in terms of homogeneous categories (such as condominium loans or such as owner-occupied residential loans with 80 to 90 per cent loan-to-value ratios, or those with 90 to 95 per cent loan-to-value ratios), and within those categories, the geographic distribution of the risk, and the nature and variety of insured lender, borrower, and collateral. In connection with its performance of this basic insurance function, the company should independently evaluate housing supply and demand, and value levels, in particular regions and communities, and project as to each the relative degree of risk inherent in the category of business originated and submitted by lenders in those regions and

communities. Aside from various statistical data obtained from various published sources, a mortgage insurer obtains community and regional data from its independent appraisers in areas where it has exposure, and obtains further data from its regular contact, through its sales representatives and underwriting staffs, with thousands of lenders on a daily or weekly basis. Likewise, data is obtained, reviewed and analyzed by its claims staff, and then fed back into the underwriting process.

Because of the nature of its business, a private mortgage insurer is a clearinghouse for real estate market data. Several of the insurers, for this reason, offer to lenders a secondary marketing service by which lenders with mortgage loans to sell may be matched with lenders desiring to invest surplus funds in mortgage loans.

On the basis of their extensive and nationwide experience, the two larger mortgage insurers are now developing new automatic data processing techniques for insurance application underwriting, claim administration, and real estate market forecasting.

#### E. Summary

Thus mortgage guaranty insurance is built on a system which depends on independence from the act of extending mortgage credit so that the insurer may attain objectivity in its evaluation of the lender's credit decision for possible bias or negligence in the exercise of banking skills in its credit analysis, property valuation, and maintenance of portfolio liquidity and profitability. (The attempt to merge mortgage credit extension with mortgage guaranty in the first quarter of the 20th century, with the consequent loss of such independence and

objectivity, was considered by the classic Alger Report, prepared in 1934 for the New York Insurance Commission, a major factor in the stunning real estate and bank reverses experienced in New York, and in the collapse of a major investment guaranty and banking industry.) Hopefully the guarantor will achieve a proper averaging of risks, inherent in the diverse viewpoints of lenders, by property type, neighborhood, loan ratio, servicing agent and year of loan origination. Successful averaging requires a national distribution of insured loans so that the averages will reflect offsets of local and regional highs and lows in employment and real estate price cycles.

The need for geographical diversification to achieve stabilized annual results can be illustrated by the experience of Seattle during the retrenchment of Boeing, or of Huntsville, Alabama, as a result of a reduction in work force at the Redstone Arsenal. Unlike the national mortgage insurer which can offset losses in these areas against the absence of current losses in growth areas, the local lender is hard pressed by the consequences of such blows to the local economy, and their depressant effect on local real estate values and their encouragement of mortgage delinquencies. Obviously economic downturns caused by such occurrences cannot be foreseen, and in many cases, where economic downturns might be anticipated, local lenders, with a vested interest in maintaining growth and investment optimism in their town, dare not withdraw from the mortgage market lest their actions precipitate or aggravate the process of economic readjustment. Even though local citizens may understand trends in their own community, they may not be

any more effective in changing their own investment decisions than is an internal auditing department when it attempts to correct management policy within its own firm.

The mortgage insurer, and its personnel, while sharing with the lender the need for general business acumen and competence, must employ different skills, and must exercise business judgment in light of very different criteria and variables, i.e., must employ insurance skills in light of those criteria and variables basic to insurance underwriting. It appears obvious that a lender, were it to engage in a mortgage insurance business, could not perform both the banking and insurance functions employing its existing banking personnel, and their banking skills, but would, of necessity, need to develop a separate insurance underwriting staff competent in the exercise of insurance skills and insurance business judgment.

From this review of the insurance methodology of the private mortgage insurer, it is evident that the primary mission of the insurer is to insure against the consequences of the economic cycle as it erodes the security of a mortgage loan, and to insure against the failure of required banking skills to foresee, and take adequate preventative action in light of, all the contingencies which could lead to random upset of the mortgage loan under circumstances which would not permit full recovery for the lender from the collateral pledge of real estate. In order to stabilize against economic cycles the insurer is required to have broad geographic diversification as well as financial mass, in the form of capital, retained earnings, and contingency reserves, of far greater size than is required for other insurance lines.

It would make no sense for a lender to insure the surveyor for his errors and omissions, or the lawyer for his title opinion, or the property owner for physical loss of the property, as such pledges by the lender would not shift the consequences of error and loss beyond the balance sheet of the lender and its affiliates. It would make equally little sense for the lender to insure its own mortgage loans since, by so doing, it would not shift the consequences of the economic cycle, or a failure of required banking skills, beyond its own balance sheet, or that of an affiliate. On the one occasion in history when banks and mortgage lenders did provide all of these services as a one-stop service, the inherent loss of objectivity and perspective, and the opportunity for conflict of interest, exacerbated the disasters reported in the Alger Report.

It is difficult to conceive, on any basis, conceptual, operational, or historic, any connection between mortgage insurance underwriting and banking which could be considered close. It is also difficult to foresee how entry by banks in the mortgage insurance industry could produce any benefits substantial enough to outweigh the inherent and obvious damage such entry would entail to a viable, sound and needed insurance service.

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