SINGLE-FAMILY MORTGAGE INSURANCE

Robert K. Brehm

October, 1977

Woodstock Institute Chicago, Illinois

About the Author

Robert K. Brehm is an Associate of the Woodstock Institute. The Woodstock Institute is a non-profit organization which conducts research, training and education for the public, private, and voluntary sectors about ways to ameliorate disparities in the availability of capital and credit.

Bob currently serves as Project Coordinator for the Chicago based Rehab: The Housing Resource Center. He received his B. A. from Northwestern University in 1977 where he majored in Urban Studies and Political Science. While attending Northwestern he participated in a research internship with the Boston Redevelopment Authority, Housing Revitalization Division. During the internship he had primary responsibility for analyzing disclosure data on Boston area financial institutions which was collected by the Massachusetts Commissioner of Banks. In 1976, Robert served as a consultant to the American Issues Forum Chicago where he wrote a paper entitled "Reform of the Municipal Housing Code In Chicago."

SINGLE-FAMILY MORTGAGE INSURANCE

Summary

This paper describes how single-family mortgage insurance has been utilized by local, state and federal government agencies, and private lenders to stimulate the flow of conventional single-family credit into mature communities. The following mortgage insurance programs are discussed: private mortgage insurance, the FHA Section 203 program, the FHA Section 244 program, the Maryland Housing Fund's insurance programs, and two local programs (Chicago Home Purchase and Rehabilitation Program and Philadelphia's Purchase and Home Improvement Loan Guarantee Assistance Program).

SINGLE-FAMILY MORTGAGE INSURANCE

Mortgage insurance, as referred to in this paper, is defined as a process where a public entity or private mortgage insurance company insures all or a portion of the financial exposure incurred by a lender in originating a mortgage. There are two types of mortgage insurance: full insurance and coinsurance. Full insurance is defined as a process where a public body insures 100% of a lender's exposure. Coinsurance is a process where one or more public bodies or private mortgage insurance companies share the risk exposure with the lender.

In the case of a financial loss suffered by a lender on a fully insured loan, the lender is reimbursed by the insuring entity for the entire balance of the loan and certain expenses incurred in servicing the loan. If a lender suffers a financial loss on a coinsured loan that is foreclosed, the lender assumes some portion of the loss and the coinsurer reimburses the lender for the balance of the loss. Insurance and coinsurance funds are usually financed from the premiums charged to the lender for each insured or coinsured loan. These premiums are generally passed on to the borrower.[1]

Full insurance and coinsurance programs influence the cost and availability of funds for the revitalization and maintenance of residential areas. By insuring part or all of a mortgage, these programs reduce or eliminate the loss incurred by a lender on a foreclosure. This may encourage a lender to make a loan in a situation where the risks are perceived as too great for an uninsured loan; or it may encourage a lender to grant more favorable terms or conditions on a loan which is normally perceived as representing an unusually high risk.

The first form of mortgage insurance was the Federal Housing Administration (FHA) program initiated by Congress during the depression of the 1930's. The most widely utilized single-family mortgage insurance program is the Section 203 program under which lenders are insured for virtually 100% of losses on single-family mortgage loans.[2] One major criticism of traditional FHA mortgage insurance is the provision for 100% coverage of risk. Some critics of FHA insurance have suggested that there is ". . . little incentive /_for lenders_/ to be careful in screening applicants or to be diligent in servicing the loans . . ."[3]

Historically there have been several other problems with FHA mortgage insurance. First, the processing time for an FHA-insured loan was often several times longer than that for a conventional, uninsured loan. Second, FHA imposes interest rate ceilings for all the loans it insures. The interest rate is set slightly lower than normal market rates for mortgages nationally. This discourages financial institutions from participating when they can charge a higher rate on non-insured loans on properties which are not deemed exceptional risks. Typically, a lender would charge the buyer a special fee (called points) at the time of the sale of the property to compensate for the difference between the restricted and normal interest rates. However, FHA prohibits lenders from charging buyers more than one point (one percentage of the mortgage amount). Often this limited amount is not sufficient to cover the lost interest resulting from FHA's interest ceiling. Mortgagees usually cover this lost interest by charging points to the seller.

A third problem with the Section 203 program concerns the application of the program to older neighborhoods. If the appraised value of the property is much greater than the neighborhood average, if more than 6% of the block is abandoned, or if more than 20% of the land use in the area is non-residential, then FHA will not insure the loan. These restrictions generally discourage investment in older neighborhoods.[4]

At the state level, a few housing finance agencies, most notably Alaska, Connecticut, Maryland and Vermont, have initiated mortgage insurance programs.[5]

The Maryland state insurance program was started in 1971 and is operated by the Maryland Housing Fund, a division of the Department of Economic and Community Development. The Fund was financed initially by a $7 million bond issue.[6] The programs of the Fund include a 100% mortgage insurance program which insures mortgages extended to borrowers who have minimal downpayment resources or purchase high risk properties. Under the full insurance program, 1340 mortgages on single-family properties have been insured. Of this total, 737 mortgages have been in the City of Baltimore.[7] The insurance claim rate is currently less than one percent. All mortgages insured under this program must be on properties which are owner-occupied and the mortgages must be valued at no more than $ 20,000.[8]

A relatively recent innovation in the field of mortgage insurance is private mortgage insurance (PMI).[9] PMI usually insures all losses on the top 20% of 90% loan to value mortgages, and the top 25% on 91-95% mortgages. PMI has served as a means by which lenders can make loans with relatively low downpayments, without incurring the total risk perceived of such loans. For the benefit of a low downpayment loan, the borrower pays the insurance premium.

The utility of PMI as a mechanism to encourage inner city lending has recently been questioned by a study of sixty New Jersey lenders.[10] The study contends that the level of insurance provided by private mortgage insurance companies is inadequate to entice lenders into extending mortgages in the inner city. However, while it may be debatable that PMI is not a sufficient incentive in itself, those lenders who are already seeking opportunities to lend in older, middle and lower income, or inner city communities are taking advantage of PMI to expand their lending in these areas. The Philadelphia Mortgage Plan, for example, makes extensive use of PMI to grant loans with reduced downpayments to lower income applicants.[11]

An example of a local coinsurance program which utilizes private mortgage insurance as well as public mortgage insurance is the Chicago Home Purchase and Rehabilitation Plan (CHPRP).[12] CHPRP is administered by the Community Service and Research Corporation, an Illinois not-for-profit corporation. The program provides mortgage and home improvement loans on one-to-four unit properties in several target neighborhoods. The loans are coinsured with participating lenders (12½% exposure) by the City of Chicago (80% insurance) and private mortgage insurance companies (7½% insurance). As of August 15, 1977, 17 loans have been made, valued at over $360,000.[13]

An example of a local coinsurance program which employs only public mortgage insurance is the Philadelphia Home Purchase and Home Improvement Loan Guarantee Program (PHILGAP).[14] PHILGAP is designed to encourage financial institutions to make conventional financing available in "higher-risk areas" by insuring the top 25% of mortgages on existing homes. Applicants must be owner occupants of single-family or duplex properties. The maximum loan eligible for PHILGAP guarantee is $20,000. The PHILGAP insurance fund was capitalized by a $500,000 grant from the William Penn Foundation and a $500,000 allocation from the Office of Housing and Community Development of the City of Philadelphia.[15]

In 1974, Congress enacted a new approach to mortgage insurance, Section 244 of the Housing and Community Development Act of 1974 which was entitled "Coinsurance."[16] Under this provision, the U. S. Department of Housing and Urban Development (HUD) may coinsure almost any loan or mortgage eligible for other FHA insurance programs. As with the earlier FHA programs, the coinsurance provides protection for the lender (mortgagee). However, the statute requires that the mortgagee shall assume not less than ten percent of any loss on a coinsured loan. The minimum underwriting standards and conditions of other FHA programs apply to this program.

Due to the fact that the mortgagee shares the risk with the federal government, the statute delegates to the lender all appraisal, underwriting and property disposition duties. Under the traditional FHA programs, many of these functions were undertaken once by the lender and then again by HUD.

After the Section 244 program was enacted, HUD developed proposed regulations to apply to the Section 203 single-family mortgage insurance program.[17] The regulations included several provisions to encourage participation by lenders. First, the liability of the mortgagee on a coinsured loan lasts for five years from the date of closing, or until the 60th monthly amortization payment is made. Second, a "stop-loss" procedure was included, under which a lender could not lose more than 1% of the total face value of coinsured loans originated in a given calendar year even though each individual loan was only 90% coinsured. Finally, secondary mortgage market investors which purchase coinsured loans incur no coinsurance liability since FHA will cover all losses incurred by secondary market investors.

The mortgage banking industry, the largest user of FHA insurance programs, replied to the proposed regulations with several criticisms. In general, the industry responded that the coinsurance approach was not competitive with the FHA 100 percent insurance programs. There was not sufficient incentive involved for lenders to choose coinsurance over the traditional programs, where the lender incurred virtually no risk.[18] In addition to the requirement that lenders share the risk, the coinsurance program limited the front end fees which lenders were permitted to charge. Mortgage bankers claimed that the fees were not sufficient to cover the appraising and underwriting expenses they would incur in originating coinsured loans. They also criticized the provisions which required the mortgagee to dispose of properties which had coinsured mortgages which were foreclosed.

Another concern of the mortgage banking industry was that a lender would have to wait six months before making a claim on a property which had not been sold. The mortgage banking industry asked for more flexibility in this regard under the coinsurance program. The mortgage banking industry also criticized the provision in the regulations which limited participation in the coinsurance program to lenders who maintained a net worth of at least $500,000. Industry lenders recommended a $100,000 minimum, since HUD's requirement would exclude many smaller lenders who participated in the 100 percent insured programs.[19]

In October, 1975, HUD revised its regulations to extend the coinsurance program over the first seven years of the mortgage rather than the first five years as defined in the proposed regulations. The one significant response to the criticisms made by the mortgage banking industry was to reduce the capital requirements of approved lenders from $500,000 to $250,000.[20]

The first pilot program to test the Section 244 coinsurance concept was initiated in California in January, 1976. The program, however, was delayed due to a state insurance law which established a 66.7 percent ceiling on the loan to value ratio for any mortgage sold by a coinsurer to other investors. FHA permits up to 97% loan to value ratio. The state insurance commissioner promised to review the restrictive law, but no exemptions were permitted.[21] California mortgage bankers were enthusiastic about the program.

One member of the California Mortgage Banking Association committee on coinsurance predicted there would only be "minimal participation." He indicated that the state's mortgage banking firms were convinced that the program would not generate sufficient income to encourage mortgage bankers to hire the new staff and appraisers necessary to participate in the program.[22]

While other states where demonstration projects were underway, such as Ohio and Michigan, did not suffer from restrictive state laws, the performance of the Section 244 coinsurance program has been very limited. In Michigan and California, HUD found it difficult to get lenders in the demonstration area agreed to participate, but they did not generate many loans.[23] The major problem seemed to be that the coinsurance program did not offer any significant advantages over the standard FHA 203(b) 100% insurance program, and the Section 244 program required the lender to share the risk. The advantages in allowing the lender to carry out all the appraisal and underwriting functions without duplication by HUD, may have been offset by the restrictions HUD placed on the charges lenders could make to cover these services.

By allowing lenders to carry out the appraisal and underwriting functions, HUD had hoped to speed up the processing time so that the use of the coinsurance program would not entail long delays in processing loans. However, at the same time, HUD was also reducing the processing time on the regular 203(b) insurance program. In California, the San Francisco insuring office has reduced this time to three days by February of 1976.[24] Thus, efforts to make the regular 203(b) insurance program more efficient worked at odds with attempts to get lenders involved in the FHA coinsurance program, which required lenders to assume more of the risk.

Conclusion

Both public and private mortgage insurance programs may be used to reduce a lender's risk and assist a lender in expanding his or her activity to higher risk loans. Local and state efforts, such as the Philadelphia Mortgage Plan and the Maryland Housing Fund, have used mortgage insurance to induce lenders to extend credit in communities and to borrowers previously perceived as high risk. However, a distinction must be made between the use of full insurance or coinsurance in situations where there is substantial risk and situations where there is a normal risk. It is an imprudent practice to charge premiums to borrowers for insurance programs or to capitalize insurance funds with public funds if there is a reasonable indication that lending to certain borrowers who are purchasing property in specific neighborhoods is not a high risk venture. The Maryland Housing Fund, for example, has been viewed by some as an example of a case where the claim levels are so low as to beg the question of whether the risks in Baltimore's inner city market are as great as had been assumed.

Footnotes

[1] When a full insurance or coinsurance program is first initiated, there are no premiums to use for the insurance fund to pay for claims and in the early years of the program the volume of insured loans may not provide enough premiums to pay for claims. Therefore, funds must be created by borrowing capital or by appropriating capital from some other source until the volume becomes sufficient to both pay back the capital and cover claims against the fund. In some public insurance programs which create high risk pools, the capital for the fund comes in the form of grants or direct allocations of government funds which may not ever be paid back as the potential uses of this fund may not generate sufficient income to pay premiums high enough to cover all of the claims and also pay back the original capital.

[2] The Section 203(b) mortgage insurance program provides 100% insurance on mortgages for proposed, under construction or existing one-to-four family homes. Any person with a good credit record and demonstrable ability to repay the mortgage can qualify for the program. The loan to value ratio is 97% of the first $25,000 of the value of the property plus closing costs, 90% of the next $10,000, and 80% of the amount over $35,000. The mortgage term can be up to 35 years. (The above material was taken from: Consumer's Primer of Housing and Urban Development (Draft), U. S. Department of Housing and Urban Development, 1977).

[3] Center for Community Change, The Lifeblood of Housing (Alexandria, Virginia: Mount Vernon Publishing Company, 1976), p. 78.

[4] See 24 Code of Federal Regulations 203.

[5] Housing and Development Reporter - Reference File, "State Housing Finance Agencies," (Washington, D. C.: Bureau of National Affairs, January 17, 1977), 50:0014.

[6] Ibid.

[7] Telephone conversation between Ms. Bender of the Maryland Housing Fund and Dennis R. Marino of the Woodstock Institute, November 14, 1977.

[8] *Ibid.*

[9] For a more complete description of mortgage insurance companies, see Mortgage Insurance Companies of America (MICA), *MICA Fact Book and Directory, 1977-78*, 1825 K Street, N. W., Suite 604, Washington, D. C.

[10] For a description of this study, see: David Listokin, "The Urban Financing Dilemma" (A report submitted to the New Jersey Department of Community Affairs).

[11] See Dennis R. Marino, *The Philadelphia Mortgage Plan*, Study Paper Number VII of the *Missouri Housing Development* Commission's Housing and Neighborhood Investment Study (August, 1977).

[12] For additional information, contact Patrick Nash, Project Director and Vice-President, Community Services and Research Corporation, 7 South Dearborn Street, Chicago, Illinois 60603.

[13] Information was secured from Community Services and Research Corporation.

[14] For additional information, contact Roberta Watterson, PHILGRAP Director, Philadelphia Housing Development Corporation, 1422 Chesnut Street 19102.

[15] News release, Office of Mayor-City of Philadelphia, March 21, 1977.

[16] *Housing and Community Development Act of 1974*, Public *Law 93-383, 93rd Congress, S. 3066, August 22, 1974*, Section 244.

[17] For a copy of the proposed regulations for the Section 244 Coinsurance program, contact the U. S. Department of Housing and Urban Development - Federal Housing Administration.

[18] *Housing and Development Reporter*, "Current Developments," Volume *3, Number 7* (Washington, D. C.: Bureau of National Affairs, January 12, 1976), p. 775.

[19] *Ibid.*

[20] For final regulations implementing Section 244 Coinsurance Program, See: 41 *Federal Register* 30, February 12, 1976, p. 6245-6258.

[21] Housing and Development Reporter, "Current Developments," Volume 3, Number 20 (Washington, D.C.: Bureau of National Affairs, February 23, 1976), p. 895.

[22] *Ibid.*

[23] *Ibid.*

[24] *Ibid.*